OVERSIGHT OF THE FEDERAL HOUSING ADMINISTRATION: EXAMINING HUD'S RESPONSE TO FISCAL CHALLENGES

- - -

THURSDAY, DECEMBER 6, 2012

United States Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, D.C.

The Committee met, pursuant to notice, at 10:06 a.m., in Room SD-538, Dirksen Senate Office Building, Hon. Tim Johnson (Chairman of the Committee) presiding.

Present: Senators Johnson, Reed, Menendez, Merkley, Hagan, Shelby, Corker, Vitter, and Toomey.

OPENING STATEMENT OF CHAIRMAN JOHNSON

Chairman Johnson. I call this hearing to order. Thank you for joining us, Mr. Secretary.

I asked you to testify today because I am deeply concerned about the recent report that the FHA could potentially need taxpayer support for the first time in its 78-year history. I would like you to help the Committee gain greater insight into the fiscal challenges at the FHA and what HUD has done and can do to mitigate losses and address the shortfall in the capital reserve ratio.

FHA has been helping stabilize the mortgage market by ensuring that qualified low- to moderate-income and first time home buyers have access to mortgage credit since 1934.

Since the beginning of the financial crisis, the FHA has increased its market share from below 5 percent in 2006 to about 30 percent at its peak volume in 2009 in pursuit of that mission. This countercyclical expansion was essential to the mortgage market, especially for first-time home buyers who comprised 78 percent of single-family purchase loans insured by FHA in 2011.

FHA's multifamily and health care insurance programs have also played an important countercyclical role since the financial crisis, with a four-fold increase in volume from 2008 to 2011. According to Mark Zandi, chief economist at Moody's Analytics, without the FHA's countercyclical support, and I quote, "the housing market would have cratered, taking the economy with it."

However, providing a backstop for mortgage credit when private sources flee from the market has a cost. The losses at the FHA stem from the now prohibited seller-funded downpayment program, heavy losses in the reverse mortgage program, and loans made at the height of the crisis to prevent a cratering of the housing market. While HUD has already taken some actions to prevent the Mutual Mortgage Insurance Fund for single-family loans from seeking Federal funds, the Fiscal Year 2012 Actuarial Report suggests that much more needs to be done to prevent such a draw.

I want to hear more today about the Administration's actions and proposals to manage the risks to taxpayers stemming from the older books of business and what safeguards are in place to ensure the quality and sustainability of the new books going forward.

If the administration's actions and proposals will not be sufficient to restore FHA's fiscal health, then I plan to work with my colleagues on both sides of the aisle on the Banking Committee to find a bipartisan way to make that happen.

Before I turn to Ranking Member Shelby, I want to recognize his work as Ranking Member on this Committee over the past 6 years. This may be our last hearing together this year, and we will have a new Ranking Member next year. I am proud of our bipartisan record over the last 2 years. We continued the tradition of bipartisanship that this Committee has been known for by passing four significant bills together this Congress, and I thank Senator Shelby for his service.

With that, I turn to Ranking Member Shelby.

OPENING STATEMENT OF SENATOR SHELBY

Senator Shelby. Thank you, Mr. Chairman.

First of all, I appreciate your remarks. I have been on this Committee 26 years, ending it, but I am not ending being on. I will just have to move down a notch as I go over hopefully to be the Ranking on Appropriations. I will not be far away, and I will not be far from the Secretary on HUD stuff either over there.

[Laughter.]

Senator Shelby. But I enjoy working with this Committee. I have enjoyed being Chairman of this Committee in two Congresses. The people on this Committee are superb. The staff is superb. And this is a very important Committee not only for the Senate but for the American people and perhaps the world, as most people know, people who are active on this Committee, because banking and housing and everything that goes with it goes right to the heart of what ticks in America: job creation, availability of money, the regulation of our banks, the Securities and Exchange Commission, money laundering, sanctions on Iran. You name it. Most of it, this is the active Committee. So I will be around right near here, but I will be yielding, moving down one notch next to Senator Crapo, and he will do well.

Having said that, welcome again, Mr. Secretary. Just days after the President's reelection, the FHA released its 2012 Actuarial Report which revealed that the economic value of the FHA Fund has fallen to negative $16 billion. A lot of money. That means the fund's capital reserve ratio, as I understand it, now stands at a negative 1.44 percent.

This news is obviously very disturbing to us and to the Secretary, for those of us who have long been concerned about the health of the FHA. For years, the problems of the Federal Housing Administration have been well known. During the housing boom, the FHA, unwisely I thought, guaranteed millions of risky mortgages with low downpayments to borrowers with poor credit scores. We are reaping that now. These mortgages have resulted in billions of losses to the FHA.

The Federal Housing Administration has made matters worse, I think, by failing to come to grips with the magnitude, Mr. Secretary, of the problems. Back in 2007, as the Federal Housing Administration's poor financial position was becoming clear to all, including right here in this Committee, I urged the FHA to devise a credible plan to improve its finances. I stated then, and I will quote, that "before the taxpayers are faced with greater losses, I believe we must determine how the FHA got into this position, Mr. Secretary, and how it intends to get out."

Unfortunately, for the past 5 years, the FHA's leadership has understated their problems and sought to kick the can down the road. This is now the fourth year in a row that the FHA Fund has been below its statutory minimum capital levels. Yet each year we are told that this is a temporary dip and that within a few years everything will be fine.

In fact, in 2009, Mr. Secretary, you told this

Committee that the drop in the capital ratio was expected to be "temporary," and that it would "return above 2 percent within the next 2 or 3 years, even if FHA were to make no policy changes at all."

We now know this forecast was way off the mark. The administration, however, continued to be optimistic. In 2011, for example, HUD still had its projections showing the FHA's capital ratio reaching 2 percent in 2014. Now, despite all these reassurances, the Actuarial Report projects that the FHA Fund has a capital reserve, as I mentioned earlier, of a negative 1.44 percent. And what is the response of the FHA's leadership here?

Just this year, after further declines in the FHA Fund, both Secretary Donovan and Acting FHA Commissioner Carol Galante testified to two different Senate Committees that the fund would "return to the congressionally mandated capital reserve ratio of 2 percent by 2015."

Needless to say, I am not nearly as optimistic about the future of the FHA. I hope it works. I hope it does.

The inability of FHA's leadership to clearly recognize and address its problems is raising doubts, Mr. Secretary, about their credibility and their willingness to properly manage FHA's financing. I think it is time for FHA to face facts. We have to.

First, the capital reserve ratio, the Federal Housing

Administration Fund, is dangerously low. You know that. And it has shrunk nearly every year since 2006.

Second, the fund's capital ratios have been below FHA's statutory obligations every year since 2008.

Third, every year since then, future growth in the capital ratio has underperformed in relation to FHA's predictions. Hopefully, the shock produced by these latest projections will finally be a wake-up call for everyone. Hard choices lie ahead for this program. We have talked about this.

FHA leadership, I believe, must fully realize its existing authority to shore up the value of this fund. Additionally, Congress must consider reductions in permissible risk layering and further underwriting reforms and a reexamination of premium structures. It is time, I believe, to get serious reform of FHA before it needs a taxpayer bailout, if it is not too late already.

I wish you well, Mr. Secretary, but you have a real challenge here. We do with you.

Thank you.

Chairman Johnson. Thank you, Senator Shelby.

Are there any other members who wish to make a brief opening statement? Senator Vitter.

OPENING STATEMENT OF SENATOR VITTER

Senator Vitter. Thanks, Mr. Chairman. Just briefly, I want to agree with the comments of our Ranking Member, Mr. Shelby. And our general concern is that we have seen this coming for a while. We have been talking about it, and the response from the administration has been very modest. Unfortunately, our worst fears are coming true, and even today I am very concerned that the response even given this news is just way too modest.

In discussing last year's Actuarial Report, the Acting Commissioner, Carol Galante, said there is no evidence or widespread prediction that home prices are going to decline to the kind of levels that would require a bailout. Yet right now the question is quickly becoming not if but when. And, still, even in the Secretary's testimony today, we are only talking about things like waiting until the second quarter of next year to raise premiums and then buy ten basis points.

So I would really urge the Secretary and others to consider other more aggressive, more proactive measures. Even the Washington Post, which is not exactly a right-wing think tank, said recently, "Right now the critics are starting to look pretty prescient. Affordable possession of one's own home is the American dream. Government support for excessive borrowing has turned into a national nightmare." And the focus of that editorial was we still have not fundamentally reformed that, including at FHA. So

I hope we start getting on that track starting today.

Thank you, Mr. Chairman.

Chairman Johnson. Senator Menendez.

OPENING STATEMENT OF SENATOR MENENDEZ

Senator Menendez. Mr. Chairman, thank you very much, and I will be brief. I look forward to hearing the Secretary's response on how FHA balances the goals of remaining self-sufficient without taxpayer funds, but also helping what is still a fragile housing market and ensuring that first-time home buyers can get credit.

There is a clear case to be made, in my mind, that but for FHA in the midst of this housing crisis we would have a far greater crisis on our hands. And so reconciling the fiduciary responsibilities here to the taxpayers as well as the mission to people of America is incredibly important, and I look forward to hearing that.

And with your indulgence, Mr. Chairman, when it comes to my time to question, while I certainly care about FHA, I have an even more pressing issue in the State of New Jersey after thousands of homes were lost, lives were lost, and we are facing the greatest devastation the State has ever had. The Secretary has been charged by the President in that regard to be the--I call it "czar," but whatever the appropriate title is, and I will have some questions in that regard on behalf of my State.

Thank you.

Chairman Johnson. Thank you all.

I want to remind my colleagues that the record will be open for the next 7 days for opening statements and any other materials you would like to submit.

Now I would like to briefly introduce our witness. The Honorable Shaun Donovan is the 15th Secretary of Housing and Urban Development. This is his ninth time before the full Committee.

Secretary Donovan, you may proceed with your testimony.

STATEMENT OF HONORABLE SHAUN DONOVAN, SECRETARY, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Secretary Donovan. Mr. Chairman, thank you, 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. I, too, want to add my thanks to Ranking Member Shelby for his leadership and partnership on so many issues these last few years.

This is an important moment for our housing market and our Nation's economic recovery. As 2012 draws to a close, there are encouraging signs: housing construction growing faster than at any time since 2008, the strongest year of home sales since the economic crisis began, and rising home values lifting 1.3 million families above water in the first half of the year alone.

FHA's programs have been a critical component of this economic recovery. That should come as no surprise given the programs' goals and history. With the dual mission of providing access to homeownership for underserved, low-wealth populations and critical financing for multi-family developments, nursing homes, assisted living properties, and hospitals, the FHA is designed to fill gaps in the market, meet important community needs, and act as a stabilizing force during economic distress.

It is clear that FHA has done just that. By ensuring much needed liquidity in the Nation's mortgage finance markets, FHA was a vital, stabilizing force as we experienced the worst economic decline since the Great Depression.

In the last 4 years, the FHA has made homeownership possible for over 3.5 million families, including 2.8 million first-time buyers and for 50 percent of all African American and Latino home buyers last year. While FHA has acted as a critical support, it has not been immune to the stresses of falling home values and rising unemployment of the recession. According to the independent actuary's annual report on the MMI Fund, this fiscal year the capital reserve ratio fellow below zero to negative 1.44 percent, representing a value of negative $16.3 billion.

We take and I take these findings extremely seriously. As stewards of taxpayer dollars, we have, since the start of this administration, made it a priority to strengthen the fund, and we are continuing to take aggressive action to return the fund to fiscal health, including those measures just announced in our annual report to Congress.

It is important for me to start by highlighting several key points that put the actuary's report in perspective. Fully $70 billion in claims are attributable just to the 2007-09 books of business. These 3 years are the major source of stress to the fund. In fact, in its report, the actuary attests to the high quality and significant profitability of the books insured since 2010, the strongest in the agency's history.

It is important to understand this report does not in and of itself mean that it will be necessary for the FHA to use its authority to draw from the Treasury to cover projected losses. While this possibility obviously exists, it is dependent on several factors.

First, that determination would be made using the assumptions in the President's budget to be released in February, not the assumptions used in the actuary's report.

Second, we expect that the new books of business generated after 2012 will create approximately $11 billion in economic value, further strengthening the MMI Fund.

Third, since the Actuarial Report is a point-in-time snapshot, it does not take into account changes FHA recently has announced to address the health of the fund. The final accounting of any shortfall would be done at the end of fiscal year 2013 in order to determine whether funds from the Treasury are necessary.

I would also like to address the primary drivers of the decline in the capital reserve ratio as compared to last year's projections.

First, the house price appreciation estimates used by the actuary for this review were significantly lower than those used last year. That may seem counterintuitive given the economic progress we have seen, but the actual turnaround in the market occurred later than was projected in last year's forecast. In addition, for technical reasons, the forecast is also somewhat artificially dampened by the significant increase in refinancing activity in the market this year.

Second, the continued decline in interest rates, while good for the overall economy, impacts the actuary's model by indicating marginally higher defaults as well as lost revenue to FHA as its borrowers pay off their mortgages to refinance at lower rates.

Third, based on recommendations made by the GAO and HUD's IG and at the direction of FHA, in this year's report the actuary changed the way it reflects losses from defaulted loans and reverse mortgages in the economic value of the MMI Fund.

Let me be clear. These are all important factors to consider when explaining the current status of the fund, but they do not minimize the seriousness of this report in any way. As I said at the outset, we have already taken significant actions to protect and strengthen the fund, including premium increases and changes to credit policy, such as increasing downpayments for lower credit score borrowers and ending seller-financed downpayment assistance. With your help, our efforts have added well over $32 billion to the fund.

The measures I will outline today further address the primary source of the problem: losses stemming from legacy books of business, particularly those insured during the 2007-09 period, and are designed to reduce our loss severities by at least 5 percent, generating approximately $3 billion in economic value over the next two years.

First, we have announced changes to our Loss Mitigation Program that targets deeper levels of relief for struggling borrowers to more effectively assist families in meeting their obligations and avoid costly foreclosures for FHA. Similarly, we are streamlining the use of short sales and aligning our practices with those recently announced by the GSEs to provide more families the opportunity to avoid foreclosure while reducing costs for the FHA. And we have dramatically increased the use of alternative dispositions for defaulted loans, including our new Distressed Asset Stabilization Program. The improvement in recoveries to FHA from this program is estimated at over $1 billion this year alone.

We are also taking proactive measures on new loans. In particular, we are reversing a policy change made over a decade ago that allowed borrowers to stop paying premiums after their loans reached a certain loan-to-value ratio. This change left the FHA without premiums to cover the losses on loans held beyond the period for which those premiums were collected, reversing the policies expected to improve the value of the fund by $2.6 billion in this fiscal year alone.

In addition, we will raise our annual mortgage insurance premiums by 10 basis points. We estimate this will increase costs to new borrowers by about $13 per month, but it will also further reduce our footprint in the market while adding an estimated $1 billion of additional economic value to the fund this year.

As private capital returns, FHA must continue to balance pricing to ensure that it occupies a smaller, healthier share of the market. In fact, FHA's market share has been declining since 2009, and 2012 represents our lowest-volume year since the start of the economic crisis.

While I focused today on FHA's single-family programs, I wanted to take the opportunity to reassure the Committee that our efforts to protect our insurance funds span the range of our programs. We have already raised our mortgage insurance premiums on multi-family and health care loans and instituted other risk management reforms, such as special reviews for large loans, post-commitment reviews by credit risk officers, and an active loan committee process.

Even as we use our existing authority to take these aggressive measures to protect the fund, other actions require your partnership. In addition to the increased indemnification authority and broader geographical enforcement powers recently passed by the House, we have a number of proposals designed to place FHA in a stronger fiscal position over the next 12 months and beyond, including new loss mitigation authority, additional enforcement authority, and greater administrative flexibility in managing the reverse mortgage program.

The house has recently passed important bipartisan FHA reform legislation, and we look forward to continuing to work with both chambers to create the tools we need to strengthen the program, meet its mission, and place the MMI Fund back on firm footing. I encourage the Senate to engage in discussions that build on this progress in the House in order to achieve a consensus that will give FHA these tools as quickly as possible.

There are no guarantees that the actions I have described will prevent FHA from tapping into the Treasury next September. However, swift action from Congress, coupled with the $11 billion in additional value from the new fiscal year 2013 business, will reduce the likelihood that a Treasury draw will be necessary.

Furthermore, these changes, as well as those we have made over the past 4 years, have laid the foundation for a stronger FHA and a healthier MMI Fund that supports the recovery of the housing market and economy while actively reducing FHA's market share.

As we work together to adapt and reform the FHA program, we must proceed with a balanced approach that recognizes both the challenges to FHA and its contributions to our economy. We are eager to work with you to achieve these shared goals.

Thank you again for the opportunity to testify today, and I look forward to taking your questions.

[The prepared statement of Secretary Donovan follows:]

Chairman Johnson. Thank you for your testimony.

As we begin questions, I will ask the clerk to put 5 minutes on the clock for each member.

Secretary Donovan, I am very concerned about the FHA's fiscal condition, as detailed by fiscal year 2012 report, particularly the negative capital reserve ratio. What action have you taken to restore FHA's capital reserve and prevent FHA from requesting taxpayer support?

Secretary Donovan. Mr. Chairman, the most important actions that we have taken have been in partnership with this Committee, and I would particularly recognize the fact that you passed a ban on seller-funded downpayments, which went into effect and we implemented in 2009. That action alone we believe has saved the FHA fund about $12 billion.

There are additional actions that we have taken. We have raised premiums four times, made underwriting changes that include raising downpayments for the riskiest borrowers. That series of changes has added, we estimate, an additional $20 billion to the value of the fund. Quite simply, if we had not taken those actions in partnership with you, we would find ourselves in a vastly worse position today for the FHA fund.

Chairman Johnson. Mr. Secretary, you have detailed several steps that would help stabilize FHA's finances. Given the condition of the FHA's old books of business, why weren't these changes made earlier? Will these changes allow the FHA to outperform projections again this year and avoid drawing funds from the Treasury?

Secretary Donovan. As I said in my testimony, I cannot guarantee that we will not need to draw at the end of the fiscal year. What I can say is that I believe we are taking all appropriate steps to try to avoid that, balancing both the health of the fund but also the fragile recovery that we have in the market.

For example, we have already moved to increase premiums for the fifth time. We believe that that is an appropriate step and that it leaves FHA appropriately priced. We would be concerned, however, about going significantly further in raising premiums both because it would have potential negative impacts on the housing market--we are seeing a recovery, but it is still fragile, and we do not want to hurt the market and in turn hurt the FHA fund by going too far to stop that recovery.

But I would also suggest, as you see in the chart on the right, we are currently--and the independent actuary confirms this, that the new books of business are highly profitable. And so I think there is, beyond the market question, a question of how far do we go in visiting the sins of the past on new borrowers. The premiums that are being paid by new borrowers more than cover the expected losses. We think that is appropriately priced and will help to shrink our market share. But what we need to do is continue to focus on these older books of business, and that is why I have focused, in the changes that we have made, we announced in our report to Congress, on steps that will increase our collections from these older books of business.

Just from the asset sales that we have instituted, and we are going to ramp up going forward, we have increased the returns on these distressed loans by more than 10 percent simply with those steps.

So we need to continue to focus on things, and we have asked for authority from you to take steps that would help increase our returns on the older books of business. We think those are the most appropriate measures that we can take.

Chairman Johnson. Secretary Donovan, one of these steps is better loss mitigation by transferring sourcing from servicers who are underperforming. What is preventing FHA from doing that under its existing servicing contracts?

Secretary Donovan. Quite simply, we need legislative authority to be able to force those transfers to happen, and that is a critical step. It is something that we have seen in the private market start to increasingly happen. It is something we believe would be very helpful to send a very strong message to those servicers that are underperforming.

But it is one of a number of steps that we would ask that you give us legislative attorney for as quickly as possible.

Chairman Johnson. One more question. Secretary Donovan, the Actuarial Report's finding of a negative economic value in the MMI Fund is mainly a reflection of problem legacy loans guaranteed during the housing bubble. What steps has FHA taken to improve its underwriting criteria and risk assessments for the new loans?

Secretary Donovan. As I mentioned earlier, clearly the steps that you took to ban seller-funded downpayment loans were a critical piece of that. We also looked at the performance of our loans very carefully, and so in addition the premium increases, we did require a 10-percent downpayment for our riskiest borrowers. That we believe was a very important step in changing our underwriting.

We also have taken many other steps on other aspects of underwriting that have to do with what costs can be rolled into the loan, and other steps that reduce the effective risk of those loans that are quite important. Part of that has been able to be done because, quite frankly, we did not have a strong enough risk focus at FHA in the midst of the crisis. We have created a very strong risk management focus through the creation of a chief risk officer for FHA--that has never existed before--as well as building a team of analysts that are really providing data on an ongoing basis on early payment defaults and a whole range of other information that we simply did not have before in real time.

So it is not only the underwriting changes themselves, it is also the focus on risk and the way that we are measuring it on a real-time basis that has given us new tools.

Chairman Johnson. Senator Shelby.

Senator Shelby. Thank you, Mr. Chairman.

Secretary Donovan, lead me through this and tell me if I wrong on this, or right, or what. It is my understanding that under the statutes now prevailing, the Federal Housing Administration could, if necessary or you deemed it necessary, tap the Treasury for an endless supply of money. A lot of us would call that a bailout. Do you anticipate that? Can you assure us and the American people today, as the Secretary of HUD, that FHA will not do that? Or you do not know yet?

Secretary Donovan. Senator, I wish I had a crystal ball and I could tell you that we will not at the end of the year. Given the Actuarial Report this year, obviously I am highly concerned about that possibility.

Senator Shelby. Are you getting close?

Secretary Donovan. Certainly we are closer than we have been in the past.

Senator Shelby. And how close are you, honestly?

Secretary Donovan. What I will tell you is, again, an independent actuarial report is the best I can give you in terms of that view.

Senator Shelby. And that is not good, is it?

Secretary Donovan. What it says--

Senator Shelby. The Actuarial Report is not good.

Secretary Donovan. It is not. But one important piece of this is that what is required for the actuarial is a review as if we stopped doing business on the date of the actuarial. The important thing that we can do and that we have done to try to avoid taking funds from the Treasury at the end of the year is to look at the revenue we expect this year--that is about $11 billion--and to make changes to underwriting and other steps that would help avoid that.

Senator Shelby. Does that include upping the premium a little?

Secretary Donovan. We have already moved to increase the premium an additional 10 basis points, an average of about $13 a month that we expect from borrowers.

Senator Shelby. And how much money would that be projecting?

Secretary Donovan. That would add about $1 billion just this year alone and much more into the future.

Senator Shelby. What is the size of your portfolio today, roughly?

Secretary Donovan. It is over $1 trillion when you combine--

Senator Shelby. $1 trillion worth of loans, right?

Secretary Donovan. When you combine all of the various programs.

Senator Shelby. And how close are you as far as working capital, so to speak?

Secretary Donovan. It is an important question. Today, even though the Actuarial Report shows a negative balance, we have a cash balance of over $30 billion today, $30.5 billion. And, in fact, one of the things the actuary looks at, assume that we continue to do business, assume that we continue to operate, what is the likelihood--which obviously we plan to continue to operate.

Senator Shelby. Sure.

Secretary Donovan. What is the likelihood that we actually--the cash balance goes negative? And the actuarial, despite the worse condition this year, still has a less than 5-percent chance that we actually run through all of those cash reserves going forward.

Senator Shelby. Give us the worst-case scenario. It is the first week of December now. Say 3 weeks from now, what is your worst-case scenario getting up to the 1st of the year where you might be or not be? What would cause you to have a lot of heartburn say around the 1st of the year?

Secretary Donovan. The single greatest issue of concern is where the housing market will go from here. If the housing market continues to recover, as it has this year, that is the most important thing that we can see to restore the fund to health. House price appreciation is the single most important variable in the health of the fund going forward, and that is also why I will say we are so concerned about balancing the steps that we are taking to make sure we are not doing anything that would impede the recovery and come back and harm the FHA in the long run by decreasing the improvement that we see in housing markets.

Senator Shelby. We all realize that FHA serves a good purpose, but it is just not sound financially. As the Secretary of HUD, shouldn't the fiscal well-being of FHA be one of your highest priorities?

Secretary Donovan. Absolutely. Absolutely.

Senator Shelby. And are you just going to deal with what comes up like you outlined today?

Secretary Donovan. I would welcome additional ideas and suggestions that you may have. I certainly feel that there--we will take steps within our power. We would like to work with you, as I have said, as quickly as possible to move additional authorities that would help us do this. But I am also open today or at any time to additional suggestions about what further steps we could take.

Senator Shelby. If you do tap the Treasury--in other words, there is a bailout, so to speak, if it is a sizable one--how would you pay that money back? Premiums or efficiency or the housing recovery, or all of the above?

Secretary Donovan. We certainly believe that we need to keep FHA in a position where our new books of business are producing substantial revenue for the taxpayer. This year alone, we expect our new loans to return a $10 billion profit, if I can use that term, to the taxpayer. That is the way that we need to continue to restore the health of the fund and, should we need to draw on the Treasury, to restore that money to the taxpayer.

Senator Shelby. Thank you.

Thanks, Mr. Chairman.

Chairman Johnson. Senator Reed.

Senator Reed. Thank you very much, Mr. Chairman, and thank you, Mr. Secretary.

I would repeat what my colleagues have said. It is very disturbing to have a report that shows 1.4 percent negative equity in a critical fund, and this is an issue that has not suddenly emerged. It has been growing over several years.

You have indicated that you are taking steps to fix these problems, and many people have said that in the past, too, and, again, can you sort of give us some assurance that this time is different?

Secretary Donovan. What I can say, Senator, is that I believe we are taking every responsible measure that we can to improve the health of the fund, while at the same time not hurting the fragile recovery that we have. I do not have a crystal ball, and I believe that we need to continue to take input and guidance on getting a better picture of the fund.

One of the reasons why the fund looks significantly worse this year than it did last year, we got criticism last year from outside experts, from the GAO, from our IG, of the way that we model claims in our actuarial. We went back and directed our actuary to change the way we model, and that change alone subtracted $13 billion from the value of the fund.

So I am not going to sit here and say we have been perfect in the way that we have looked at the fund or that we have modeled it. And one of my responsibilities is to continue to make changes to get as accurate a picture as we possibly can and to take steps based on that.

Senator Reed. Let me ask perhaps a related question. As you look forward in terms of the health of the fund, one fact, it would seem to me--and I would assume it would be explicitly in the model--would be an assumption about unemployment rates going forward. What unemployment rate are you assuming over the next year or so? Because it directly affects payment.

Secretary Donovan. Absolutely. One of the important changes we made to the model this year, not to get too wonky here, is to go to something that is called "stochastic modeling." One of the criticisms we had is that we--the way the model worked is we chose one path and modeled based on that. State-of-the-art modeling assigns probabilities to a whole different range of paths that the economy might go through. So we have actually modeled a vast range of scenarios.

One of the things we looked at last year, that we directed our actuaries to look at, was to say: What if interest rates go low? What is going to happen to the fund? We ran that last year. That scenario predicted that the fund would go negative. In fact, we have had what is effectively the low interest rate scenario happen this year with QE3, and that has clearly had a substantial impact, roughly a $10 billion negative impact on the fund, just from those interest rates alone. So those are clearly steps that we are taking. We would be happy to share with you the various unemployment rate scenarios that we are looking at and home price paths that we are looking at. But, again, we look at a range of those to get to the best possible prediction.

Senator Reed. You got close to watching this with stochastic modeling, but you avoided Bayes' theorem, so you are fine.

One of the problems that you face is this series of years of terribly mispriced loans in 2007 to 2009, and it would seem to me one of the things that you are trying to do is to clear these as quickly as possible. But as you have indicated to us, you need help with servicing, that you have to do much more aggressive modification sales, and also for the real estate that effectively you own, you have to dispose of it.

Can you comment on how much you think you can achieve in relieving pressure on the fund by doing that, looking back and taking care of that period?

Secretary Donovan. We think with a set of changes that we are already taking, that we announced in our report to Congress with the actuarial, that include the loan sales that we have taken, changes to short sales, changes to what we call our loss mitigation waterfall, how we work with borrowers that are in trouble, those alone could add about $3 billion to the fund over the next couple years.

What we need help on is that many of our enforcement authorities--and, again, if you think about how we collect on the bad loans, enforcement is an important piece of that, to say to lenders, you made a bad loan, there was fraud or there was something else involved, we need to hold you accountable for that and bring funding back to the taxpayer. There are a number of provisions that would help us.

One is giving us broader geographic authority. We have some perverse restrictions right now in legislation in terms of the way that we can hold lenders accountable on a narrow geographic basis, what we can do to require indemnification of loans, the standard for fraud. Those are all pieces of what we would want to work with you to get passed very quickly to be able to enhance our enforcement authority. Those as well would likely add billions of dollars to the fund.

As you know, we have been able to recover well over $1 billion just this year in settlements around servicing and originations with many of our biggest lenders.

Senator Reed. Thank you very much, Mr. Secretary, and thank you, Mr. Chairman.

Chairman Johnson. Senator Corker.

Senator Corker. Thank you, Mr. Chairman. And, Mr. Secretary, thank you for your testimony today. You asked for some suggestions, and I would like to make just a few.

It is my understanding that on the private side right now, FICO scores really at 620 is where the market is. And FHA is at 580, and basically it is creating a situation where the private lenders are being made out to be bad guys because even though your FICO scores are 580, they are not doing anything below 620.

As one of the steps that you might take, would it make sense for you to go ahead and get on up to 620? Right now there is huge demand out there, and at some point that is going to diminish, and then we will drive back down as people try to get market share again. Would it not make sense to go ahead and implement what the market is telling you to do?

Secretary Donovan. That is something that we are actually looking at. I think it is likely that we take additional steps as we are working towards the President's budget and understanding in more detail the results of the actuarial. That is clearly something we are looking at.

We are concerned that some of the overlays that lenders are putting on go farther than are necessary. In other words, we do believe that there has been an overcorrection, if you will, in some parts of the market where we have what are very safe borrowers that are having a hard time accessing credit. But I also agree that we need to be looking at and perhaps adjusting on the FICO side as well.

Senator Corker. And, generally, for what it is worth--I appreciate your testimony today. I know we have had discussions about that sometimes in the past, and I do realize you had a lot of bad loans on the books that you inherited. I do think there are things you can do now to really cause the fund to be far more sound, and I do think you all are being a little slow in moving that way.

And so a second one I would move to is reverse mortgages. I mean, you are losing your shirt on reverse mortgages. Losing your shirt. It is a small part of what you are doing, and yet you have got mortgage brokers out there that are making an absolute fortune right now--a fortune. Some of them are good operators. A lot of them are schlocky operators. And I do not understand why you do not shut the program down for 24 months, as I know has been suggested to you. Why don't you do that?

Secretary Donovan. Once again, Senator, you have hit on an issue that is an important one and that we do believe we need to make changes on.

Senator Corker. But why don't you just do it?

Secretary Donovan. Well, frankly, we did make changes. We introduced a much safer--better, we thought--alternative through our SAVER program. We could effectively do what you said, which is to just create a moratorium on the other program. What we are concerned about is, particularly given the economic crisis that seniors are going to--have gone through, that we would be eliminating an option that works for some seniors if it is done safely in order to eliminate also the bad loans that are being made.

Our preference, if we could authority from you to change the structure of the program to make it much more effective and safe, that would be a better way to go. If we cannot get that authority quickly, we will have to look at--

Senator Corker. I mean, I would think--why can't we do a unanimous consent? It seems to me that most people would be willing to do that.

Secretary Donovan. Let us talk about that today. I would love to--

Senator Corker. I know you have got a partial situation that has been very healthy, and it seems to me if you are worried about seniors, you could keep the ability to draw down a partial amount, which is very safe, and you would eliminate--and you could do that all by yourself, and we could worry about the legislation whenever it is time. I am willing to look at it now, but just for what it is worth, it does feel like there is a lot you could do to make FHA healthy today that is not being done. But let us talk further, okay?

Loan limits. It seems like right now--I mean, Fannie and Freddie are down at, I think, 625. You are still up at 729. Wouldn't it make sense to go ahead now and make some changes that need to be made? I mean, you can do that yourself. Why don't we do that?

Secretary Donovan. We, as I think you know, supported our loan limits coming down, and they were supposed to expire last year. Congress made the decision to lower the GSEs' loan limits, but kept FHA's--

Senator Corker. Can you self-implement that, though? You cannot do that without--

Secretary Donovan. I do not believe, given that Congress explicitly extended those higher limits, that we can take that step and--

Senator Corker. Would you like for us to help you do that?

Secretary Donovan. We have supported before and I will state again today that going back to the pre-HERA limits makes real sense, and I will go further than that, that we should lay out a path to go back to even lower limits that existed before the crisis in a way that is done consistent with how we do housing finance reform. That is a larger question, but the immediate step of going back to the pre-HERA limits is one that we would support.

Senator Corker. Well, you are developing a fan, and I hope that we can look at some of those things.

Home mortgage insurance. The way I understand that it works is private mortgage insurers, when you get down to a certain loan-to-value ratio, the premium is dropped, but also the insurance is dropped. And yet you have a $1 trillion in loans on your books where the loan-to-value has dropped, they are no longer paying premiums, but you are keeping the guarantee in place. That does not make any sense to me. Why don't you continue to make the homeowner who has that guarantee continue to make the premium payments? That would be something that, it seems to me, would be extremely helpful to you during this difficult time.

Secretary Donovan. Once again, an excellent suggestion. We announced with our report to Congress that we are doing that for new loans. Unfortunately--

Senator Corker. But why not the trillion that are on the books?

Secretary Donovan. Unfortunately, we cannot go back and modify a contract. When that homeowner took that loan, they signed a deal with FHA that said this is the way the premium structure would work. We looked at this. We fully analyzed it. We cannot break those contracts, unfortunately. And so it is something that we're going to need to implement.

I will say, however, that the value of doing it now in a low interest rate environment is substantially larger on these new loans, for two reasons: the lower the interest rate, the faster the amortization of the principal, and, therefore, this will be a more valuable change; second, because these loans are so low interest rate, they will be on our books far larger. So, frankly, not many loans in the past have hit that limit. So even though it is a $1 trillion portfolio, the value of that change is quite small for the old loans. It is really going to be quite valuable for these newer very low interest rate loans.

Senator Corker. Mr. Chairman, I made no opening statement. Briefly, two more questions.

I see that FHA is now making loans to people who 3 years ago were foreclosed upon, and that is a very different standard than even exists at Fannie and Freddie. I do not understand. Why are you doing that?

Secretary Donovan. This is another area where we are working on changes, and here is the issue: We have a significant number of homeowners that were responsible homeowners, had good credit scores, that lost their jobs in the biggest economic crisis this country has faced since the Depression. And we believe if somebody can show that they are back at work and are a responsible borrower again, that is somebody that we ought to work with.

I would agree that our standards are not clear enough in dividing those, so what we believe we need to do is clarify those standards, but not necessarily eliminate the possibility that somebody who has done the right thing and through no fault of their own lost a job but can now be a responsible homeowner again has the chance.

So my view would be it is not just the 3-year limit that is important. It is: What are the criteria that we set for how somebody re-establishes their credit and being a responsible homeowner? That is where I would propose we work together.

Senator Corker. Okay. My last question, and thank you for your patience. First of all, it sounds like there are a lot of things that could be done right now to solve a lot of problems, and I hope that we as a Committee will figure out a way to work with you on those things we need to work with you on, but that you will do the things you can do on your own now.

You and I had a pretty long conversation several months ago when Carol Galante had the opportunity, candidly, to assume her post on a permanent basis, and we could not get the administration to agree to not air-drop something and bypass the Committee. It was an unfortunate circumstance. But I guess, as I look at it, I would just ask you the question: Did we dodge a bullet in appointing her full-time with all the issues that we have at FHA? And does she really have the ability to press the administration to overcome political issues to actually cause the fund itself to be actuarially sound? Because it appears to me that we are still not quite doing the things we ought to do to make the fund operate. And it seems to me that maybe there is a little political pressure, and maybe she is not strong enough to make that happen.

Secretary Donovan. Senator, here are the facts as I see them: We have taken the most aggressive steps I think in the history of the agency to make sure the new business that we are doing is strong. If you look at that chart right there, what you will see is huge profitability relative to the history for the new loans that we are making. We have only so much that we can do to fix the problems of those older loans.

So I agree with you on many of the steps that you describe today. What we should not imagine is that somehow taking those steps can take us from the difficult financial condition that we find the FHA in today, somehow eliminating what has been an enormous trauma in the housing market.

I have enormous confidence that Carol can and will lead us on the path that we need to take. And, in fact, you do not have to take my word for it. I think the evidence of the changes that we have made, the steps that we took--you remember last year the President's budget thought that we might need a draw at the end of last year. Carol took aggressive steps on enforcement, on changes to underwriting that meant instead of close to a negative $1 billion balance, we ended the year with a more than $3 billion positive balance.

Those were aggressive steps that she took. I listened to her, but she took those. And I believe that that is the kind of leadership that can help us continue down this path.

Senator Corker. Thank you.

Chairman Johnson. Senator Hagan.

Senator Hagan. Thank you, Mr. Chairman. And, Mr. Secretary, thanks for your testimony today.

I know that Senator Corker asked about reverse mortgages, and I am concerned about that issue. And I am particularly concerned that $2.8 billion of the $16 billion economic shortfall are related to that program.

Can you talk a little bit more about why these losses under the reverse mortgage program are so severe?

Secretary Donovan. Here is the fundamental problem, without getting into too much of the history. At one point when Fannie Mae was issuing these loans, they were generally variable rate, and they allowed a borrower to basically draw on, you know, over time the amount of money that they needed.

As that program has switched to being a Ginnie Mae program, there is basically no option for those borrowers to do anything but draw the full amount.

Senator Hagan. And why?

Secretary Donovan. Because we do not have the statutory authority to be able to make the changes to the program that would allow us to limit the draw up front. That is the change that we are asking that be made.

Our alternative--and I was just discussing it with Senator Corker--we could basically eliminate or put a moratorium on our regular program and just go to what we call our SAVER program, which is somewhat safer. But the problem is we still do not have the authority even under that program to avoid this full-draw feature of it.

So the right answer, in our view, is: Give us the authority to make the changes we need so that we end up with what is a safer product for FHA and, frankly, a safer and better product for seniors. What we are finding is with this full-draw product, too many seniors end up in situations where they cannot cover their insurance and their taxes, and too often we lead to a situation where they have more leverage, more debt than their home is worth by the time they are ready to sell that home.

Senator Hagan. And so you are saying because of that change, there is what resulted in the $2.9 billion?

Secretary Donovan. That is for many of these--for most of the new loans that we are making, they are at this full draw, and the actuary predicts there are going to be enormous losses on those going forward because of this full-draw feature.

Senator Hagan. Okay. And, also, the last time you testified before the Committee, we discussed the National Mortgage Settlement. Can you talk briefly about the MMI Fund, how it has benefitted from the settlement?

Secretary Donovan. In the most direct way, it has benefitted by well over $1 billion that came directly to the fund from that settlement or that series of settlements. Also important, though, is we put in place, not just for FHA loans but for every kind of loan serviced by the five banks that were part of it that control 60 percent of all servicing, new standards for how they foreclose on loans, how they work with troubled borrowers, and in the long run those changes will have very important effects not just for homeowners and communities but also benefits to the FHA fund, because we will have fewer foreclosures and better recoveries on the loans, whether it is through short sales or keeping homeowners in their homes.

Senator Hagan. The settlement also includes billions of dollars in debt forgiveness for the borrowers, and generally the discharge of indebtedness is taxable to borrowers, but certain exceptions exist for indebtedness related to principal residences. This exception is set to the expire at the end of this year.

What is the interplay of the expiring tax provision and principal reduced from borrowers? And how would the expiration of that provision impact participation in the settlement and the relief that borrowers see now?

Secretary Donovan. Well, it would be a cruel irony if homeowners have the ability to stay in their homes because of a principal reduction that is both good for them and their lender because it is going to lower the losses on that loan in the long term, only to get, come tax time, a giant tax bill for that principal reduction, which drives them back into delinquency and potentially foreclosure.

And so the President has made it a real priority to try to get that provision into whatever tax extenders we may do at the end of this year, and it is a very high priority for us among the many things that will be at issue in that tax extender.

Senator Hagan. Thank you, Mr. Chairman.

Chairman Johnson. Senator Vitter.

Senator Vitter. Thank you, Mr. Chairman. Thank you, Mr. Secretary.

Again, as I said at the beginning, I have the real concern that I think is shared by a lot of Committee members that the changes in reforms FHA has made and you are talking about today are not significant enough given the looming threat. And you say they are unprecedented. Both of those things could still be true. They could be more than ever before, and still not enough given the magnitude of what we are talking about. And that is the concern.

First of all, let us talk about the clear potential now for a taxpayer bailout. Is it not right that under the Federal Credit Reform Act it would allow the Treasury to make necessary cash or credit transfers to FHA in order for them to continue making payments sort of automatically?

Secretary Donovan. That is absolutely correct. That is the way not only FHA but other similar programs are designed.

Senator Vitter. That is obviously significant for the taxpayer. We call care about that. Can you commit to us that you will keep us and the Congress fully apprised of your moving projections with regard to that, and certainly fully apprised when that happens?

Secretary Donovan. I am absolutely committed to make sure that if we are going to take that step, you would be fully notified.

Senator Vitter. Well, my question was a little more than that. It was to keep us fully apprised of your current and updated projections toward that issue. Can you commit to us to give us that information, your best projections today and whenever that changes, and certainly if that is going to happen?

Secretary Donovan. I do. And, Senator, what I would suggest--we do provide a monthly report to Congress on the status of the fund. If there is additional information or somewhat different information that would be useful to you in that, we are very happy to work with you on that.

Senator Vitter. Okay. Well, what I am talking about is, as of today, when do you project there is going to have to be a taxpayer-funded bailout? What is your best projection?

Secretary Donovan. What I would say is our best projection will be contained in the President's budget. We are still working on the underlying economic assumptions that go into that. And so I do not have anything beyond what the actuary did that would be a different prediction today.

Senator Vitter. So today, within all of HUD and all of FHA, you have no best guess about that?

Secretary Donovan. I am not sure what you would suggest is a best guess other than to say the Actuarial Report has a value of the fund as of the date it was performed. In addition to that, we expect about $11 billion of new revenue, and the changes that we have implemented we believe will bring billions of dollars of additional revenue to the--

Senator Vitter. Based on all of that, do you expect a taxpayer bailout, as we sit here today? If so, when?

Secretary Donovan. Based on those steps, I believe we have significantly decreased the chance of having a bailout at the end of 2013 or having to draw on the Treasury. I am not going to assign a probability at this point because we are still working on the assumptions and other steps in the budget, and I will be able to give you a number when we have completed the budget projections.

Senator Vitter. Okay. Well, again, I want to re-ask for your best information about that as it develops, and, unfortunately, we do not have that today. I think you all have some idea, some best guess. You are not giving it to us. We would really like that as soon as you can give it to us and from then on, on an updated basis.

With regard to changes that are being made, you just said they are unprecedented and the proof is in the pudding and the changes that Ms. Galante made in the last year stepped us back from that possibility. I just want to add for the record, there was another big factor. The $1 billion in the AG settlement--that was just found money--was a huge factor that had nothing to do with reforms or changes.

But I also want to associate myself with Senator Corker's suggestions about a whole menu of things that we believe exist that you all are not doing that I believe is warranted. There are several ways--and Senator Corker touched on this--that FHA has much laxer standards than Fannie and Freddie. And as a result, you are creating a huge magnet to draw the worst problem loans to FHA because of that. One of those is maximum loan limit, and another is the issue he brought up of allowing a borrower to re-borrow 3 years after a foreclosure. Fannie and Freddie, that is 4 to 7 years.

On those two things and anything else like that, why wouldn't you align FHA with Fannie and Freddie to stop this negative selection that is occurring toward FHA?

Secretary Donovan. Senator, two things I would just say.

One is it is not accurate to say that the reason the fund remained positive last year was because of the settlement. The value at the end of the year was over $3 billion. If the settlement had not happened, we still would have been positive.

And the second thing I would say is I do not see the settlement as unrelated to policy changes. Strong enforcement is part of what we need to do to make sure that we hold lenders accountable and that we minimize losses from those older books of business which are causing the stress to the fund.

And so I believe very strongly it was the right policy decision. It is related to steps that we have taken. And even if it had not happened, we would have remained positive last year.

So on loan limits, as I said before, we do not have the authority without Congress acting. The administration advocated that loan limits come down. I thought it was, frankly, perverse to bring Fannie and Freddie's loan limits down and not to lower FHA's at the same time, exactly for the reasons that you have said. We are concerned that it would drive business to FHA that should go back to the private market.

So I would urge you and others--I know you are supportive, but to work with your colleagues to try to do that as quickly as possible. And I do agree that we need to look at--and we are doing that, looking at the standards for how we allow borrowers who may have defaulted in the past to borrow. Again, I would say, though, we should not hold a responsible homeowner who has demonstrated their ability to pay back their debts and to be a homeowner, a successful homeowner, simply because they may have lost a job due to what is an unprecedented economic crisis that we have been through.

So this is not just about timelines. It is about what the standards are for when we allow folks to borrow.

Senator Vitter. Well, my broader point is this and several other factors should also be about doing it in a way that you are aware of what competing opportunities' rules are, like Fannie and Freddie. And if FHA has laxer standards, I mean, clearly you are going to encourage the accumulation of weaker loans. I think that is obvious.

Secretary Donovan. Yes, I agree with you. One of the things that we announced just a few weeks ago with the Actuarial Report is that we are implementing standards on short sales that are aligned with what Fannie and Freddie are doing. So we are looking for opportunities wherever we can to try to align those standards. That does not mean on everything that we should be identical to them, but aligning where appropriate makes great sense.

Senator Vitter. And as I understand it, another significant factor in terms of potential loss is the whole reverse mortgage program, which is projected to be a drain on the system even in the best economic circumstances. And as I understand it, FHA has the authority to suspend that program. It is a huge profit center for folks who participate in the private sector. It is costing the taxpayer money essentially, or threatening exposure in the best of times. Why wouldn't we suspend that tomorrow?

Secretary Donovan. That is an option that we are clearly looking at. We believe there is a better option, which would be to get legislative reform to allow us to implement a better product. That is something, as I talked about with Senator Corker, we would love to work with you on the next few weeks. The House has passed an FHA reform bill. We would love to be able to do something even in this session of Congress before the Ranking Member leaves. That is area--

Senator Vitter. Well, let me--

Chairman Johnson. Senator Vitter, please begin to wrap it up.

Senator Vitter. Sure. I will wrap it up very quickly.

Let me suggest melding those two ideas together. I think if you suspend that program tomorrow, you will start saving the taxpayer money and create more pressure for the reform you are describing.

Thank you.

Chairman Johnson. Senator Menendez.

Senator Menendez. Thank you, Mr. Chairman.

Mr. Secretary, while I clearly have questions about Sandy, let me just create some balance here from my perspective.

First of all, am I wrong to say that the HUD report says that FHA continues to be impacted by losses from mortgages originated prior to 2009?

Secretary Donovan. That is exactly right, and, Senator, if you look at the chart, on the right here, what you see is that through 2007 and 2008 in particular are huge costs to the fund that in 2009 we saw still negative impact but real improvement, and then in 2010 through 2012, those loans are expected to contribute substantial revenues to the fund and to the taxpayer.

Senator Menendez. So a good part of the portfolio that we have been suffering with here certainly took place prior to this administration.

Secretary Donovan. That is correct. But I would also give you all credit for acting to end seller-funded downpayment at the end of 2008, which we implemented in 2009.

Senator Menendez. Now, I know there is some talk about the higher loan limits and your own view, but let me just say, Doesn't the audit also say that "larger loans tend to perform better compared with smaller loans in the same geographical area, all else being equal"?

Secretary Donovan. Our early data is that these larger loans are performing somewhat better. We do believe, however, it is too early to make any final conclusions about it simply because these loans have not had much time to season at this point.

Senator Menendez. Well, it seems to me that so far they have probably strengthened FHA's balance sheet by allowing larger, better performing loans. And there is a problem here. There are parts of the country in which those lower loan limits would make FHA virtually non as valuable to its core mission as it would in other parts of the country, which is why on a bipartisan basis we passed preserving the higher loan limits. So I am looking forward to seeing the continuing performance of them because I think it would make another case. And I am waiting for the private sector to come in. I mean, I keep hearing about the private sector ready to come in, but it just does not seem to be happening.

Now, there are some who would suggest that Ms. Galante has not been performing well. Maybe my eyesight is not good, but I look at that second chart, and it seems to me in the time period that she has become the acting head, in fact, the performance of the portfolio under her watch has gone from the negative performance that existed before her watch to a positive performance, significantly positive performance during her watch. Is that a fair statement?

Secretary Donovan. That is absolutely fair. I would add that the chart just to the left of it also shows that we have done that while reducing FHA's market share. So we have taken steps to try to bring private capital back to shrink our market share, but still to have the performance improve substantially.

Senator Menendez. Do you have a different view than Moody's data that shows that the FHA's presence in the market prevented housing prices from dropping another 25 percent?

Secretary Donovan. I think that is as good an analysis, as thorough an analysis as we have seen of the important impact that FHA had on the market and, frankly, what would have happened if we had not been there as you see--Congress intended FHA to be here when the country went through a crisis, either a regional crisis where there was not lending available or a national crisis. And that is exactly the role that FHA played with that increase in market share. We agree it is time, as the market is improving, to shrink that share, but not to do it in so precipitous a way to raise premiums or to take other steps that would hurt what is still a fragile recovery.

Senator Menendez. And I would simply say that in a time in which the housing market, although we see some indicators moving upward and prices, values moving upward, it is still a very significant challenge. And just like a doctor, I mean, I think the principle starts off with you do no harm, especially when you are in the midst of a challenging recovery.

So I look forward to seeing how we move in this dual track of making sure the taxpayers are held whole, but at the same time preserving some of the core missions of FHA.

I want to turn to hurricane recovery. This hurricane, Mr. Chairman, we are not used to hurricanes in the Northeast. We have been blessed not to have them. But when you have a superstorm that comes with a full moon, high tides, and a drawing-in of what was the hurricane because of a front that came from the west, you have a perfect storm in all of its iterations.

I have lived in the State of New Jersey my whole life. I have never seen the type of devastation that exists in the State. The pictures that some of my colleagues have seen on television and whatnot do not do justice to the death and scope of devastation. We have thousands of people who do not have a home to go back to. I know that when people talk about the New Jersey shore because of some of these shows, they think of a certain thing. These are people's homes. I am not talking about second homes. I am talking about their lifetime homes, year-round communities that do not have a home to go back to. I am talking about a $35 billion tourism industry that is largely devastated. I am talking about the megaport of the east cost, the port of New York and New Jersey that suffered huge damages, 250,000 jobs, $30 billion of economic activity for the Nation, national security because we closed the only port in the Northeast in Bayonne, New Jersey, that was a military port, and now we use the commercial port for forward deployment when we need to in the case of emergencies. And I could go on and on.

So, Mr. Secretary, in your other role here, I want to get a sense from you as to the commitment of this administration and the Federal Government to helping New Jersey, and certainly New York as well and the region, recover. Because, you know, when we had Hurricane Katrina on the gulf coast in Mississippi and Alabama and Louisiana, I was there; when we had tornadoes in Joplin, Missouri, I was there; when we had flooding along the Mississippi, I was there; when we had crop destructions in the Midwest, I have been there--because I believe this is the "United" States of America. And so I fully expect that now that for the first time we have the type of devastation that others have suffered and should understand, that we are going to have the type of response that others have received.

And so I would like to get a sense of--I know we are working towards this goal, but I would like to get a sense from you as to the type of commitment that this administration has towards those goals.

Secretary Donovan. Senator, thank you for the eloquent remarks about this. As you know, this is a region I, too, have deep roots in. I think, to use your term, I "married up," married a Jersey girl, and have worked in New Jersey, grew up in New York. And besides the personal commitment I feel, I have also seen a President who was on the ground in New Jersey almost immediately, has done everything he can to help the short term, and has given me the responsibility to help make sure that this recovery is a full, complete recovery, not just to build back what was there but to build back smarter and stronger.

So you have my commitment that we will do that. We will propose a supplemental this week that I hope you will see demonstrates that commitment. But we will also be committed to making sure that we get that supplemental passed in the next few weeks because, frankly, there are too many homeowners, too many small businesses, too many renters that have lives that are simply on hold until they know what resources will be available to them to rebuild.

FEMA cannot by statute provide for a full recovery. They are a response organization. And we need to take further steps through a supplemental this month to be able to move towards a fuller recovery and give those families and those businesses some hope that there is a future for them in New Jersey and around the region.

Senator Menendez. Well, Mr. Chairman, let me close, if I may, with your indulgence, because of the nature of this issue, by saying, number one, we await what the supplemental looks like, and we will reserve judgment until them.

Number two, regardless of the size of the supplemental, we need flexibility in being able to seek the recovery that we all want.

Number three, in addition to a perfect storm, there is another perfect storm here. We get this storm in the midst of the beginning of winter. Most of the hurricanes are in gulf seasons, in summer seasons, totally different in terms of the consequence to people--huge in terms of the impact, but still time to recover without the ravishing of the winter months.

If we have a northeaster, our defenses are so far down that it would be like a person's immune system being susceptible to any type of illness. And, thirdly, we come with less than 30 days to the end of a Congress in which this has to be done. I feel like I have to be Houdini to accomplish this, so--but we are going to do this. We are going to do this. And so, Mr. Secretary, I look forward to your work and your help as we get there, and to our colleagues as well.

Thank you, Mr. Chairman, for your indulgence.

Chairman Johnson. I would note that Senator Menendez will chair our Subcommittee field hearing in New Jersey next Monday, December 10, on Superstorm Sandy.

Senator Toomey.

Senator Toomey. Thank you, Mr. Chairman, and thank you, Mr. Secretary, for joining us.

I would like to understand better an aspect of the actuarial review, and the question that I have arises from the interest rate assumptions and the interest rate environment that is used to determine the prevailing view about the value of the Mutual Mortgage Insurance Fund, the single-family fund.

More specifically, you observe on page 8 of your testimony the fact that the lower the interest rate environment, the worse shape the fund is, to simplify things. You walk through the mechanisms by which lower interest rates, while good for the economy overall, tend to have an adverse impact on the value of the fund.

My understanding is that the actuarial review contemplates a low interest rate environment, and in the low interest rate environment, the value of the fund is negative $31 billion.

Aren't we in a low interest rate environment today? And aren't we by virtue of what the Fed has said, which is to say, maintaining current policy at least through mid-2015--so 3 years or so, at least--isn't it very likely that we are going to stay in a low interest rate environment? And shouldn't that be the prevailing environment assumption?

Secretary Donovan. You make a very important point in terms of the fact that the actuarial review was done not today but at a point with economic projections that are primarily in July, over the summer.

Senator Toomey. Right.

Secretary Donovan. And so it is accurate that interest rates have dropped further than were built into the primary actuarial view. There are two offsetting factors to that, though.

One is that home prices have performed better than were used in the actuarial, and based on what we know today, even for this year, the actuarial would be significantly better if it were performed today just on that one variable.

And then the second point is that the actuarial review is a point in time that assumes that we do no further FHA business, and one of the things that is artificial about it, if I can use that term, is that when interest rates go lower, it assumes people pay off faster. That is accurate. What it does not take into account is that typically about half of those folks refinance into an FHA loan. So by the nature of the actuarial, taking a snapshot in time, assuming that you are closing down the fund, there are revenues that will come to the fund that are not built in.

Senator Toomey. Right.

Secretary Donovan. All that being said, we will in the President's budget include the lower interest rates that you describe; we will also include an updated projection of house prices; and at that point, we will have a clearer picture of how these offsetting factors play. But it would not be accurate to say that the right number is today the $30 or $31 billion because of that.

Senator Toomey. Do you believe that the difference in home prices that prevail today versus at the time that this was done and the difference in the volume that you referred to would be enough to offset the lower value that is caused by the fact that we are in a lower interest rate environment?

Secretary Donovan. The truth is, just to be honest, we have not finished those calculations. We are in the midst of doing that for the budget. What I will tell you is they are both large effects, and it is certainly conceivable that they could be offsetting or in the range of offsetting, but we simply do not have an answer to that.

Senator Toomey. It is a pretty large effect that comes from the difference in the interest rate. Do you know what the low interest rate environment scenario assumes for the 10-year Treasury yield, by any chance?

Secretary Donovan. Let me ask my crack team behind me to get that. We will have that for you in a moment.

Senator Toomey. All right. My guess is--I am not sure even that assumption is as low as the rate is today. With an interest rate, 10-year Treasury, of about 1.6 percent, it is shockingly low, and we have a Fed insisting that it is going to keep it this way for a long time. So I will be very interested in seeing what the net effect of these changes are because we know that the interest rate component will reflect a significant adverse valuation here.

Secretary Donovan. Yes. But, again, I would just point out that there is an artificiality of the point in time because it presumes every one of the payoffs, we have no more revenue to FHA; whereas, in fact, we know a large number of those refinance--

Senator Toomey. So you are saying there is a flaw in the model.

Secretary Donovan. No, no. Congress requires that the actuarial review be done in a way that is what we call a "runoff scenario."

Senator Toomey. Okay.

Secretary Donovan. We also in the actuarial look at what if we keep doing business, so we have those projections in the actuarial. That is not the 2-percent calculation, but it is something that we could sort of give you more detail on from the actuarial of what the net effect would be with the refinances.

Senator Toomey. The other question is: Does the modeling assume any recession between now and 2017?

Secretary Donovan. The modeling does include a range of runs from a mild recession to a very severe recession, and through the kind of stochastic nature of the modeling, we do look at probabilities for those recessions--

Senator Toomey. But the model that comes up with a valuation of negative $13.5 billion, does that assume a recession?

Secretary Donovan. It assigns probabilities to the potential for different types of recessions and builds those in. I am not sure if I am being clear, but it is not--

Senator Toomey. All right. Let me put it this way: What is the average economic growth rate that is implicit in or explicit in that valuation?

Secretary Donovan. Again, I can get that for you momentarily.

Senator Toomey. Okay.

[The information follows:]

/ COMMITTEE INSERT

Senator Toomey. And my last point, the Senator from New Jersey made a very important and impassioned argument about the effects of Hurricane Sandy. In Pennsylvania, we had very significant damage, but it was exclusively from wind, almost entirely from wind damage. Millions lost power. But the damage was not comparable to the damage that was compounded by the water damage, of course, that was done along the shore. I am looking forward to seeing a supplemental that is well crafted and, I hope, properly offset, because we also have a fiscal crisis of enormous magnitude. So the necessary spending to address emergencies is very real, but it is really important that that be offset.

Thank you, Mr. Chairman.

Chairman Johnson. I would like to thank Secretary Donovan for his testimony and for being here with us today.

The financial stability of the FHA is an issue that the Committee does not take lightly, and we will continue this dialogue and take action where necessary to protect taxpayers.

We appreciate your testimony, Mr. Secretary. This hearing is adjourned.

Secretary Donovan. Thank you, Mr. Chairman.

[Whereupon, at 11:36 a.m., the Committee was adjourned.]