Mission Critical: Retooling FHA to Meet America's Housing Needs

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TERNER CENTER FOR HOUSING INNOVATION
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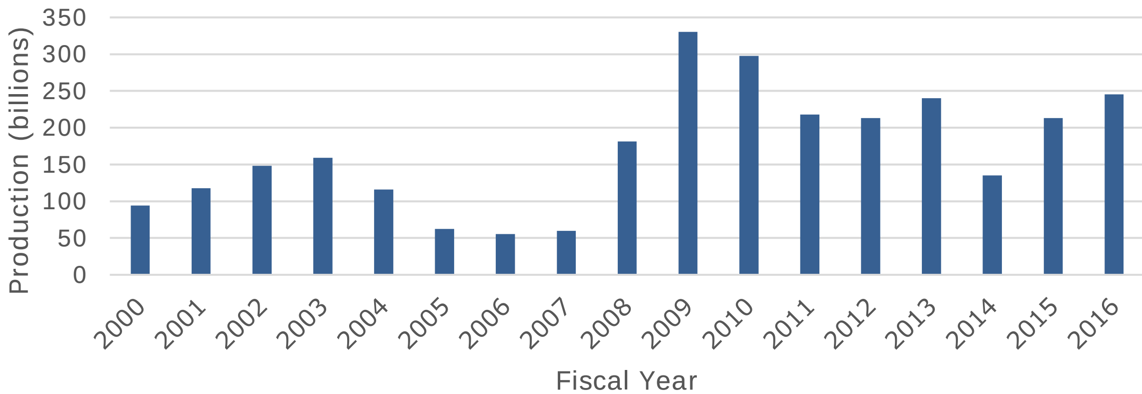
Introduction

Despite its importance to housing finance in America, the subject of the Federal Housing Administration (FHA) and its future has largely been excluded from current debates over housing finance reform. This is a critical mistake. A reformed conventional mortgage finance system without an appropriately retooled FHA to complement it could threaten access to homeownership for American families and increase risk to taxpayers – precisely the opposite of the intended goals of reform. Indeed, if policymakers fail to modernize FHA for a new century, they will fail at fixing the housing finance system, and as a result, they will fail the American people.

For more than eighty years, FHA has been an important component of the United States housing finance system, particularly for first-time homebuyers and for borrowers not adequately served by the private mortgage market. Today, nearly one in five mortgages used to purchase a home in the United States is FHA-insured (United States Department of Housing and Urban Development, 2016a) and in fiscal year (FY) 2016, over three quarters of FHA purchase loan originations went to first-time homebuyers (United States Department of Housing and Urban Development, 2016b). Moreover, nearly one in two African-American and Hispanic homebuyers using a mortgage to purchase a home did so with an FHA-insured mortgage. This is a remarkable and significant shift from the early days of FHA when redlining and other racially discriminatory practices excluded people of color from attaining the dream of homeownership or otherwise securing safe and affordable housing, contributing to the devastation of many urban neighborhoods and substantially inhibiting wealth accumulation for minority families.

In addition to now being a central point of access to the American dream, especially for lower wealth, minority, and first-time homebuyers, FHA also serves to ensure liquidity to the housing market in all economic circumstances, and acts as a countercyclical force in periods of economic stress. Indeed, it has been noted that were it not for FHA, the recent housing crisis and economic recession would have been far deeper and more prolonged. While historically accounting for approximately 10 percent of U.S. single-family mortgage originations, in the lead up to the recession FHA loans comprised only approximately 2 percent of the nation's single-family mortgage originations. As the recession hit, however, that share ballooned to a peak of 24 percent as lenders and investors flocked to the stability of FHA's insured mortgage products. Moody's has estimated that absent FHA's activity from October 2010 through the end of 2011, home prices would have declined by an additional 25 percent, new and existing home sales would have fallen by an additional 40 percent, and new home construction would have declined by 60 percent. As a result, economists estimate that the economy would have contracted another 2 percent, resulting in the loss of 3 million more jobs and pushing the unemployment rate to nearly 12 percent (Quercia and Park, 2013).

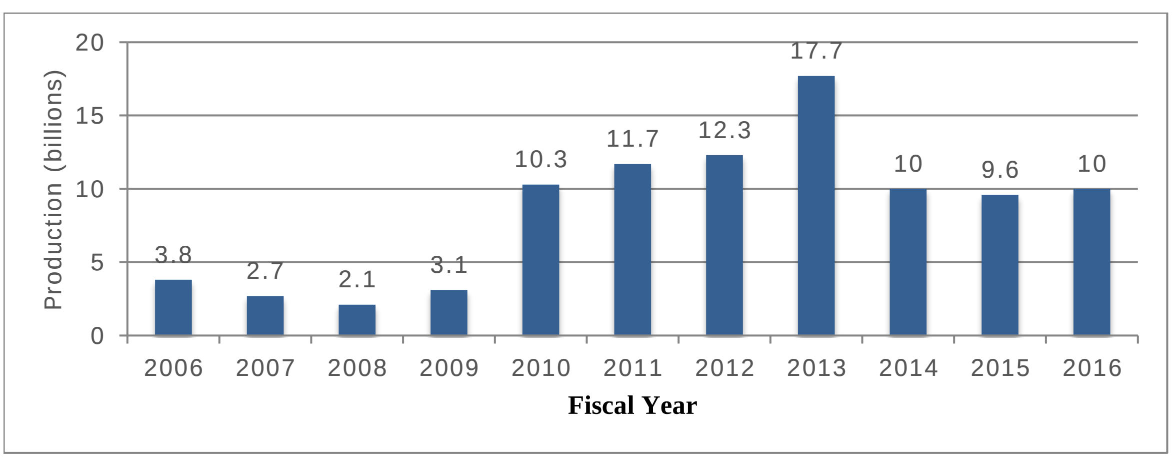
Figure 1: FHA Single-Family Forward Mortgage Endorsements



Source: United States Department of Housing and Urban Development

While the importance of FHA's role in providing access to credit for homeownership during the financial crisis cannot be overstated, FHA also provided a crucial lifeline to the nation's rental market during this period. A surge in new renter households resulting from the foreclosure crisis, along with customary household formation (albeit at a rate lower than normal), generated a significant demand for a limited stock of available rental housing. Meanwhile, private financing for multifamily construction was severely constricted. Just as it did for single-family financing, FHA acted as a countercyclical support to facilitate liquidity and enable developers and owners of rental properties to better meet this new market demand. In 2007, FHA insured just $2.6 billion of rental property financing, as private capital was plentiful. When the securitization market collapsed, this figure climbed to a high of nearly $17.1 billion (United States Department of Housing and Urban Development, 2016c). Today, FHA multifamily insurance continues to facilitate needed liquidity for the rental market at a more normalized rate, including providing a stable source of capital for affordable housing development and recapitalization of public housing in conjunction with HUD's Rental Assistance Demonstration Program.

Figure 2: Multifamily Endorsements



Source: United States Department of Housing and Urban Development

Principles Underlying a Proposal for Reform

What reforms are necessary to retool FHA and ensure its ability to perform in the housing market today and in the future? Before discussing a number of proposed actions, it is important to articulate the principles that should underpin this effort:

FHA must continue to focus its activity first and foremost on providing access to affordable mortgage credit for those households and communities that are underserved by the private mortgage finance market. Providing a critical pathway to homeownership and wealth creation for American families must continue to be at the core of FHA's mission and activity. Regardless of the ultimate state of the housing finance system that results from reforming the government-sponsored enterprises (GSEs)[1], history has shown that financing gaps will persist in the conventional lending marketplace, continuing to make FHA's programs vital to a fully functioning mortgage finance system. To preserve access and opportunity for the full spectrum of creditworthy borrowers, FHA must continue to make available mortgage products that offer:

- Low down payments
- Long-term fixed rate loans
- Mortgage insurance premium pricing that averages pricing across the full range of credit risk, and
- A 100 percent insurance guarantee backed by the full faith and credit of the United States Government.

These basic elements have served as the bedrock of FHA lending for decades and will continue to be essential to ensuring the availability of credit to lower-wealth households.

FHA must continue to be available as a countercyclical force in periods of economic stress. Whether in smaller regional events, like the oil patch crisis of the 1980s, or during broader and more sustained economic events, like the Great Recession, FHA has long been an important bulwark against the volatility of America's mortgage markets and has helped to mitigate the effects of disruption in the housing market and broader economy.

Serving as this countercyclical force and providing an appropriate flow of capital in a contracting market will require the continued and explicit backing of the federal government for FHA's insurance guarantee, as well as flexibility in program eligibility guidelines during periods of market disruption.

FHA must have the tools and resources to manage its risks while executing its role and mission in the housing finance system. As of FY 2016, FHA's Mutual Mortgage Insurance Fund (MMI Fund)[2] held nearly $1.2 trillion in insurance commitments (United

[1] For purposes of this paper, government-sponsored enterprises refer to the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac).

[2] The Mutual Mortgage Insurance Fund, or MMI Fund, is the primary insurance fund used to operate FHA's single-family mortgage insurance business. Premiums are retained in the MMI Fund, and claims associated with defaulted loans are paid from it.

States Department of Housing and Urban Development, 2016b). With a portfolio of this size, and in light of its important roles in the nation's housing finance system, FHA must be resourced and authorized to effectively operate its programs and protect taxpayers from risk. The Great Recession revealed substantial weaknesses in FHA's structure, systems, processes, and policies that inhibited optimal performance and increased risks and losses.

Recommendations to Better Equip FHA for its Role in the Nation's Housing Finance System

The Great Recession made clear that the 20th-century GSE model needs retooling to accommodate the risks and demands of a 21st-century housing market. The same is true for FHA. The rapid expansion of FHA's insurance portfolio amid the collapse of the private mortgage market, while important, also exposed inadequacies that impeded FHA's response, and increased risks to the taxpayer. At a time when FHA's role was crucial to an economy in freefall, it was operating with antiquated technology, outdated policies, challenging operational constraints, and significant staffing challenges. These realities had real costs – operationally and financially.

In spite of these obstacles, FHA leadership was able to make substantial improvements in the aftermath of the recession that made FHA more stable and efficient. It strengthened counterparty risk management in a number of ways, including through the creation of FHA's first ever Office of Risk Management; the introduction of alternative loss mitigation and property disposition strategies; and a host of other programmatic changes. And improvements have continued as FHA has consolidated its program guidance into a single comprehensive handbook, developed a new mechanism for systematically classifying defects in loan quality, and implemented new technology systems for lender approval and monitoring of loan quality.

While FHA and its leadership should be lauded for these critical enhancements, much work remains. The changes undertaken by FHA in the past decade were tantamount to emergency surgery that enabled FHA to continue operate in an impaired condition; the time has now come for a more comprehensive treatment of FHA's ailments that will promote more robust health and long term efficacy.

Some of the changes needed to better equip FHA for its role backing over a trillion dollars in mortgage loans can be made by FHA now under its existing authority. Others will require legislative action by Congress. We believe that the following recommendations, if adopted, would contribute significantly to making FHA more efficient and successful in delivering benefits to American households, as well as stability to the nation's economy.[3]

[3] While all three of FHA's mortgage insurance business lines are important to their respective sectors, our recommendations focus primarily on the single-family business line, as it is the largest and most vital component of FHA's support of the housing market.

1. Refined Targeting of FHA Lending

The eligibility parameters for FHA loans must ensure that lower-wealth, first-time, and/or minority borrowers – those generally less able to access conventional mortgage products – are the target of FHA's programs. Current eligibility parameters, product offerings and loan limits enable many individuals to use FHA programs who are capable of using conventional mortgage products, while those who truly need FHA programs are sometimes prevented from taking advantage of them. New program parameters which limit FHA's activity in periods of normal market conditions would better target those consumers who stand to benefit most from FHA products and prevent unnecessary competition with private capital sources.

FHA Loan Limit Methodology

FHA's current methodology for establishing loan limits produces a number of unintended consequences. Within many metropolitan areas, substantial variations in home prices sometimes result in FHA loan limits that preclude buyers from using FHA loans in certain parts of the region. Meanwhile, by virtue of their inclusion in the same metropolitan statistical area (MSA), some counties have loan limits that substantially exceed median home prices for that particular county. And in many higher cost areas, FHA's loan limits mirror conventional limits, enabling borrowers with higher incomes who could otherwise utilize conventional financing to choose FHA instead.

For example, the current maximum FHA loan limit for the Denver-Aurora MSA is $493,350, which mirrors the conventional loan limit for the region. However, there is substantial variation in home values within the MSA. According to sales data from Trulia for May to August 2017 (Trulia.com, 2017), the median sale price for a home in the 80209 zip code in Denver County was approximately $735,000. In contrast, the median sale price for zip code 80011 in neighboring Adams County, also in the Denver-Aurora MSA, was only $276,500. Thus, a homebuyer in the 80011 zip code could utilize an FHA-insured mortgage to purchase a home that far exceeds the median price for that market, yet a homebuyer in 80209 would be constrained from accessing an FHA loan for homes far below the median home price.

To better target FHA programs to lower-wealth households, FHA loan limits should be established according to the median home price in a population-based geographic jurisdiction. For example, in more densely populated urban locales, a particular loan limit may only encompass a specific zip code or census tract, while in less densely populated locations, county level data might remain appropriate and would continue to be utilized. Using the aforementioned example of price variations in the Denver-Aurora MSA, the two zip codes mentioned would have different FHA loan limits, with the higher cost zip code still utilizing the maximum FHA loan limit for the area while the lower cost zip code would have a lower maximum FHA loan limit. With the technology and data analytics available today, FHA could be authorized to develop a more refined methodology to more precisely manage the risks of insuring loans (whether at the zip code or some other delineation of market geography).

Loan Limit Maximums

In addition to more precise targeting, FHA's loan limit methodology should also be revised so that limits are set at 100 percent of the area median home price for a particular geographic location rather than the 115 percent that is presently utilized. The floor for FHA's loan limits would remain at 65 percent of the national conforming loan limit. This change would ensure that FHA's programs are truly targeted to the entry level market, yielding the financing of properties with prices that exceed area median values to the conventional market.

Revising FHA's loan limit methodology via the usage of greater geographic granularity and establishing a maximum loan limit of 100 percent of a jurisdiction's median sales price would address a host of unintended consequences that arise from FHA's current approach. It would shift lending for many higher-wealth households back to private capital sources, which are well equipped to serve this market, and would prevent instances where homebuyers are able to utilize FHA-insured financing to purchase homes that far exceed median home prices for a respective area. In short, our proposed approach for FHA's loan limits better aligns with FHA's mission to serve lower-wealth homebuyers and shifts more risk away from American taxpayers to the private sector.

Restricting FHA's Product Offerings

FHA currently offers programs that permit non-FHA borrowers to refinance into an FHA-insured mortgage. To better target the usage of its programs, FHA's product offerings should be restricted *only to purchase mortgages and refinances of existing FHA mortgages*. This would leave the balance of the refinance market to private lenders, reducing unnecessary competition for refinance business and once again shifting risk away from U.S. taxpayers. In FY 2016, the elimination of conventional-to-FHA refinances would have shifted approximately 107,000 loans to the conventional market (United States Department of Housing and Urban Development, 2016b).

It should be noted that while more precise targeting of FHA lending activity is important under normal economic conditions - when mortgage markets are healthy and functioning well - exceptions to these parameters could be made available in periods of substantial economic decline or market disruption. The conditions under which, and the process by which, FHA could make this type of temporary adjustment are described later in this paper.

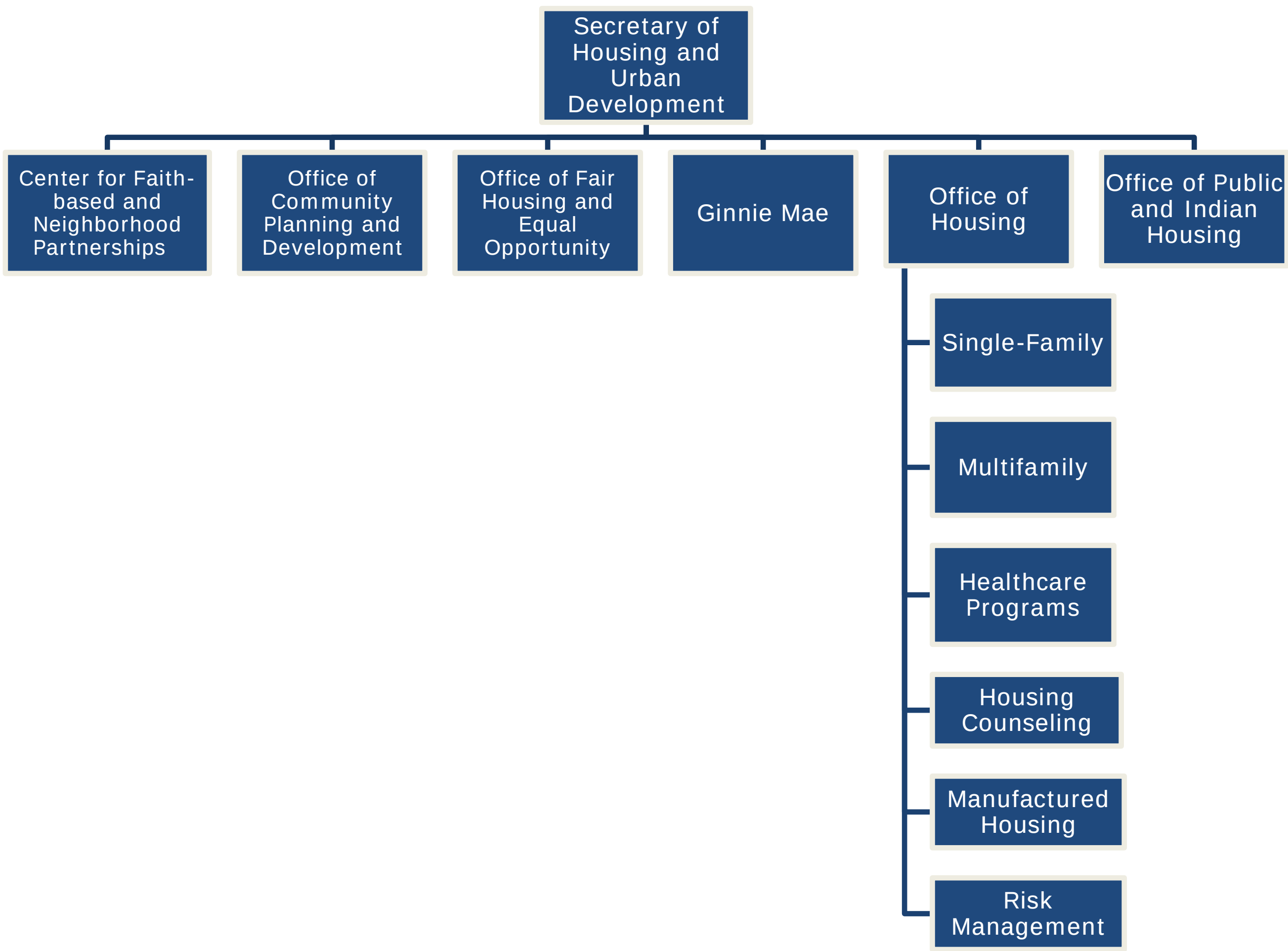
2. Structural Changes

A number of structural changes are critically necessary to address FHA's risk management, operational efficiency, and overall program effectiveness. Absent such changes, FHA will remain vulnerable to fraud and program abuse and will struggle to adequately identify and analyze program risks that threaten consumers and taxpayers. FHA must be properly structured and equipped to deliver its programs and services safely and effectively within an increasingly complex financial services market.

Government Corporation Status

Although FHA was established decades before HUD was created and is legally constituted as a government corporation, practically speaking, FHA functions as an office of HUD. As a result, it has only limited control over its goals and activities, which impedes its ability to nimbly adapt and respond to shifting market conditions and opportunities.

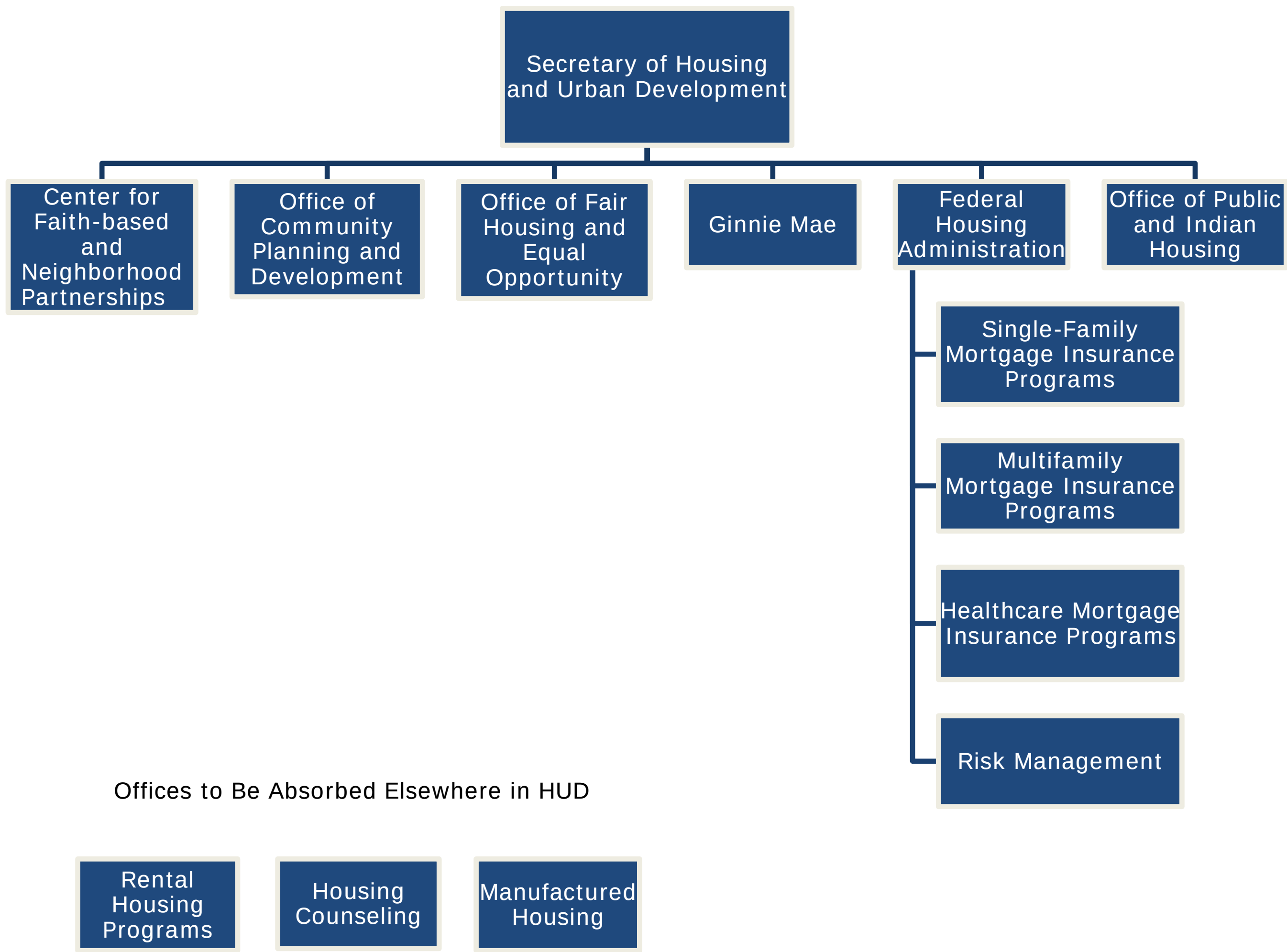
Figure 3: Current Structure of HUD Program Offices*



*Excludes HUD administrative offices.

While FHA would formally remain within HUD and would continue to report to the HUD Secretary with regard to oversight of its programs and activities, it should be granted much greater independence with regard to its budget and operations. Such autonomy would position FHA to obtain and utilize new resources and flexibilities (to be discussed later in this paper) while still enabling it to contribute to HUD’s broader housing objectives. FHA would retain all existing mortgage insurance programs, and would maintain for its products the full faith and credit of the United States government, and mandatory appropriation authority to ensure that it can continue to respond in periods of economic disruption. All of FHA’s core single-family, multifamily, and healthcare mortgage finance programs would be included in this new entity.

Figure 4: New Proposed Structure of HUD and FHA



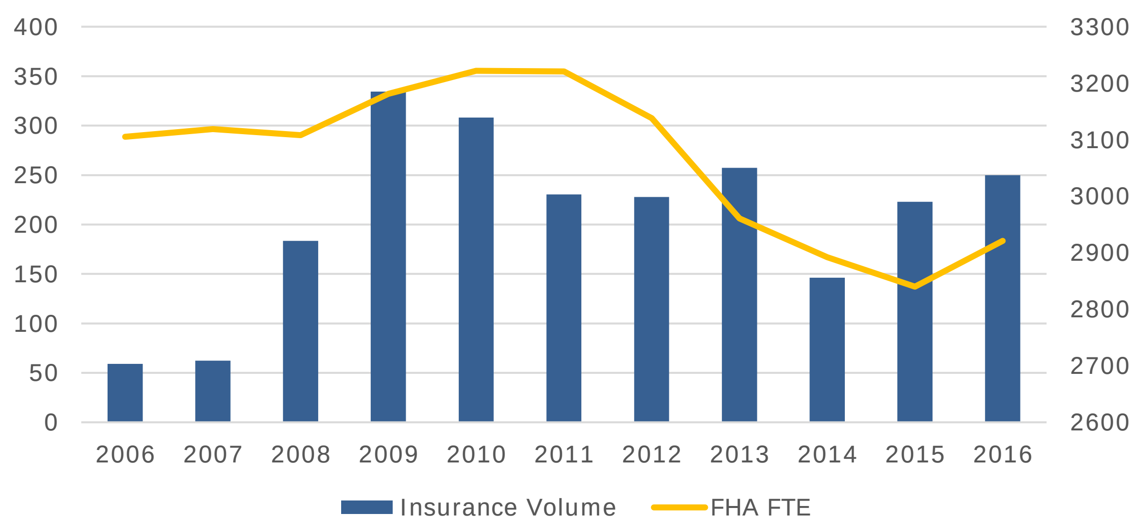
The remainder of the programs currently residing in HUD's Office of Housing, including HUD's Housing Counseling and Manufactured Housing programs, would be absorbed into other offices of HUD. The largest subset of remaining programs which presently reside in HUD's Office of Housing – the rental subsidy programs – would be included in a new Office of Rental Housing that would have oversight over all HUD rental programs, including public housing, housing vouchers, and Project Based Rental Assistance.

This restructuring would permit FHA to focus on mortgage finance programs while better aligning policies, procedures and resources with other HUD programs. Depending on the ultimate positioning of Ginnie Mae resulting from housing finance reform, FHA could also potentially be partnered with Ginnie Mae to create a comprehensive entity focused on the government's support of the mortgage finance system. This consolidation would also serve to align policies and procedures between FHA and Ginnie Mae that would maximize efficiencies and impact for the two organizations. As these structural changes are undertaken at HUD, Congress might also consider additional opportunities for consolidation of federal government mortgage guarantee programs, which would further contribute to increased efficiency and effectiveness in the delivery of government mortgage products.

3. Budget Flexibility

FHA generates profits for the government that substantially exceed its costs. In spite of this, HUD still oversees utilization of those resources. While FHA personnel comprise approximately 35 percent of all HUD staff, and a significant portion of non-FHA staff exist to support FHA and its programs, FHA lacks control over both its budget and the support services upon which it relies. As part of the broader HUD budget, FHA's budget is subject to the federal appropriations process and its receipts (revenue) are not retained by the agency and cannot be used to cover administrative expenses, but are instead utilized as budget offsets for other federal programs. Despite the size and complexity of its profitable enterprise, FHA must compete for funding with HUD subsidy and grant programs for even the most basic of operational resources, including those for personnel, information technology, and procurement. In addition, appropriated funds are not necessarily commensurate with FHA's activity. During and after the Great Recession, while FHA's lending volume and activity increased dramatically, its budget and staffing actually declined.

Figure 5: Comparison of Insurance Volume and Staffing Levels at FHA 2006-2016



Source: United States Department of Housing and Urban Development

To better meet its budget needs, we propose that FHA receive a baseline appropriation, which is supplemented by retention of a portion of the revenue generated from its mortgage insurance activities. Such an approach to FHA's budget would ensure that FHA has adequate funding in periods of both low and high loan volume, and would offer greater certainty and stability with regard to the funds available to manage its activities.

Due to its unique role in the market, FHA experiences substantial fluctuations in its insurance activity in short periods of time. However, a substantial portion of its costs, including information technology, employee salaries, and contracting expenses, are fixed and cannot be easily reduced in periods when the private market is robust and FHA loan volumes are low. A baseline appropriation for salaries and expenses, administrative costs, and information technology – indexed for inflation – would provide the resources necessary for FHA to remain operational regardless of changes in insurance activity resulting from market cyclicality. And, when FHA insurance volume increases in periods of private market constriction, the ability to retain portions of its insurance premium revenue to self-fund expanded operational and risk management activities would ensure that FHA is able to execute its countercyclical role safely, responsibly, and with efficacy. *Although a growth in expenditures to accord with expanded production is a standard strategic business practice, the current structure of the FHA budget prevents it from utilizing this customary approach to managing production increases*.

In the President's FY 2018 budget request, FHA's total budget request for salaries and expenses and administrative contracts is approximately $530 million.[4] Under our proposal, this appropriation could be cut in half to approximately $265 million.[5] The remaining resources needed for FHA's operations would be funded by retaining a portion of the receipts FHA generates from mortgage insurance premiums. From FY 2012 to FY 2016, FHA averaged mortgage insurance premium revenue of $11.3 billion per year. Our proposal would require FHA to retain *less than three percent* of its revenues to fully fund its operations at levels commensurate with its staffing, procurement and information technology needs. In addition to this new budget methodology, both FHA's appropriated and self-generated funds should be separated from the rest of the HUD budget so that it can be assured that all funds remain under its control and are not used as budgetary resources or offsets for other HUD programs.

The President's FY 2018 budget anticipates fiscal year profits from FHA's insurance activities of $7.1 billion for FY 2018. Using this revised budget methodology, FHA would still provide approximately $6.8 billion in profits to the government that could be used to offset other federal expenditures while obtaining substantially greater control of the finances used to operate its programs.

With regard to the baseline for appropriated funds, FHA should conduct an analysis of its needs over time to determine the recommended amount, as well as the appropriate benchmark for use in calculating inflation to the baseline. These recommendations and their justification should be provided to Congress to inform its ultimate determination of FHA's budget methodology and funding.

4. Capital Reserves

The recent recession made obvious that FHA's current statutory capital reserve methodology has little logical relevance to its actual insurance activities. For example, at the end of FY 2007, FHA's capital reserve ratio stood at a seemingly robust 6.4 percent. However just five years later this ratio fell to *negative* 1.44 percent. While higher than

[4] This figure includes FHA's request to charge an administrative fee to lenders, which is anticipated to yield an additional $30 million in resources for FHA beyond those funds appropriated by Congress.

[5] For purposes of discussion, this example simply assumes that FHA's appropriation is halved. The precise level of FHA's baseline appropriation versus its percentage of retained receipts should be examined in greater detail by FHA.

expected losses on FHA's insured books of business during the recessionary period were part of the problem, the capital reserve methodology exacerbated those miscalculations and increased the instability of FHA's Mutual Mortgage Insurance Fund.

Even the policymakers who initially enacted FHA's two-percent capital reserve ratio requirement knew that it would only be sufficient to weather a moderate recession. And the seemingly arbitrary standard of a two-percent ratio does not adequately account for fluctuations in business activity and the economy. In its 2015 Annual Report to Congress Regarding the Financial Status of the Mutual Mortgage Insurance Fund, FHA stated that under stress scenarios created by its actuary, it projected that to withstand losses resulting from the Great Recession the MMI Fund would have needed an additional $30 billion, equivalent to a three percent capital reserve ratio. Further, FHA also stated, "While achieving the two percent capital ratio target represents a crucial milestone for FHA, managing the Fund goes beyond achieving a minimum capital ratio at a particular point in time. Prudent risk management practice should overlay the statutory capital requirement with a risk management approach that would take into account the health of the economy, and implications of the sensitivity of the fund to small changes in interest rates" (U.S. Department of Housing and Urban Development, 2015).

By FHA's own assessment, the current capital reserve methodology is seriously flawed. Therefore, Congress should direct FHA to examine its historical loan performance and capital reserve levels to establish a new standard for FHA's capital reserves.

Separating Reserves for Forward and Reverse Mortgage Programs

FHA's Mutual Mortgage Insurance Fund (MMI Fund) is used for both its forward mortgage program (traditional home purchase and refinance mortgage loans) and reverse mortgage program (a program for elderly homeowners to draw down the equity in their home for other expenses). In recent years, FHA's reverse mortgage program - the Home Equity Conversion Mortgage (HECM) program - has experienced vast fluctuations in its performance and actuarial valuation. This has yielded an outsized impact on FHA's capital reserve ratio. As of FY 2016, the HECM portfolio stood at $111.9 billion, roughly 10 percent of the $1 trillion forward mortgage portfolio. However, while FHA's actuary stated that the forward mortgage program had a positive valuation of $35.2 billion as of FY 2016, the HECM program was valued at *negative* $7.7 billion, reducing the overall value of the Fund to $27.5 billion. The forward program alone would have had a capital reserve ratio of 3.28 percent, but due to the negative impact of the HECM program the ratio fell to 2.32 percent for the combined programs.

While there is certainly merit for assisting America's burgeoning population of senior citizens to age in place using the equity they have earned through homeownership, that effort is very distinct from the mission of FHA's forward mortgage program to make homeownership possible for lower-wealth homebuyers. Moreover, forward and reverse mortgages are very different products with substantially different risk profiles and budgetary needs. As such, the insurance funds and capital reserves of the two programs should be separated. Doing so will clarify the respective performance and risk of each program, and will require both to stand alone with regard to their results. And it will eliminate situations in which one program is unduly disadvantaged by the poor performance of the other, or conversely, one program's poor results are masked by the stronger performance of the other.

Greater Flexibility with Regard to Loss Mitigation and Use of Operating Capital

At present, the requirements and practices for loan servicing and property disposition for delinquent and defaulted FHA-insured mortgages prevent FHA from achieving best execution in its efforts to protect and preserve the MMI Fund. For example, FHA's requirements governing loan modifications for distressed borrowers are more restrictive than those employed by the conventional market, limiting FHA's ability to utilize loan modifications to avoid foreclosures, ultimately yielding greater losses for FHA. Additionally, FHA's rigid processes for handling defaulted loans limit opportunities to assign properties to FHA quickly, again resulting in higher losses for FHA. FHA should be given greater flexibility in the approaches it uses for loan workouts and recovery strategies, and FHA leadership should have the ability to deploy working capital resources in ways they deem most effective for minimizing losses.

5. Operational Flexibility

Minimize Red Tape to Enhance Operations and Risk Management

FHA is subject to a substantial and disproportionate amount of government red tape. Of the fifteen federal statutes from which government corporations may potentially be exempted, FHA is currently statutorily exempted from only one. In contrast, the Federal Deposit Insurance Corporation (FDIC) is fully exempted from six of the statutes, and partially exempted from five others. And the National Credit Union Administration is likewise exempted from six of the statutes (United States General Accounting Office, 1995). Such exemptions provide these entities with substantially more control over their business operations and procurement, and were intended to provide them with the flexibility necessary to effectively execute their unique government roles in finance markets. With that same objective in mind, FHA should be exempted from the Federal Property and Administrative Services Act, specifically, which dictates contracting requirements for government agencies, and portions of Title 5 of the U.S. Code[6], which prescribe employee classifications and pay rates for government agencies.

Higher Pay Scale for FHA Employees

As a part of HUD, FHA uses the General Schedule pay system for its employee compensation. However, several government entities with regulatory and operational responsibilities similar to FHA (such as the Federal Housing Finance Agency (FHFA), Consumer Financial Protection Bureau (CFPB), Federal Deposit Insurance Commission (FDIC), and National Credit Union Administration (NCUA) utilize distinct and more competitive compensation plans with higher salary offerings.[7] FHA is consequentially at a

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[6] 5 U.S.C. § 5101-5115 and 5 U.S.C. 5331-5338
[7] This is permitted by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

distinct disadvantage in recruitment for high caliber financial services and risk management human capital. This is particularly true with regard to senior level leadership and financial and risk management positions. For example, a senior leader at the FDIC can earn a salary that is over $100,000 higher than that of a comparable official at FHA. To properly steward the significant taxpayer investment that FHA represents, it must be able to attract and retain top tier industry talent and expertise.

6. Emergency Powers Authority

During the financial crisis, federal rulemaking requirements could not keep pace with the speed of change that FHA and the economy were experiencing. Although the need for specific policy changes was often abundantly clear, FHA could not enact them before substantial additional costs were incurred. This was illustrated in the seller-funded down-payment assistance program. Under this program, sellers were permitted to provide a buyer's required down-payment for an FHA-insured mortgage. As a result, property prices were frequently inflated to accommodate the cost of the down-payment, and buyers without sufficient resources were enabled to become homeowners – with FHA bearing the resultant risk from a buyer's default on a mortgage that exceeded a property's true value. FHA identified the risk and potential for losses associated with this program, but was prevented from promptly responding to protect its insurance fund. Ultimately, losses to the MMI Fund from loans utilizing seller-funded down-payment assistance totaled approximately $17 billion.

FHA should be granted emergency powers authority that enable it to immediately address identified needs and risks which arise in periods of distress, to be triggered under the following circumstances:

- When the capital reserves of FHA's insurance funds decline to a level below mandated limits; or
- When the continuation of a program under current program parameters exposes FHA's insurance funds to an elevated risk of loss to such an extent that the program fails to serve the public interest; or
- When there is significant evidence that changes to FHA programs would help stabilize a highly unstable housing market.

Under the emergency powers, FHA would be able to:

- Suspend FHA insurance programs or make emergency modifications to regulations governing such programs (at the discretion of the Commissioner);
- Receive an exemption from the Federal Acquisition Regulation (FAR)[8], which would enable it to more easily enter into contracts to expand consulting, research, and operational capabilities, and/or mitigate risk.

[8] The FAR is distinct from the contracting requirements of the Federal Property and Administrative Services Act, from which it was recommended previously that FHA be exempted under its new standard flexibilities as a reconstituted government corporation.

The scope and duration of FHA's emergency powers authority would be limited. Actions deemed necessary by the Commissioner would be implemented 10 calendar days after provision of notice to Congress. Further, any actions undertaken via emergency powers authority would sunset within 18 months of implementation unless codified via regulation or extended with the consent of Congress.

7. Non-Legislative Policy Changes

In addition to the changes to FHA's structure and authority that require Congressional action, there are a number of policy and programmatic reforms that FHA can undertake autonomously. In particular, building on the success of its development of a loan defect taxonomy and Loan Review System, FHA must address the remaining ambiguity and uncertainty with regard to lender liability for errors in the origination of FHA loans. FHA's policies and practices must ensure accountability while also offering clarity and certainty to lenders with regard to loan compliance and liability.

Additionally, FHA should publish permanent updated requirements for condominium properties, providing much-needed transparency and consistency with regard to its policies governing loans for such properties. And it should fully examine its loss mitigation and property disposition policies and procedures to identify opportunities to improve and streamline these programs.

To formulate an agenda for modernization and change, FHA should engage in a strategic planning process that 1) articulates the obstacles it currently faces in executing its mission, 2) lays out solutions to those obstacles, and 3) identifies emerging opportunities to further expand access to safe, quality, and affordable housing. The plan should conduct a comprehensive examination of FHA's policies and procedures throughout the mortgage lending lifecycle – from origination to servicing and loss mitigation – to identify antiquated and/or problematic regulations and practices that do not comport with contemporary regulatory and industry best practices.

Conclusion

FHA has become a central component of making the American dream attainable for lower-wealth, first-time, and/or minority households. Whether by enabling wealth creation through homeownership or facilitating the availability of safe and affordable rental housing, FHA is vital to maintaining access and continuity in the nation's housing finance market. Its ability to counter the cycles of disruption and distress in mortgage markets has proven crucial to stabilizing the U.S. economy. As such, as policymakers debate the future of the nation's housing finance system, it is essential that they carefully consider the changes necessary to ensure that FHA is capable of carrying out its unique and important role in the housing market.

Adopting the changes recommended in this paper would equip FHA with the flexibility, tools, talent, and resources necessary to become more efficient and effective in delivering its existing programs and to reemerge as an innovative partner in the development of new approaches to addressing emerging needs and opportunities in the housing market. For example, FHA could spearhead strategies to develop a lease-purchase product to serve borrowers not yet qualified for homeownership, or develop new shared equity models to address affordability challenges in areas with high home values, or create a new financing products for the acquisition and/or preservation of single-family rental homes.

If FHA is to continue performing its critical roles, it must be retooled for the challenges and opportunities it faces today, and will continue to face in the future. The time has passed for tinkering around the margins of FHA's diminished capacity. We know it's time for a new housing finance system; it's also time for a new FHA.

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