# TESTIMONY

# Modernization of Federal Housing Administration Programs

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It is an honor to appear again before this Committee to testify on proposed reforms for the Federal Housing Administration (FHA) single family mortgage insurance program. I am Basil N. Petrou, managing partner of Federal Financial Analytics, a firm which provides consulting services on, among other things, the array of policy issues affecting residential finance. As a result, we are deeply involved in the issues raised by the subprime crisis, and I would like today to put my FHA testimony in the broader context of events shaking not only mortgage lenders and investors, but also – most importantly – borrowers.

These events are, I believe, a critical, if sadly overdue, reminder of the vital importance of focusing not just on homeownership per se. This is often called the American Dream, but it's a nightmare for homeowners and their communities unless homeownership is promoted in a way that enhances long-term homeownership and neighborhood stability. Sadly, the last few years have seen a rush not only of new mortgages that put first-time homeowners at undue risk, but also loan products that put long-time homeowners in danger of losing their homes because of refinancing structures that at best were speculative and, at worst, predatory. To the degree FHA changes its product offerings, it must do so in the context of broader reforms to the mortgage-origination and securitization process, as well as alongside significant improvements in the infrastructure of FHA.

I recognize that the Administration believes its proposed reforms will help subprime borrowers now facing delinquency or foreclosure. This is a worthy policy objective and it is, I think, an appropriate role for government to play if private-sector mortgage options are not suitable for these borrowers. However, we need to remember that the FHA has a long history of being abused by disreputable lenders and that fraud remains a serious problem for the FHA single family program.[1]

Thus, today I would like to propose the following policy for the Committee's consideration:

- FHA reform should follow, not precede, long-overdue reforms to the mortgage-origination process. This Committee has rightly called on the federal banking agencies to take stern and strong action, and new standards are, as a result, emerging.[2] Recent action by the Office of Federal Housing Enterprise Oversight (OFHEO) – the regulator of Fannie Mae and Freddie Mac -- will help to ensure that all lenders – not just federally-regulated ones – comply with these enhanced origination standards.[3] However, there is much more to do with regard to improved origination, as legislation before this Congress makes clear. If FHA reforms are enacted ahead of these reforms, originators will have still greater incentives than before – a new federal guarantee atop fees that encourage poor practice – to put borrowers in unsuitable mortgages at risk to them and their communities.

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[1] Indeed, the most recent HUD IG report covering the past six months of FHA operations highlights successful fraud investigations where FHA faces potential or realized losses of over $120 million. See the *U.S. Department of Housing and Urban Development, Office of the Inspector General, Semiannual Report to Congress, October 1, 2006 through March 31, 2007, pp. 13-29.*

[2] See *Interagency Guidance on Nontraditional Mortgage Products Risk*, October 4, 2006. See also, *Statement on Subprime Mortgage Lending*, June 29, 2007.

- Further, program reforms must be conducted not only in tandem with broad market reform, but also after changes within the FHA. This Committee is all too familiar with presentations that suggest risk control problems are being addressed, only to discover a year or so down the road that this in fact was not the case. Promises aren't enough; performance is all that counts to prevent long-term taxpayer risk. In this regard, the HUD Inspector General has noted that the FHA modernization legislative package proposed by the Administration could bring higher default and foreclosure risks and will require FHA system modifications and impose new administrative and cost burdens on originating and servicing lenders.[4] The FHA must and should satisfy its Inspector-General and the General Accountability Office (GAO) before being allowed into new ventures with untold risk.

- That there is risk is clear from current market turmoil. Simple dependence on underwriting factors like a credit score or third-party rating is no protection from significant credit risk. If FHA offers high-risk mortgage products – those with no downpayment, for example – it must do so with state-of-the-art internal controls built in advance, tested beforehand and validated by expert third parties like GAO.

- Finally, in crafting its reform, FHA should focus on truly underserved borrowers who, if helped through the government's programs, can buy a home and stay in it. Looking solely at "market-share" – as FHA did when it first proposed these

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[3] *Statement of OFHEO Director James B. Lockhart on Issuance of Letters by Fannie Mae and Freddie Mac Regarding Nontraditional and Subprime Mortgage Products*, July 13, 2007.

changes – is not only the wrong approach for the federal government, but also one that could put the FHA alongside some other market players who favor their own self-interest ahead of borrowers. Backed by a full-faith-and-credit guarantee from the U.S. Government, the FHA and investors in its mortgages operate without effective market discipline regarding credit risk, so Congress should ensure that the program is effectively controlled by defined policy objectives in a rigorous governance process.

The two GAO reports[5] presented to this Committee today include many important findings and recommendations. I would like among these to point to one that may be overlooked. Much in the FHA-reform proposal is aimed at assisting moderate-income borrowers. However, the GAO analysis points to a significant risk for moderate-income minority borrowers. In analyzing the proposed new premium structure, GAO found that, in fact, 72% of African-American borrowers either would pay more under the plan or be denied FHA insurance in contrast to the FHA's current program.[6] GAO rightly recommends that HUD implement FHA reforms in a cautious way to monitor risk and borrower impact to avert widespread, unintended consequences.

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[4] Ibid., pp.144-145. See also, *Statement of Kenneth M. Donohue before the Committee on Appropriations, Subcommittee on Transportation, Housing and Urban Development, and Related Agencies, United States Senate*, March 15, 2007.
[5] GAO-07-645, Federal Housing Administration, *Decline in the Agency's Market Share Was Associated with Product and Process Developments of Other Mortgage Market Participants*, June 2007; GAO-07-708, Federal Housing Administration, *Modernization Proposals Would Have Program and Budget Implications and Require Continued Improvements in Risk Management*, June 2007.
[6] GAO-07-708, Federal Housing Administration, *Modernization Proposals Would Have Program and Budget Implications and Require Continued Improvements in Risk Management*, June 2007.P.20,Fig.4.

## FHA Reform Under Current Market Conditions

I last testified before this Committee on FHA reform on June 20, 2006.[7] At that time, I argued for caution in part because of emerging trends in the national mortgage market I thought deeply disturbing. High-risk mortgage structures – for example, certain hybrid adjustable-rate mortgages – were a ticking time bomb. Now, the time bomb has gone off and we are facing sharply rising foreclosures alongside significant risk for the financial system. SEC Chairman Cox recently commented that the problems created by the Bear Stearns hedge-fund collapse posed systemic risk, although none has in fact materialized so far. That is, to be sure, cold comfort as losses mount and the problems with complex financial instruments depending on untested rating-agency models unfold.

In September of last year, Chairman Shelby called on the banking agencies quickly to finalize guidance on non-traditional mortgages (NTMs), and they finally did so that October.[8] Under Chairman Dodd's leadership, this Committee has continued to press the federal banking agencies to protect borrowers and stabilize the residential-finance system. This has led to the Federal Reserve's ongoing review of the subprime mortgage market and inter-agency action in late June on tough new standards governing subprime hybrid adjustable-rate mortgages.[9]

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[7] *Testimony of Basil N. Petrou before the Housing and Transportation Subcommittee, Committee on Banking, Housing and Urban Affairs, United States Senate, June 20, 2006.*

[8] *Interagency Guidance on Nontraditional Mortgage Products Risk*, October 4, 2006, 71 FR 192, pp. 58672-58678.

[9] *Statement on Subprime Mortgage Lending*, June 29, 2007. http://www.occ.treas.gov/ftp/release/2007-64.htm

A critical problem here is, however, the degree to which such standards protect all borrowers. Last week, OFHEO took a major step in ensuring that federal bank standards protect all borrowers. Going forward, Fannie Mae and Freddie Mac will require all lenders from whom they purchase loans to meet the NTM standards and it is likely they will soon follow through and similarly implement the subprime standards.

All of these actions are an important first step to helping troubled borrowers now and preventing predatory lending going forward. They are not, however, enough. Indeed, if the FHA launches new products in the absence of broader market reform, risks and abuses only now being addressed in the private market could migrate to the FHA.

Much testimony before this Committee has focused on why so many borrowers were put in so short a period of time over the past two or three years in high-risk mortgages. FDIC Chairman Bair has, for example, commented in depth on the incentive problem. That is, too many players – starting with the mortgage broker – have "no skin in the game." At each stage, a loan is offered, made, securitized and then structured into a mortgage-backed security or collateralized debt obligation. Somehow, everyone thought all of this could be done without credit risk – in other words, even the riskiest borrowers could be put in mortgages that ate up every dollar of home equity without a real risk of loss. The ratings agencies, for example, have rated securitized subprime mortgages as if 80% of the securities could be seen as AAA – the same as a Treasury obligation even though this is of course far from the correct risk parallel.

As risk is now coming home to roost in the private mortgage loan market, originators and securitizers are remembering hard lessons either on their own or with the help of their regulators and the market is beginning to correct itself.  Now, put the FHA into this picture.  If it offers the array of new products it proposes, brokers will have some new arrows in their quiver with the same fee-based incentives to get as many borrowers into as many mortgages they can as quickly as possible.  This time, though, there will be no private-sector controls, because all of the FHA's mortgages go out the door in a Ginnie Mae mortgage-backed security with a full-faith-and-credit stamp from the U.S. Government.

Letting this program loose in the absence of broad reform of the origination market is, I believe, a dangerous proposition.  FHA can and should help troubled subprime borrowers now, and a modified version of its current program is well designed to do so.  If FHA suddenly goes nationwide with high-risk products in a period of sinking house prices, brokers and other originators will rush to the FHA's door as others are rightly closed to them.  The FHA "market-share" gains previously sought by the Administration will come, at considerable long-term cost to the Treasury and to homeowners who could still be placed in high-risk mortgages – albeit this time perhaps taking even less care to understand the mortgage because it comes with a stamp from the U. S. Government.

Additionally, the FHA single family program today is in a financial condition which leaves no room for error in the nationwide implementation of either new products or a risk-based premium as currently proposed. The current FHA single family program no longer generates a budget benefit to the government. Despite the anticipated increase in loan volume for the FHA single family program "CBO estimates that no additional offsetting collections would be realized because [they] expect the subsidy rate for the single-family program to be zero over the next five years."[10] Whereas in the past the FHA single family program had generated budget benefits (i.e., a negative subsidy) and essentially paid for itself, now it is assumed to be, at best, break-even for the next five years. GAO goes one step farther and notes that, because "FHA has consistently underestimated its subsidy costs, FHA runs some risk of missing its target and requiring a positive subsidy."[11] If a mistake is made in changing the single family program or in implementing a proposed Congressional change to the program, then, for the first time, Congress will have to appropriate funds to keep FHA afloat.

Also, it is clear that FHA is not yet ready successfully to implement the reform it proposes. GAO found that the Administration's proposals for changing FHA "present risks and challenges and should be viewed with caution…"[12] and that "weaknesses in FHA's risk management raise questions about the agency's ability to successfully implement the proposed legislation."[13] Furthermore, FHA has not used "the risk-management tools already at its disposal to mitigate adverse loan performance that has had a detrimental impact on the Fund."[14] In light of these weaknesses, GAO recommends

[10] *Congressional Budget Office Cost Estimate, H.R. 1852, Expanding American Homeownership Act of 2007*, June 11, 2007., p.10.
[11] GAO-07-708, Federal Housing Administration, *Modernization Proposals Would Have Program and Budget Implications and Require Continued Improvements in Risk Management*, June 2007, p.40.
[12] Ibid.
[13] Ibid. p.2.
[14] Ibid.. p.40.

that Congress "consider requiring FHA to limit the initial availability of any new products..."[15] and notes that "piloting or otherwise limiting the availability of new products would allow FHA the time to learn more about the performance of these loans and could help avoid unanticipated insurance claims."[16] However, FHA management refuses to do so. "[W]hile other mortgage institutions use pilot programs to manage risks associated with changing or expanding their product lines, FHA has indicated that it does not plan to pilot any zero-downpayment product it is authorized to offer and lacks the resources to do so."[17] Surprisingly, FHA cites as sufficient history for dealing with a zero-downpayment product its experience with the downpayment assistance program.[18] However, the HUD Inspector General's office recently testified that the cumulative claim rates for this program exceed 15%.[19] FHA now is planning to shut the program down. How can Congress be sure that the problems that plagued the downpayment assistance program will not be replayed and augmented in FHA's new concept of a zero-downpayment product?

Perhaps most importantly, the implementation of an FHA risk-based premium closely tied to the borrower's credit score runs the risk of dramatically altering which families are served by the FHA single family program. FHA's proposed risk-based premium would disproportionately harm minority borrowers. GAO found that 57% of all borrowers who got an FHA loan in 2005 would either be charged a higher premium or be

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[15] Ibid.
[16] Ibid..
[17] Ibid.
[18] Ibid., p.49, Letter from FHA Commissioner Montgomery (p.2.).
[19] See *Statement of James A. Heist, Assistant Inspector General for Audit, Department of Housing and Urban Development, Before the Subcommittee on Housing and Community Opportunity, Committee on Financial Services, United States House of Representatives,* June 22, 2007, p.6, Exhibit IV-10.

denied an FHA loan had the risk-based premium now advocated by FHA been in effect. GAO also found that the burden of paying more for an FHA loan or not qualifying for an FHA loan would fall disproportionately on minorities. It found that 72% of African-American borrowers and 59% of Hispanic borrowers would either be charged a higher premium or denied a loan altogether under FHA's risk-based premium proposal. Indeed, while 18% of White borrowers would not qualify for an FHA loan using the new premiums, almost twice as many African-American borrowers (32%) would no longer be served by FHA.[20]

Additionally, giving FHA authority to replace its current premium structure with a credit-score focused risk-based premium is a very risky proposition. The GAO report reconfirms that FHA does not yet have the necessary data or analytical capability to establish a successful credit-score based risk-based premium using FHA's loan performance models and its TOTAL scorecard.[21] A mispriced FHA premium structure would be devastating to the single family insurance Fund and the borrowers it was meant to serve.

Finally, as the mortgage markets begin to enter a cycle of pricing stress, more factors than the borrower's initial credit score must be taken into account if FHA wants to protect its insurance fund. Credit scores were never a substitute for careful underwriting during the best of times and are far less reliable during periods of market stress. Historical experience and current experience in the subprime and non-traditional

[20] GAO-07-708, Op.Cit.,p.20 Figure 4.
[21] Ibid., pp.25-26.

mortgage arena show clearly that credit scores are not reliable predictors of probability of default, loss-given-default and unexpected loss under stress conditions.[22] Institutions that over-relied on credit scores in underwriting their recent mortgage books have experienced painful and costly surprises. As an executive of a subprime lending operation of a major commercial bank was quoted as saying, “What is now clear is that FICO scores are less effective or ineffective when lenders are granting loans in an unusually low interest-rate environment.”[23]

**Specific Recommendations for Reforming the FHA Program**

Given the importance of getting reform of the FHA single family insurance program right on the first try, I suggest several initial changes be made to be followed by separate major changes to assure that FHA will continue over the long term to serve the borrowers who cannot be served by the private sector while still assuring that the financial status of the insurance fund is not put in jeopardy:

- Eliminating the 3% minimum downpayment requirement must be carefully structured to prevent risk to borrowers, communities, and the rest of the single family insurance Fund. Careful underwriting is critical. HUD should rely only on proven FHA lenders, validated by increased sampling of the loans they underwrite. A zero downpayment program should begin

[22] See Comment letter of the Mortgage Insurance Companies of America to the U.S. banking regulators on Risk-Based Capital Guidelines; Advanced Capital Adequacy Framework and Market Risk, March 26, 2007, pp. 8-10.

only as a pilot program and, if subsequently expanded, should always be limited to low- and moderate-income buyers who prove they do not have the necessary 3% minimum downpayment.

- Raising FHA area loan limits – both the base limit and high-cost area ones -- will not help low- and moderate-income families to become homeowners. Raising the base limit would push the FHA insured loan amount in low-cost areas to $271,000 and the income of borrowers qualifying for a mortgage of this size is over $86,000. Raising the high-cost limit would push the mortgage amount that could be insured by the FHA to $417,000, which would only reach borrowers with incomes over $132,000. In key markets, raising the base limit would mean that the FHA would insure homes well above the median house price in an entire state. This would further distance the FHA from its mission, as well as expose the single family insurance Fund to increased risk from regional economic downturns. Congress should not raise either loan limit and instead should consider commissioning a study from FHA -- with the participation of affordable housing groups -- on the implications of making FHA an income-targeted program rather than a median-house price targeted one. The study should also consider the implications of reducing the 100% federal guarantee behind FHA insurance for those borrowers with incomes in excess of the median household income in their

[23] Douglas Flint, HSBC's finance director, as quoted in ,“ FAULTY ASSUMPTIONS: In Home-Lending Push, Banks Misjudged Risk,” Carrick Mollenkamp, *Wall Street Journal*, February 8, 2007.

area. Borrowers with incomes of $25,000 to $40,000 seeking to buy in inner city neighborhoods may well need FHA insurance covering 100% of their loan amount. The same cannot be said for borrower with $100,000 incomes seeking to buy in established suburban areas. Excessive FHA insurance coverage undercuts the financial health of the single family insurance Fund, provides incentives for lax underwriting, and is not needed to make FHA insurance useful for most of its target borrowers.

- Finally, FHA must revise its premium structure to take account of the underlying risk of the mortgage being insured and not the credit score of the borrower seeking the loan. FHA is allowed by law to charge a fully financed upfront premium of as high as 2.25% and an annual premium of as high as 50 basis points for loans with initial loan-to-value ratios (LTVs) of 95% or less and 55 basis points for loans with initial LTVs above 95%. FHA has chosen to charge an upfront premium of only 1.5% and an annual premium of 50 basis points to all of its borrowers even though the bulk of them have initial LTVs above 95%. This premium has proven to be insufficient. FHA has made clear to Congress that it requires a 1.66% upfront premium and 55 basis point annual premium applied to all of its borrowers to achieve a zero net subsidy cost.[24] In order to begin to achieve a meaningful premium schedule that is tied to the risk of the mortgage being insured, I recommend that FHA be given the authority to raise it

[24] See the President's FY 2008 Budget, *Credit Supplement Tables, Table 6-Loan Guarantees: Assumptuions Underlying the 2008 Subsidy Estimates,* p.22.

annual premium on those borrowers seeking an adjustable rate mortgage where the interest rate is not fixed for the first five years of the mortgage term. Similarly, if FHA is given authority to insure a zero downpayment mortgage, borrowers seeking this higher-risk mortgage should be charged a higher annual premium than those seeking a fixed rate mortgage.