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MODERNIZATION OF FEDERAL HOUSING ADMINISTRATION PROGRAMS

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

ON

A REVIEW OF PROCESSES AND PROPOSED STATUTORY CHANGES IN ORDER TO MODERNIZE THE FEDERAL HOUSING ADMINISTRATION

WEDNESDAY, JULY 18, 2007

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MODERNIZATION OF FEDERAL HOUSING ADMINISTRATION PROGRAMS

WEDNESDAY, JULY 18, 2007

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 9:33 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Thomas R. Carper presiding.

OPENING STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. Good morning, everyone. The hearing will come to order.

I am pleased to be here with my friends, Senator Shelby, my ranking member, Senator Crapo, Senator Menendez. These guys look fresher than I would have believed possible after the night that they have been through. Delighted you are here with us and this will wake us up, if nothing else.

Today's hearing, as you know, is to review the Administration's proposals for the modernization of the Federal Housing Administration's flagship program, and that's the Single-Family Mortgage Insurance Program.

I want to thank Chairman Dodd for calling this important hearing, for the participation of my colleagues, and the many distinguished witnesses we have, two panels. We are delighted that you have joined us.

I want to point out that the Chairman has made clear that he is working closely with the Administration and colleagues on both sides of the aisle, as well as all of the groups that are representing here today in an effort to move legislation on the FHA program through the Committee prior to the August recess.

This is a timely hearing, as a result. A recent article in the News Journal, which is a local Delaware paper, reports that foreclosures in my own home State of Delaware have reached a record high of almost 3,000, a 29.5 percent increase over the previous year. To the extent that FHA can serve as an alternative to these homebuyers, it is not only important to Delaware but I think to the entire Nation.

It can be fairly said that our modern mortgage market owes its beginning to the Federal Housing Administration. FHA set many of the standards that we now take for granted in the mortgage market. For example, the low down payment 30-year fixed prepayable amortizing mortgage became the standard mortgage product largely because of FHA. For many years, FHA was the tool

by which working Americans, minorities and first-time buyers achieved the dream of homeownership.

In recent years, however, we have seen a drastic decline in the FHA's market share. Just 10 years ago, the FHA had about 19 percent of the purchase market. By the end of 2005, however, that share had dropped 13 percentage points to about 6 percent of the purchase market and 4 percent of the overall market.

This raises a serious concern because the business that seems to be migrating away from the FHA seems to be moving to the subprime market, with its myriad abuses that we have documented through numerous hearings both this year and last.

In fact, a June 2007 GAO report indicates that the drop in the FHA program is mirrored almost exactly by an increase in the subprime market which increased its share by 13 percentage points, exactly what FHA lost, from 2 percent to 15 percent of the market. Unfortunately, this is a trade-off that is a very bad one for the homebuyers and homeowners of America, as has been made abundantly clear in recent months.

Indeed, data shows that the FHA borrowers have credit scores very close to subprime borrowers and on average substantially lower than subprime borrowers. Yet FHA borrowers pay interest rates much closer to those paid by prime borrowers and substantially less than those paid by subprime borrowers.

Moreover, FHA loans do not have the same abusive characteristics that most subprime loans have. For example, FHA loans have no prepayment penalties. They require escrows for taxes and insurance. FHA ARMs are all underwritten at the fully indexed rate, a practice that was just finally embraced by the Federal regulators. Furthermore, FHA has a good record of providing loss mitigation though substantial improvements can still be made. That is why though FHA serves a very similar clientele as the subprime market, its foreclosure rates are half or less than seen in subprime markets.

The conclusion all of this leads me to reach is that we need to find a way to make FHA a more viable and effective program in the many communities in which it has been made irrelevant either by overly restrictive loan limits or other problems.

I look forward to working with Chairman Dodd, with this man right here, our ranking member, Mr. Shelby, who I called Mr. Chairman for many years, and other members of the Committee to achieve his goal.

With that having been said, I recognize our ranking member, Senator Shelby, for whatever comments he would like to make.

Thank you.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman, for calling today's hearing on the Federal Housing Administration.

Over the years, FHA loan guarantees have helped millions of Americans become homeowners. We all know that. Because the American taxpayer stands behind the FHA's guarantees, I believe this Committee should not only examine closely the status of the FHA programs but also any effort to expand it.

According to the President's budget submission, the FHA, for the first time in its history, will lose money this fiscal year, becoming a net loss to the taxpayer, the first time. Mr. Chairman, before the taxpayers are faced with greater losses, I believe we must determine how the FHA got into this position and how it intends to get out. Some would suggest however, Mr. Chairman, that we allow the FHA to grow its way out of insolvency with new products and expanded powers. This is a road we have been down, right here in this Committee.

For instance, as the S&L crisis was beginning the response right here was to allow S&Ls to offer new products and to expand their business. Because we failed to address the underlying fundamental weakness, the result of that expansion was a much larger bill for the American taxpayer.

Over the last several months, this Committee has been watching the growing problems in the subprime mortgage market that you alluded to. According to GAO, part of the growth of the subprime market came at the expense of FHA. As liquidity in the subprime market declines, however, we can expect FHA activity to expand as more homeowners look to FHA-insured products to meet their needs.

As this happens, Mr. Chairman, I think this Committee must make sure that the FHA expands in a responsible way.

While the subprime market has witnessed considerable stress, the losses in that market are being borne by investors, and I hope will always be. Were these same losses, Mr. Chairman, to occur in FHA programs it is likely they would be borne by the taxpayer, something we should try to prevent.

One lesson learned from the current pattern of defaults and delinquencies in the subprime market is that those borrowers with little or no activity in their home will be the most likely to fail. That is just plain common sense.

As we are already witnessing delinquency rates in the FHA's portfolio that mirror the subprime market, I believe we must approach any attempt to expand the program or lower the program's standards with great caution.

I want to welcome all of today's witnesses and look forward to the program here today.

Thank you, Mr. Chairman.

Senator CARPER. Thank you, Senator Shelby. Senator Menendez, you are recognized.

STATEMENT OF SENATOR ROBERT MENENDEZ

Senator MENENDEZ. Thank you, Mr. Chairman.

Let me thank Chairman Dodd for calling the hearing, for you for presiding today and your interest in this, as well as our ranking member, for holding what I think is an incredibly important hearing today.

I have been a long-time supporter of FHA reform and I believe the debate is especially important in the context of the current subprime crisis that we face.

In March, when this Committee held its first hearing to address the subprime crisis, I spoke then about the need to raise the FHA loan limit in order to give borrowers more options. I knew then

what I believe to be the case now, that raising the FHA loan limit is long overdue. I appreciate that the Administration seeks to do so, as well.

If Congress had modernized the FHA years ago I do not think we would be in such a serious detrimental subprime crisis. Right now many borrowers have no alternatives to a subprime loan and the FHA has no tools with which to help these borrowers. Homebuyers need more options than just the subprime market. But if we do not raise the FHA loan limit, they do not have a real alternative.

In my home State of New Jersey 13 out of the 21 counties are at the FHA ceiling of $362,790. In eight of these 13 counties the median home price is over $40,000. These numbers simply do not add up. 75 percent of New Jerseyans live in those 13 counties and they deserve better, more affordable options.

By the way, in the context of New Jersey—and I am sure this exists in many housing markets across the country—this is not about luxury housing. This is about the housing you get to afford for the essence of trying to achieve homeownership and the beginning of a middle-class existence.

Borrowers in New Jersey and across the country have largely nowhere to turn. Right now we are basically asking them to choose between either a zero down payment mortgage with all the risks that go with that or an adjustable rate mortgage that will possibly push them into foreclosure or an FHA loan for an insufficient amount. This is an unfair deal for borrowers in New Jersey and in America and I am glad that we are addressing these concerns today.

I believe the housing situation in many parts of our country is in a crisis. And it is not just the subprime market. I believe the Administration is drastically underfunding programs. Congress has yet to provide alternative solutions and borrowers are simply crying out for help.

In closing, Mr. Chairman, I also want to ask my colleagues to remember that many of the borrowers that we are talking about today are often minority, low income, first-time homebuyers who simply dream of owning a home. Our job is to do everything we can to make that dream come true. Unfortunately, FHA has had a dramatic downturn in covering that part of our American family. So I look forward to working with my colleagues on these issues, from hearing our witnesses today, and hopefully moving to an FHA reform bill, Mr. Chairman.

Senator CARPER. Senator Menendez, thank you for that statement.

Let me recognize now Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman.

I appreciate your holding this hearing on the modernization of the Federal Housing Ministration programs.

I look forward to learning more about HUD's proposed legislation and how it will affect the demand for FHA's loans, the cost and availability of insurance to borrowers and the risks to the insurance program and ultimately to the taxpayers.

There is one program in particular that I hope we as a Committee can get a lot more information about and pay a lot more attention to, and that is the reverse mortgage program. I understand that HUD's proposal proposes eliminating the cap on reverse mortgages and I commend that aspect of the proposal. I am a strong supporter of HUD's reverse mortgage program, known as the HECM or Home Equity Conversion Program.

This program is an important example of a successful public-private partnership. It allows our elderly citizens the opportunity to age in place by spending their own equity and retaining their own integrity. And predictions are being made that in the future HECMs will be a common financial planning tool for retirees.

So it is this kind of new innovation and advanced thinking that I think we need to pay attention to as we move forward with FHA modernization.

I also want to commend Commissioner Montgomery's administrative efforts that have led to significantly reduced processing times for FHA loans, reduced the cost of its FHA business, and shortened the time that it takes to close an FHA loan. These are very positive changes and I am hopeful that the process that we are now going through can also result in new improvements that can, as I indicated, not only be innovative and help us to move into new tools that will help those who—particularly the elderly and others who need support in their homes, as well as new tools to improve the overall operation of the FHA.

Thank you, Mr. Chairman.

Senator CARPER. Thank you very much.

Senator Dole, you are recognized at this time.

STATEMENT OF SENATOR ELIZABETH DOLE

Senator DOLE. Thank you, Mr. Chairman, ranking member Shelby, delighted that we are holding this hearing on the modernization of the Federal Housing Administration. And I want to thank our witnesses and look forward to hearing from you.

Commissioner Montgomery, let me say what a privilege it was to have you in North Carolina last month as we hosted a workshop on making homeownership a reality. This event was designed to help potential homeowners maneuver through the often stressful home buying process and also to provide information to Realtors and to local organizations that do so much important work to help assist people in purchasing and renovating homes.

We had great success with that workshop. We are already planning another across the state. So Commissioner Montgomery, heartfelt thanks for your continued efforts and those of your staff in helping us with these programs.

Today approximately 70 percent of Americans own their own homes and minority homeownership has now eclipsed 50 percent. While this is very good news, we must continue to focus our efforts on further increasing homeownership, particularly for minorities.

The FHA is critical in this regard as it assists many first-time homebuyers by providing affordable mortgage insurance. In fact, 79 percent of FHA-insured home purchase loans in 2006 went to first-time buyers, 31 percent of whom were minorities.

According to a 2006 GAO report the FHA's share of the private mortgage insurance market is only 6 percent, down from 19 percent a decade ago. In North Carolina, the number of FHA single-family purchase mortgage endorsements has fallen 33 percent from the year 2000 to 2006. This signals that it is time to consider the responsible modernization of the organization so that the FHA can remain a positive force for the housing sector.

As we examine FHA reform, this Committee must take into account today's real estate environment. In North Carolina and around the country a sharp rise in foreclosures is hurting homeowners and neighborhoods, as we have all heard and know.

In recent years more Americans have turned to unconventional lending products such as interest only, balloon payment, and option adjustable rate mortgages. While these products have made it easier for people to get into homes, we are seeing the dangers associated with their usage as borrowers are pushed beyond their means. Any changes to the FHA should support the ability of buyers not only to get into homes but also to afford to remain in their homes.

In addition, whatever authority Congress grants to the FHA, this Committee must be confident that the agency can both implement it and manage risks appropriately. In the past, FHA has not had a perfect track record. For example, FHA has not used pilot programs to test some products before they are marketed. As is the case with certain no down payment products, FHA does not plan to first test a program that will provide mortgage insurance for zero percent down loans which can pose significant risks.

In addition, I am concerned about the so-called score-based pricing proposals and their impact on minorities. Among African Americans alone, 40 percent would pay more in mortgage premiums under this plan and 32 percent would be shut out of the market entirely. No question we should be promoting homeownership opportunities for these families, not shutting them out.

Furthermore, I appreciate FHA's desire to improve its assessment of mortgage risk. That being said, in addition to relying on credit scores as the principal determinant of borrower loan eligibility I would encourage FHA to consider other factors, including the amount of the down payment or the type of loan such as fixed or adjustable interest rate.

Mr. Chairman, ensuring to continued success of our Nation's housing programs will enable millions more families to own their own homes and achieve the American dream. I look forward to working with this Committee as FHA modernization efforts move forward.

Thank you very much.

Senator CARPER. Senator Dole, thank you very much. Senator Schumer, you are recognized.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Mr. Chairman. I want to thank you and ranking member Shelby for holding this hearing on modernization of FHA, which is needed so badly.

The FHA provides an invaluable service to millions of Americans every year by giving them the resources and protections needed to purchase a new home and truly live out the American dream. To

most of my constituents and most Americans, their home is their piece of the rock. It is their largest and most important asset that they work very hard to gain and maintain.

However, as home prices continue to surge, those same resources and protections are needed now more than ever as the price of purchasing a single-family home moves farther out of reach for many average Americans.

Nowhere is this problem more apparent than in my home State of New York, particularly in the suburbs surrounding New York City. The price of housing in Nassau, Suffolk, Westchester, Rockland Counties has soared in recent years. And while no one wants to wag a finger at rising property values, we need to make sure that first-time homebuyers still have access to quality homes for their family.

Middle-class families are the fabric of these communities. But unfortunately they have been driven out of the market. Over the long term this can have a calamitous effect on these areas, not only in terms of housing but basic social services and the overall economy. Teachers, firefighters, nurses, librarians, small business owners must be able to live in the communities they serve, plain and simple. Suburbs cannot be havens only for the upper middle class and the very rich.

One of the primary mechanisms for keeping middle-class families in the home-buying market and still be able to afford homes in suburban communities is the FHA loan guarantee. However, this mechanism is no longer available to homebuyers in high cost communities because of the FHA loan limits.

For example, in Long Island the median home price, right in the middle and not even the average pulled up by those mansions, megamansions, the median home price is currently $479,000. That is almost $120,000 more than FHA loan limits currently allow. So unlike just about every other part of the country, fewer than half of all Long Islanders can get an FHA loan. It is as high as 80 or 90 percent in other parts of the country where home prices are lower.

And this happens, I know my colleague, in New Jersey and California and Massachusetts and many other places. As we all know, FHA mortgage insurance protects the lender against default which allows the lender to offer a competitively priced prime loan to lower income, to minority, and to first-time homebuyers, three groups of homebuyers that are often unable to obtain prime loans in the market.

In recent years, we have seen a sharp decline in the number of safe and affordable FHA-insured loans sold. Why? The answer is simple, according to FHA, the GAO, and other experts. It is because the FHA has not adapted to the realities of the changing real estate markets. Median housing prices in suburban communities throughout America far exceed the limits imposed under current FHA rules. This ideology is unfair.

And so we are here today to discuss changes we can make in Congress, a long-overdue change. The most important change is one that was suggested by the FHA itself, raising the FHA loan limits to reflect the reality of rising home prices. We all know that home prices have dramatically increased but FHA loan limits have

not been raised to reflect these increases. Because FHA loan limits have not been revised upward, FHA-insured mortgages are virtually nonexistent in higher cost communities. And in my home State of New York this is acute.

That is why I am introducing the FHA Loan Limit Adjustment Act of 2007. I just introduced it late last night. My bill will raise the FHA limits so that more homebuyers, especially those living in high-cost areas, will have the opportunity to purchase safe and affordable FHA-insured prime mortgages. In high cost communities like Long Island the bill would raise the upper limit from $362,000 to $417,000.

This is a needed change. I look forward to working with the Committee to improve FHA's ability to provide services to many more Americans. Raising the limits will have a positive effect on the growing crisis in our country, that of subprime mortgages, as well. I recently chaired a Housing Subcommittee hearing that focused on subprime and we found a whole lot of terrible practices. We have a large and growing body of data that suggests that the decline in FHA mortgages and the corresponding increase in subprime loans has been extremely detrimental and has helped cause—the inability to get FHA loans has helped cause or exacerbate the subprime crisis.

I believe that access to FHA-insured loans provides a sound alternative for some borrowers in the subprime market. It has been estimated that about 40 percent of subprime borrowers could actually qualify for prime loans under an FHA guaranty. And so I look forward to hearing your opinions today on the issue of loan limit increases.

And thank you, Mr. Chairman, for having this hearing and hope we can get support for the bill.

One other thing, I have discussed this with Chairman Frank on our House side and he is supportive of this type of proposal.

Senator CARPER. Thank you, Senator Schumer.

For our witnesses, let me just say there is a rule in the Senate that committees may not meet while the Senate is in session. That rule is routinely waived by unanimous consent, someone asks unanimous consent that committees be allowed to meet during the Senate's session. It is routinely agreed to so he can hold our committee meetings.

I have just learned from Sean Maher, our Legislative Staff Director on the majority side, that there has been an objection by minority in the Senate to committees meeting today while the Senate is in session. As a result, we are in an awkward position where, under the Senate rules, we are not allowed to meet.

I regret that and I apologize for the inconvenience this has probably caused for a number of our witnesses and, frankly, for many of us. But I am informed that we are not able to proceed to the rules of the Senate, at least at this time.

I am going to ask our witnesses, if you will, just to take a few minutes and to meet immediately after we adjourn here in a moment, to meet with Sean Maher and his staff and our minority staff as well to talk about how we are going to proceed.

This is the first time, I would say to my colleagues, the first time I have been privileged to chair a full Committee hearing. I have a feeling——

[Laughter.]

Senator MENENDEZ. Mr. Chairman.

Senator CARPER. This is a bad omen.

Senator MENENDEZ. Mr. Chairman, I have a parliamentary inquiry.

Senator CARPER. Go ahead.

Senator MENENDEZ. Even though this meeting had been scheduled before the present debate, and had been noticed as such, with both sides of course agreeing to it, there is an ability to proceed now?

Senator CARPER. That is correct. I have talked on the side here with Senator Shelby who said there has been any number of times when he was Chairman and when Paul Sarbanes was Chairman of the Committee that they have had to adjourn in a similar situation. It is not just this Committee, I think probably all the committees in the Senate——

Senator MENENDEZ. Mr. Chairman, I was looking forward to your excellent leadership.

Senator CARPER. You know what I was looking forward to? I will say this with a little bit of humor here. The second panel, the first witness on the second panel is William Shear, William Shear. It is too bad Chuck Schumer has left because he and I are great music aficionados.

I was listening this past week or so to NPR radio and they were doing an interview previously recorded with a guy named George Martin, who some of you will recall was the legendary producer of all of those Beatles' records for many, many years. One of which began with the words, "It was 20 years ago today that Sergeant Pepper taught the band to play. It's been going in and out of style, but they are guaranteed to raise a smile. So let me introduce to you the one and only Bill Shear."

Bill Shear. Think about that one for a while, folks. Where is Mr. Shear? You are guaranteed to raise a smile. But unfortunately we are smiling through our tears today. We are just not going to be able to proceed.

Senator Martinez, we are out of luck today. There has been an objection to our proceeding, and frankly to all committees proceeding. So we are going to break it off. Did you have something you would like to say before we call it——

Senator MARTINEZ. There is a lot I would like to say but not if it is not going to be a meeting. I will do it the next time.

But I wanted to always welcome FHA Administrator, Mr. Montgomery, who does a terrific job and to express my strong support for an FHA modernization bill, which I think is so desperately necessary, given the current situation with subprime lending and foreclosures and so forth.

So I look forward to an opportunity when we can meet and have a full discussion on this important legislation.

Senator CARPER. Again, to Secretary Montgomery and Mr. Donohue, to Billy Shear, and the full panel, second panel of witnesses, we regret this has happened. We hope that you will work

with us so that we will have an opportunity to reschedule this promptly because we hope to mark up the bill before the beginning of the August recess.

Senator MARTINEZ. Mr. Chairman, if I may, because of the late night, I think I forgot to also include Mr. Donohue in my regards, having worked with him in the past. I consider him a great American and a great servant.

Senator CARPER. Do you want to say anything to Billy Shear out in the audience?

[Laughter.]

Senator MARTINEZ. I do not know Billy Shear but I am sure he is also a fine American and I am glad he is here.

Senator CARPER. He is guaranteed to raise a smile.

All right, ladies and gentlemen, let us get back together in a few days, I hope, and be able to get this show on the road.

Thank you all.

[Whereupon, at 10:02 a.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

STATEMENT OF BRIAN D. MONTGOMERY

Assistant Secretary for Housing – Federal Housing Commissioner
U.S. Department of Housing and Urban Development

Hearing before the Committee on Banking, Housing and Urban Affairs

United States Senate

"Modernization of Federal Housing Administration Programs"

July 18, 2007

Thank you Chairman Dodd, Ranking Member Shelby for inviting me to testify on the Administration's proposal to modernize the Federal Housing Administration. All of us appreciate the priority you have given to this legislation.

As you are all aware, the Federal Housing Administration was created in 1934 to serve as an innovator in the mortgage market, to meet the needs of citizens otherwise underserved by the private sector, to stabilize local and regional housing markets, and to support the national economy. This mission is still very relevant, perhaps now more so than ever.

Moreover, the FHA model represents the very best of what a government working with the private sector can and should do. Since its inception, FHA has helped more than 34 million low- to moderate-income Americans become homeowners. By operating through a private sector distribution network, FHA efficiently reaches working families in need of safe and affordable home financing. Simply put, FHA insurance protects lenders against loss, enabling these private sector partners to offer market-rate mortgages to homebuyers who would otherwise remain unserved or underserved.

FHA also protects the homebuyer, especially those who are experiencing temporary economic hardship(s). FHA offers foreclosure prevention alternatives that are unparalleled in the industry. In fiscal year 2006 more than 75,000 FHA insured borrowers facing serious default were able to retain homeownership through FHA's toolbox of foreclosure prevention options. In an environment of increasing defaults, FHA's foreclosure rate actually decreased last year. This protection against foreclosure is good for families and good for communities. It also resulted in $2 billion in loss avoidance for the Insurance Fund, which illustrates our commitment to sound financial management.

We believe that FHA should continue to play a key role in the national mortgage market and I'm here today to make the case for changes to the National Housing Act that will permit us to continue to fulfill our critical mission.

Allow me to explain. In recent years, FHA's outdated statutory authority has left the agency out of synch with the rest of the lending industry. Over the last decade, the mortgage industry transformed itself, offering innovative new products, risk-based pricing, and faster processing with automated systems. Meanwhile, FHA continued to offer the same types of products with the same kinds of pricing, becoming less attractive to lenders and borrowers alike.

As a result, FHA's volume has dropped precipitously in housing markets all across the nation. For example, in Senator Reed's home state of Rhode Island, FHA's volume dropped from 3,110 loans in FY 2001 to just 385 loans in FY 2006 – a decline of 88 percent or $256 millión. For Senator Martinez, Florida saw its loan volume drop 79 percent, from 55,524 loans to 12,091, resulting in a loss of $3.25 billion. And any discussion of FHA volume would be incomplete without a mention of California, which

until recently led the nation, but has now seen its loan volume drop from 109,074 to just 2,599; that's a decline of 98 percent and a loss of $13.6 billion.

These statistics suggest that tens of thousands of low and moderate-income families, who would have chosen FHA, instead turned to alternative methods of mortgage finance. While many of them were well-served, some were not and ended up with an expensive and sometimes risky exotic loan. We see today the unfortunate outcomes such families across the nation are experiencing.

To offer a better and more attractive mortgage product, over the last 18 months we have made significant administrative changes to FHA, streamlining and realigning operating procedures. While these changes are good and were long overdue, they are not enough, a point our industry partners have clearly conveyed to us and to you. That is why last year FHA requested that Congress amend the National Housing Act to give it the flexibility it needs to fulfill its original mission in today's ever changing marketplace.

As the dynamic mortgage market passed FHA by, many homebuyers, especially those living in higher cost states such as California, New York, and Rhode Island, to name a few, purchased mortgage products with conditions and terms they would not be able to meet.

Some homebuyers, especially those in high home cost states like California, turned to high-cost financing and nontraditional loan products to afford their first homes. While low initial monthly payments may have seemed like a good thing at the time, the reset rates on some interest-only loans are substantial and many families have been and will continue to be unable to keep pace when the payments increase. In addition, prepayment penalties often times make refinancing cost-prohibitive. According to *Mortgage Strategist*, more than $2 trillion of U.S. mortgage debt, or about a quarter of all mortgage loans outstanding, is due for interest rate resets in 2007 and 2008. While some borrowers will make the higher payments and many others will refinance, some will struggle and some will be forced to sell or lose their homes to foreclosure. And I think we can all agree that foreclosures are bad for families, bad for neighborhoods, and bad for the economy as a whole.

In the context of this economic environment, we see FHA Modernization as part of the solution. FHA reform is designed to restore a choice to homebuyers who can't qualify for prime financing and more options for all potential FHA borrowers.

Moreover, the FHA bill proposes changes that will strengthen FHA's financial position, improving FHA's ability to mitigate and compensate for risk. The proposed changes would permit FHA to price its products commensurate with the risk, as opposed to having some borrowers pay too much and some too little. Imagine if a car insurance company charged all clients the same premium – the 17-year-old teenager and a 40-year-old adult would pay the same rate. Is that fair? With a blended rate, those who know they're paying too much switch to another insurance company. That leads to a portfolio that is increasingly lopsided: too many riskier borrowers, too few safer borrowers that

collectively pose greater risk to an insurance fund. This scenario, known as adverse selection is exactly what happened to FHA over the last decade. Those who were lower credit risks went elsewhere. The premium changes proposed in the Administration's proposal will restore balance to the FHA funds, providing appropriate levels of revenue to operate in a more fiscally sound manner.

While we are on the topic of the soundness of the insurance fund, I am proud to report that the Office of the Inspector General found no material weaknesses in its FY 2006 audit of the FHA, and that in January 2007, the GAO removed FHA's single family mortgage insurance programs from its high risk list – where we had been since 1994. Both of these developments reflected improvements that HUD has made in recent years in its management of property disposition contractors, its oversight of lenders, its implementation of a mortgage scorecard, and its ability to predict claims and estimate credit subsidy costs.

I know my introduction was lengthy, but I want you to understand how important FHA reform really is – for FHA, for the homebuyers we serve, and for the industry as a whole. FHA's private sector partners – the lenders, the realtors, the brokers, the home builders – want to tell their clients about the FHA alternative. They want low- to moderate-income homebuyers to have a safer, more affordable financing option. They want FHA to be a viable player again.

Now let me explain a little bit about the simple changes we're proposing. First, we're proposing to eliminate FHA's complicated downpayment calculation and three percent cash investment requirement. Before the rest of the market began offering low downpayment loans, FHA was often the best option for first-time homebuyers because it required only a minimal downpayment. But, as I said before, the market passed FHA by. According to the National Association of Realtors, last year, 43 percent of first-time homebuyers purchased their homes with *no* downpayment. Of those who did put money down, the majority put down two percent or less.

The downpayment is the biggest barrier to homeownership in this country, but FHA has no way to address the barrier without changes to its statute. FHA Modernization would permit borrowers to choose how much to invest, from no money down to one or two or even ten percent and to be charged appropriate premiums for the size of the downpayment they make.

The proposal also provides FHA the flexibility to set the FHA insurance premiums commensurate with the risk of the loans. For example, no downpayment loans would be priced slightly higher, yet appropriately, to give homebuyers a fairly-priced option and to ensure that FHA's insurance fund is compensated for taking on the additional risk. FHA would also consider the borrower's credit profile when setting the insurance premium. FHA would charge lower-credit risk borrowers a lower insurance premium than it does today, and higher-credit risk borrowers – many of whom we are unable to reach today – would be charged a slightly higher premium. In so doing, FHA could reach deeper into the pool of prospective borrowers, while protecting the financial

soundness of the FHA Fund and creating incentives for borrowers to achieve good credit ratings and save for downpayments.

A slightly higher premium would increase a borrower's monthly payment only minimally. For example, on a $225,000 loan, a 1 percent upfront premium financed into the loan would cost the borrower $13.97 per month; a 2 percent premium would cost $27.94 and a 3 percent premium, $41.90. Clearly, this higher premium is still affordable. Moreover, it's a smart investment, because the borrower is paying for the FHA insurance to obtain a market rate loan.

Some say that with a risk-based pricing approach FHA will target people who shouldn't be homebuyers and charge them more than they should pay. I want to address these concerns directly. Our goal is to reach families who are capable of becoming homeowners and to offer them a safe and fairly-priced loan option.

With a risk-based premium structure, FHA can reach hard-working, credit-worthy borrowers – store clerks, bus drivers, librarians, first responders, social workers – who, for a variety of reasons, do not qualify for prime financing. Some have poor credit scores due to circumstances beyond their control, but have put their lives back together and need a second chance. For some, the rapid appreciation in housing prices has simply outpaced their incomes. Many renters find it difficult to save for a downpayment, but have adequate incomes to make monthly mortgage payments and do not pose a significant credit risk. They simply need an affordable financing vehicle to get them in the door. FHA can and should be there for these families.

If granted, FHA's new legislative authorities would save homeowners a lot of money, because FHA's loan product would carry a lower interest rate than a non-prime loan product. The higher premiums that FHA will charge some types of borrowers are still substantially lower than they would pay for subprime financing. For example, if FHA charged a 3 percent upfront insurance premium for a $225,000 loan to a credit-impaired borrower versus that same borrower obtaining a subprime loan with an interest rate 3 percent above par, the borrower would pay over $300 more in monthly mortgage payments with the subprime loan and over $137,000 more over the life of the loan. In addition, FHA borrowers do not have to be concerned about teaser rates, unmanageable interest rate increases or prepayment penalties.

So while FHA may charge riskier borrowers more (and safer borrowers less) than it does today, the benefit is four-fold. First, FHA will be able to reach additional borrowers the agency can't serve today. Second, many borrowers will pay less with FHA than with a subprime loan. Third, the FHA Fund will be managed in a financially sound manner, with adequate premium income to cover expected losses. Finally, borrowers will be rewarded for maintaining good household financial practices that lead to good credit ratings and higher savings for a downpayment.

Another change proposed in FHA Modernization is to increase FHA's loan limits. Members of Congress from high-cost states have repeatedly asked FHA to do something

about our antiquated loan limits. This proposal answers those concerns. FHA's loan limit in high-cost areas would rise from 87 to 100 percent of the GSE conforming loan limit; in lower-cost areas, the limit would rise from 48 to 65 percent of the conforming loan limit. In between high- and lower-cost areas, FHA's loan limit will increase from 95 to 100 percent of the local median home price. This change is extremely important and crucial in today's housing market. In many areas of the country, the existing FHA limits are lower than the cost of new construction. Buyers of new homes can't choose FHA financing in these markets. In other areas, most notably California, FHA has simply been priced out of the market.

We are proposing to manage the Fund in a financially prudent way, beginning with the change in FHA pricing to match premiums with risk. This will avoid FHA being exposed to excessive risk, as it is today, because some borrowers who use FHA are under-charged for their risk to the Fund while those who are overcharged are fleeing from the program. Of course, we will continue to monitor the performance of our borrowers very closely, and make adjustments to underwriting policies and/or premiums as needed.

I know I've talked a lot here today, but I want to convey to you how passionate I am about the proposed changes. I believe we have an opportunity to make a difference in the lives of millions of low- and moderate-income Americans. We have a chance to bring FHA back into business, to restore the FHA to an innovative role. And when people ask me why we are proposing these changes, I tell them these exact words: "Families need a safe deal, at a fair price. Families need a way to take part in the American Dream without putting themselves at risk. Families need FHA."

I want to thank you again for providing me the opportunity to testify here today on modernizing the Federal Housing Administration. I look forward to working with all of you to make these necessary reforms a reality.

STATEMENT OF KENNETH M. DONOHUE

INSPECTOR GENERAL
DEPARTMENT OF HOUSING
AND URBAN DEVELOPMENT

BEFORE THE
COMMITTEE ON BANKING, HOUSING,
AND URBAN AFFAIRS
UNITED STATES SENATE

JULY 18, 2007

Statement of Kenneth M. Donohue, Inspector General
Department of Housing and Urban Development
Before the Senate Committee on Banking, Housing, and Urban Affairs

Chairman Dodd, Ranking Member Shelby, and members of the Committee; thank you for inviting me to testify today.

Background

The U.S. Department of Housing and Urban Development (HUD) Inspector General is one of the original 12 Inspectors General authorized under the Inspector General Act of 1978. The Office of Inspector General (OIG) has forged a strong alliance with HUD personnel in recommending ways to improve departmental operations and in prosecuting program abuses. The OIG strives to make a difference in HUD's performance and accountability. The OIG is committed to its statutory mission of detecting and preventing fraud, waste, and abuse and promoting the effectiveness and efficiency of government operations. While organizationally located within the Department, the OIG operates independently with separate budget authority. This independence allows for clear and objective reporting to the Secretary and to the Congress.

The Department's primary challenge is to find ways to improve housing and to expand opportunities for families seeking to improve their quality of life. HUD does this through a variety of housing and community development programs aimed at helping Americans nationwide obtain affordable housing. These programs, which include Federal Housing Administration (FHA) mortgage insurance for Single Family and Multifamily properties, are funded through a $30+ billion annual budget and, in the case of FHA, through mortgage insurance premiums.

One of the largest home mortgage insurers in the world, FHA has provided coverage to over 34 million homes since 1934. Its Single Family programs include insuring mortgage loans to purchase new or existing homes, condominiums, manufactured housing, houses needing rehabilitation, as well as offering reverse equity mortgages to elderly homeowners. FHA insurance protects HUD-approved lenders against losses should a homeowner default on their mortgage loan.

However, in recent years, what may be called a paradigm shift in mortgage lending practices has occurred with devastating impact on FHA market share and its traditional mission. Conventional mortgage lenders, both prime and subprime, offered financing options that attracted low-to-moderate income, first-time, and minority borrowers. These borrowers had previously looked to FHA loan products to buy their homes. Instead, they found that conventional mortgage lenders offered loan products featuring flexible payment and interest options, high loan-to-value (LTV) ratios, and relaxed underwriting guidelines. As a consequence, low-to-moderate income and other borrowers have decreased their usage of FHA's products; FHA's market share in terms of

numbers of loans fell from 19 percent in 1996 to 6 percent in 2005, with almost all of the decline since 2001. Strikingly, this decrease also affected the very underserved communities FHA has previously seen in its special mission: FHA lost 35% of its Hispanic borrower market, 27% of its African American borrower market, and 25% of minority borrowers overall.

OIG Efforts

Based upon our review of modernization proposals, we think that one aspect of FHA reform that is lacking is ***oversight and enforcement***. With the exception of a single provision in one of the House versions of modernization reform, which expanded one of HUD's Civil Money Penalty statutes, none of the proposals, including HUD's, address oversight or enforcement in a substantive way. Our semi-annual reports make clear that fraud is prevalent in the Single Family program, and, thus, any reform proposal should, we believe, consider such provisions. Our collective work in both auditing and investigation underscores the need for strong FHA oversight. I believe that it is important to highlight for the Committee the history of our OIG efforts to show where we are now in order to understand where we may go.

Single Family Fraud

We continue to compile evidence through our audit and investigative activities of organized groups and individuals who scheme to take advantage of first-time homebuyers and minority customers. These groups and individuals conspire, with or without the borrowers' knowledge, to provide materially false applications, documents and statements to obscure information that would otherwise demonstrate that borrowers do not qualify for the loans they seek or that the property in question does not meet FHA insurance guidelines.

We are also seeing a trend with organized groups in some parts of the country recruiting undocumented aliens to purchase FHA-insured homes. Undocumented aliens are not qualified to purchase FHA-insured homes due to their immigration status. As a result, this group is often preyed upon by unscrupulous mortgage professionals who assist them in obtaining fraudulent and stolen social security numbers, tax documents, and employment documents. All too frequently these borrowers soon realize that they are unable to bear the recurring costs associated with homeownership and default on their loan. In turn, these ever increasing defaults degrade entire communities where the organized groups target their efforts.

Gulf Coast

Congress estimates that damage to residential structures will range in the billions of dollars. The devastation caused by Hurricanes Katrina, Rita, and Wilma, and more importantly, the unprecedented volume of Federal assistance provided in reaction to the hurricanes, has created an environment ripe for fraud. FHA Single Family program potential insurance exposure includes more than 328,000 mortgages with an unpaid

principal balance of $23 billion. The HUD OIG will continue to focus, to the greatest extent possible, on the ultimate disposition and accountability of Single Family insurance claims against the FHA fund.

These practices could be prevented to a large extent by simple information sharing, that could be authorized as part of FHA reform legislation. Since Single Family loan origination fraud frequently involves false statements regarding the identity and income of borrowers, we believe that an automated identity/income verification system similar to that utilized by HUD's Enterprise Income Verification (EIV) program may prove useful in preventing FHA mortgage insurance fraud. Specifically, as HUD secured in the EIV program, we believe that FHA should pursue legislation to gain limited access for FHA-approved mortgagees to the National Directory of New Hires.

We envision an arrangement whereby FHA would obtain three data fields (e.g., name, Social Security number, and income) from the directory, and then make these data fields available to FHA-approved mortgagees via an encrypted Web-based system. As a condition of insurance endorsement, FHA-approved mortgagees would be required to access the Web-based system, verify prospective borrower identity and income, and resolve any discrepancies. The EIV has surpassed expectations of fraud prevention and detection in HUD's public and assisted housing programs, and we believe that this proposal could substantially prevent fraud in FHA's Single Family mortgage insurance program.

Examples

Over the past 3 years, the OIG has issued 190 audit reports in the area of FHA. These FHA-related audit reports identified over $1.1 billion in questioned costs and funds that could be put to better use. During the same time period, the OIG opened 1,078 mortgage fraud investigations. The following represent a sampling of some of the types of fraud we encounter in the FHA program:

Charlotte, North Carolina

Seven Charlotte residents were indicted by a federal grand jury on 66 counts relating to conspiracy, wire fraud, bank fraud, making false statements and entries, and money laundering. The Defendants owned and operated a mortgage brokerage corporation. The scheme entailed defrauding HUD and the Government National Mortgage Association (GNMA).

The Defendants executed an elaborate mortgage fraud scheme to generate over 100 loans that were purported to be FHA-insured loans on nonexistent properties. GNMA was required to make the investors whole when the fraud was discovered. The defendants would recruit strawbuyers to secure fraudulent FHA-insured home loans through a builder and these loans, in most cases, were secured by properties that were vacant lots or for homes belonging to legitimate homeowners. The Defendants received the loan proceeds and used the money for their personal benefit and to

advance the fraud scheme. This investigation has resulted in the seizure of assets worth $8 million.

Detroit, Michigan

The OIG investigated a large mortgage company in Detroit and found that it submitted to FHA as many as 28,000 loans with underwriter's certifications purportedly signed by one of two FHA-approved underwriters. However, the loans were underwritten by other staff- not FHA approved- who merely signed the underwriters' names on the certifications. OIG referred the matter to the United States Attorney's Office for the Eastern District of Michigan, which entered into a civil settlement valued at in excess of $40 million.

Baltimore, Maryland

The OIG has operated a Housing Finance Fraud Task Force in Baltimore for several years in response to Senator Mikulski's concerns about predatory lending focused in this area. Forensic auditors and investigators have been instrumental in stemming 'flipping abuses' in the City of Baltimore and Baltimore County. For example, we initiated an investigation against a group known as the Bel Air 'flippers,' in reality a practicing title attorney and his investor/real estate agent conspirators who defrauded mortgage lenders on scores of properties that were quickly resold to strawbuyers at exorbitant profits. FHA and conventional loans were both exploited by these individuals. They were convicted, incarcerated, and ordered to pay restitution for their crimes.

Risk Mitigation and Fraud Deterrence

Over the last two years, FHA has made changes to its operations to increase efficiency in the processing of loans for insurance endorsement. Higher performing lenders now can endorse loans for FHA insurance without prior review by FHA. FHA appraisal requirements now mirror those of conventional market appraisals. Eligibility criteria for FHA loans in the hurricane-impacted Gulf States have been relaxed. These are just a few examples of how FHA has actively deregulated its programs to compete with the private sector.

A remedy to reduce fraud in mortgage loan programs is in the emergent stages. Mortgage bankers are beginning to use predictive models that screen loan applications for fraud at pre-funding. FHA needs to move beyond post endorsement monitoring and embrace this new technology through policy and programmatic changes, as part of FHA reform.

I want to emphasize that the Office of Inspector General is committed to working collectively with FHA management to deter fraud and abuse of its Single Family program. We also want to provide support to the Mortgage Bankers Association in this effort. In 2006, the Mortgage Bankers hosted a fraud symposium, which we attended and

were an active participant. We hope such collaboration will continue to serve as a model for all our future cooperative efforts.

The Reform Challenge

Your invitation letter asked that I address and state my views on HUD's proposals for modernizing FHA. FHA reform is about recovering market share, competing on a level turf with private sector mortgage lending, and improving the financial solvency of the Mutual Mortgage Insurance (MMI) Fund. Our reading is that the reform is not about offering a way out of trouble, despite the headlines in the news lately, for those borrowers with high loan-to-value conventional and subprime loans in foreclosure.

I spent seven years at the Resolution Trust Corporation as Assistant Director for Investigations, uncovering the fraud and abuse among directors of the failed savings and loan institutions. I have seen first hand the damaging results of a solely profit-driven industry, which ultimately cost the American taxpayer billions of dollars. With the current trend of rising interest rates and the resulting payment shock as adjustable rate mortgages reset, coupled with low home appreciation, we can expect to see increasing delinquency and foreclosure rates for some time.

As a mortgage insurer, FHA pays the ultimate cost of loans that go bad. Lenders are made whole, but FHA seldom recovers that cost in reselling the properties to the public. FHA loses an average of 30% of each insurance claim it pays, when sales costs are netted against the payout to the lender/claimant.

FHA Risk

Does this scenario mean FHA faces an immediate financial crisis? Not based on the recent actuarial findings that estimate a capital ratio of 6.82 percent for the MMI Fund that well exceeds the 2 percent capital ratio mandated by the 1990 Cranston-Gonzalez National Affordable Housing Act. FHA actuaries found the MMI Fund to be adequately capitalized to defray expected claims over the next decade including losses from the hard hit Gulf Coast region, which is estimated at $613 million. Revenue shortfalls from insurance premiums were predicted, but these shortfalls were offset by expected interest income from Treasury investments.

This capital ratio was accumulated over a period of several years when the MMI Fund maintained a negative credit subsidy rate, meaning estimated cash inflows exceeded estimated cash outflows. However, FHA's FY 2008 budget submission casts a somewhat different light as it concerns the risk of the MMI Fund. It states: "*Because of adverse loan performance and improved estimation techniques, the base line credit subsidy rate for FHA's single family program—assuming no programmatic changes—is positive, meaning that total costs exceed receipts on a present value basis, and therefore would require appropriations of credit subsidy budget authority to continue operation. The 2008 baseline includes no budget authority to cover these costs and assumes FHA would*

use its existing authorities to increase premiums to avoid the need for credit subsidy appropriations. Under the Budget's proposals, FHA will be able to set premiums that are based on risk and are sufficient to avoid the need for credit subsidy appropriations." (emphasis added)

Because FHA's FY 2008 business is projected to be riskier than prior years, FHA may be really left with only two choices: to request a credit subsidy by means of appropriations or to increase its premiums to avoid an estimated shortfall of $143 million in FY 2008.

FHA's response to this impending predicament is through the passage of FHA modernization reform. In earlier testimony, the FHA Commissioner stated, "...the FHA bill proposes changes that will strengthen FHA's financial position, improving FHA's ability to mitigate and compensate risk. The proposed changes would permit FHA to operate like every other insurance company in the nation, pricing its products commensurate with the risk, as opposed to having some clients pay too much and some too little." I do note that some of the FHA reform proposals —which include zero-down payment loans, risk-based premiums, and higher mortgage limits—seem to be directed at expanding FHA's reach to the higher income housing market. A market reach, it may seem, that could go beyond its mission to serve the underserved: the low-to-moderate income family, the first-time homebuyer, and the minority borrower.

Zero Down Payment and Seller-Assisted Down Payment Assistance

We believe FHA should be wary of inviting future claim risks by insuring 100 percent and greater (after financing closing costs and insurance premiums) loan-to-value loans. If the proposal were to advance despite such sober concerns, prudent underwriting standards must be developed, loan performance tracked, and program modifications timely made, if these borrowers default at unacceptable rates.

FHA is currently experiencing higher default and claim rates on seller-funded nonprofit down payment assisted loans provided by Nehemiah, Ameridream, and other nonprofit organizations. These mortgages are effectively zero down payment loans (100 percent loan-to-value), because the sellers typically raise the price of the homes to cover the down payment amount. GAO reported in 2005 the probability of such loans resulting in an insurance claim was 76 percent higher than comparable loans without such assistance. It is reasonable to conclude that zero down payment loans could represent a comparable insurance risk.

The OIG testified before the House recently concerning seller-funded down payments. Our message was to strongly support HUD and FHA, and the proposed Rule (72 Fed. Reg. 27048 (May 11, 2007)), to effectively ban this practice in FHA lending. The current President of one of the largest seller-assisted down payment providers recently wrote an opinion piece that was published in the Wall Street Journal. He pressed that, in his view, we need to "send the Inspector General of HUD to charm school." While my wife would have objected to that assertion, I nevertheless cannot stress enough the importance of implementing the proposed rule, without material changes as part of FHA reform.

In 1999, we initially questioned the legal validity of the 'nonprofit gift' as a quid pro quo transaction rather than one made gratuitously without consideration, as fits the definition of a gift. The OIG has conducted substantial audit work at selected FHA lenders that approved loans with nonprofit down payment assistance. Three recent examples provide evidence of how these programs can adversely impact FHA borrowers:

> **America's Mortgage Resource, Inc.** (Audit Report No. 2006-FW-1006; March 28, 2006). A branch manager formed an identity-of-interest nonprofit entity to provide gifts for loans initiated by America's Mortgage. However, this entity was never granted nonprofit eligibility by the IRS as its down payment gift program was determined not to provide a charitable service. Nevertheless, America's Mortgage closed 73 FHA loans with down payment gifts through the entity, 38 percent of which were seller funded through increased sales prices. The markups ranged from $1000 to $13,000 depending on the cash needs of the borrowers to close the loans. The entity collected a 1 percent processing fee for each of the ineligible gifts.
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> **K. Hovnanian American Mortgage** (Audit Report No. 2006-FW-1004; January 26, 2006). In this case, a K. Hovnanian identify-of-interest homebuilding company provided gifts to nonprofits for loans underwritten by a K. Hovnanian lender that increased the sales prices of the homes. K. Hovnanian agreed to refund the fees inappropriately charged to the borrowers.
>
> **Broad Street Mortgage** (Audit Report No. 2005-FW-1010; May 26, 2005). Audit testing of the lender's loan files found documentary evidence showing that sellers increased sales prices to cover the cost of "donations" to down payment assistance providers. Correspondence between lender staff cited specific amounts needed from sellers to close the loan, the price markups required to fund the sellers' 'gifts.'

The results of these and other audits have validated our early findings on the overall program risk to the FHA insurance fund associated with nonprofit down payment assistance. In addition to specific audits of down payment assistance providers, we conducted comprehensive analyses looking in depth at these loans as they increasingly consumed a larger share of FHA loan originations. Our audit results concluded that HUD allowed nonprofit organizations to operate programs that circumvented FHA requirements. We found that the down payment loan transactions did not meet the intent of FHA requirements in that the assistance was not a true gift from the nonprofit; default rates for buyers receiving such assistance were significantly higher than for other FHA loans; and, sellers raised the sales prices of properties to cover the cost of the assistance programs causing buyers to finance higher loan amounts. We recommended that HUD implement a proposed rule to eliminate such programs and it is now in the rulemaking process. We have not been the only voice of concern. The Government Accountability Office (GAO) has repeatedly cautioned that FHA needed to better manage the risks of FHA-insured loans with down payment assistance.

Risk-Based Premiums

As I stated earlier in this testimony, FHA needs to be sure that a risk-based premium structure does not price out the availability of mortgage insurance to the underserved market.

FHA customers traditionally have been first-time homebuyers and minorities, some with credit history problems and marginal reserves to avoid default when facing financial stress. FHA reform will require these higher risk borrowers to pay higher premiums. Risk-based pricing, therefore, may increase the mortgage carrying costs of FHA borrowers that are the least able to afford them. Currently, all FHA-insured borrowers pay an up-front premium of 1.5 percent of the original loan amount, and annual premiums of 0.5 percent of the remaining insured principal balance. Lower-risk borrowers subsidize higher-risk borrowers under this level premium pricing concept. Administratively, the premium billing process is straight forward, the concept/billing readily understood by the borrower, and, most importantly, the collected premiums have been sufficient to maintain fund solvency since 1934.

Moving to a risk-based premium structure could also, by its very complexity, require increased budget authority to make FHA system modifications and impose new administrative/cost burdens on originating and servicing lenders. Further, it could potentially expose the FHA Single Family insurance program to fair housing questions and accusations of "red-lining" unless the decision matrix for pricing is unquestionable.

GAO's recent analysis found that higher-risk borrowers who qualified for FHA insured loans under the level premium structure would have their loan applications rejected under this premium pricing. GAO estimated that approximately 20 percent of FHA's 2005 borrowers would not have qualified for FHA mortgage insurance under the parameters of the risk-based pricing proposal they evaluated. It may be likely that such results, in the event that risk-based premiums are enacted, could prompt accusations of discriminatory practices on the part of both lenders and FHA.

Higher Mortgage Limits

In an assessment of the modernization proposal, one could argue that FHA appears to be strategizing to capture some share of the conventional prime market or borrowers who may not need a government program to acquire homeownership. Moreover, raising FHA area loan limits, especially in the high-cost area ones, may not necessarily help low-to-moderate income families become homeowners. In some markets, raising the base limit would mean that FHA would insure homes well above the median house price statewide, further potentially distancing FHA from its mission, and possibly exposing the MMI Fund to increased risk from regional economic downturns. If the limits for 2-4 unit properties are also included, FHA will be assuming even greater financial risk on what are essentially investment properties.

Combining Single Family Programs into the MMI Fund

The FHA modernization legislation contains proposals to move the 203k (rehabilitation), 234 (condominium) and the HECM (Home Equity Mortgage Conversion) loans into the Mutual Mortgage Insurance (MMI) Fund from the General Insurance (GI) Fund in order to consolidate all Single Family loans into one fund. The loans originated per month in the 203k and 234 programs are small compared to the loans originated in the standard FHA 203b program. However, the HECM loan program is significantly larger and could increase due to the cap being permanently lifted.

As stated above, FHA's base line credit subsidy for the Single Family program is expected to be positive in FY 2008 and would require either an appropriation or an increase in premiums. Moving these programs into the MMI Fund would improve that fund's overall subsidy rate. The Congress should be aware of the budgetary implications that this would have for the GI Fund and any need for additional appropriation. FHA officials told us that the largest of the three programs – the HECM program – has and will continue to receive a separate credit subsidy rate and that, therefore, the overall budgetary impact will be minimal. Nevertheless, the Congress should assure itself that any negative subsidies from the HECM program are not used to offset premium requirements for the standard FHA 203b program.

Conclusion

We continue to support the Department and FHA's mission. We will actively pursue fraud and abuse in FHA lending, regardless of whether changes are made to the FHA program. It is our mandate. We do recognize, however, that there are great challenges confronting FHA programs. Nevertheless, aggressive oversight and enforcement is crucial to prevent a recurrence of what we are witnessing in the subprime market today and the savings and loan industry in years past. It is the counter-balance that unfortunately is missing from the FHA reform proposal and I hope the Committee will consider as it contemplates its own modernization proposals. We would be available at the Committee's discretion to provide technical assistance if such support was needed.

That concludes my testimony and I thank the Committee for holding this important hearing and I look forward to answering questions that members may have.

United States Government Accountability Office

GAO

Testimony
Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate

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FEDERAL HOUSING ADMINISTRATION

Proposed Legislative Changes Would Affect Borrower Benefits and Risks to the Insurance Funds

Statement of William B. Shear, Director
Financial Markets and Community Investment

GAO-07-1109T

July 18, 2007

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Highlights

Highlights of GAO-07-1109T, a testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate

FEDERAL HOUSING ADMINISTRATION

Proposed Legislative Changes Would Affect Borrower Benefits and Risks to the Insurance Funds

Why GAO Did This Study

Fewer borrowers are using the Federal Housing Administration's (FHA) single-family and manufactured housing insurance programs. To help counter this trend, proposed changes to the single-family program would raise loan limits, allow risk-based pricing of premiums, and reduce down payments. Changes such as higher loan limits also were proposed for the manufactured housing program. To assist Congress in considering the impact of these changes, this testimony provides information from recently issued GAO reports and preliminary views from ongoing work. Specifically, GAO discusses (1) trends in FHA's share of the mortgage market, (2) likely impacts of proposed changes to the single-family program, (3) practices important to implementing the changes to the single-family program, if passed, and (4) preliminary observations from our work on the manufactured housing program. To conduct this work, GAO analyzed agency, Home Mortgage Disclosure Act, and Census data and interviewed agency and lending industry officials and other stakeholders.

What GAO Recommends

While making no new recommendations, GAO reemphasizes the need for continued management attention to prior GAO recommendations that could help address risks and challenges associated with the single-family legislative proposals.

www.gao.gov/cgi-bin/getrpt?GAO-07-1109T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact William B. Shear at (202) 512-8678 or shearw@gao.gov.

What GAO Found

FHA's share of the single-family mortgage market declined 13 percentage points from 1996 through 2005, with conventional lenders gaining notably increased percentages of lower-income and minority borrowers. This decline in market share was associated with a number of factors, including FHA's product restrictions and product innovations in the conventional market.

The proposed changes to the single-family program could affect borrowers as well as program costs. For example, GAO estimated that in 2005 FHA could have insured 9 to 10 percent more loans if proposed mortgage limits were in effect. But, if the risk-based pricing proposal had been in effect in 2005, 20 percent of borrowers would not have qualified for FHA insurance. FHA determined that the expected claim rates of these borrowers were higher than it found tolerable for either the borrower or the Mutual Mortgage Insurance Fund. Absent any program changes, FHA estimates that the fund would require an appropriation of approximately $143 million in fiscal year 2008. If proposed changes were passed, FHA estimates that the fund would generate $342 million in negative subsidies (i.e., net cash inflows).

Although FHA is taking steps to enhance tools important to implementing the proposed changes to its single-family program, it does not plan to use a common industry practice, piloting, to mitigate the risks of any zero-down-payment product. In response to prior GAO recommendations, FHA improved its loan performance models and is refining its mortgage scorecard (which evaluates the default risk of borrowers). However, the proposals would introduce new risks and challenges. The proposal to lower down payments is of particular concern given the greater default risk of these loans and the difficulty of setting prices for new products whose risks may not be well understood. One of the ways FHA plans to mitigate new or increased risks is through stricter underwriting standards, but it does not plan to pilot any zero-down-payment product. Other mortgage institutions use pilots to manage risks associated with changing or expanding product lines.

Proposals for the manufactured home loan program would increase loan limits, insure each loan made, incorporate stricter underwriting requirements, and set premium rates. While the changes could benefit borrowers, according to FHA and the Congressional Budget Office, the potential costs could expand the government's liability. However, FHA has not articulated which borrowers would be targeted if the program were expanded, specified changes in its underwriting requirements, developed a risk-based pricing structure for the proposed legislation, or estimated costs to the General Insurance Fund. As a result, the potential effects of the changes on the program and the insurance fund are unclear.

Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to share information and perspectives with the committee as it considers modernization proposals for the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA). FHA provides insurance for single-family home mortgages made by private lenders. In fiscal year 2006, it insured almost 426,000 mortgages representing $55 billion in mortgage insurance. According to FHA's estimates, the single-family insurance program currently operates with a negative subsidy, meaning that the present value of estimated cash inflows (such as borrower premiums) to FHA's Mutual Mortgage Insurance Fund exceeds the present value of estimated cash outflows (such as insurance claims). However, absent any program changes, FHA has estimated that the program would require a positive subsidy—that is, an appropriation of budget authority—in fiscal year 2008. In addition to single-family home mortgages, FHA insures loans for manufactured housing—that is, factory-built housing designed to meet HUD's national building code. Comparatively, this is a much smaller program than the single-family insurance program, insuring 1,438 loans in 2006 representing $54 million in mortgage insurance. FHA insures its manufactured home loans under the General Insurance Fund.

FHA has faced several challenges in recent years. Its single-family insurance program has experienced rising delinquency rates and a sharp decline in the number of participating borrowers, due partly to increased competition from conventional mortgage providers.[1] The conventional market has prime and subprime segments. Prime borrowers typically have strong credit scores and obtain the most competitive interest rates and mortgage terms.[2] In contrast, subprime borrowers typically have blemished credit and lower credit scores, may have difficulty providing income documentation, and generally pay higher interest rates and fees than prime borrowers. As conventional providers have improved their ability to evaluate risk, FHA has experienced adverse selection—that is, conventional providers have identified and approved relatively lower-risk borrowers in FHA's traditional market segment, leaving relatively higher-risk borrowers for FHA.

[1]The conventional market comprises mortgages that do not carry government insurance or guarantees.

[2]Credit scores, which assign a numeric value to a borrower's credit history, have become a common tool for assessing loan applications.

Additionally, the lending market associated with manufactured homes has undergone significant changes over the last 15 years. Market growth in the 1990s was followed by a large number of repossessions from 2000 to 2002 due to the deteriorating credit quality of borrowers, and many lenders exited the manufactured home loan market. The FHA-insured segment of the market experienced a dramatic decline over this period. The number of manufactured home loans insured by FHA decreased from 23,897 loans in 1990 to 1,438 loans in 2006, a 94 percent decline.

To adapt to market changes, FHA has implemented new administrative procedures in its single-family insurance program and proposed legislation designed to modernize its insurance processes and products. FHA's recent administrative changes include allowing higher-performing single-family lenders to endorse, or approve, loans for FHA insurance without prior review by FHA and adopting conventional market appraisal requirements. The legislative proposals for the single-family insurance program also would raise FHA's mortgage limits, give the agency flexibility to set insurance premiums based on the credit risk of borrowers, and reduce down-payment requirements from the current 3 percent to potentially zero. In addition, legislative changes have been proposed for FHA's Title I Manufactured Home Loan program that include increasing the loan limits, incorporating stricter underwriting requirements, and revising the premium structure.

My testimony today discusses two reports that we issued in June 2007 on FHA's share of the single-family mortgage market and FHA's proposals to modernize its single-family insurance program, as well as preliminary views from ongoing work we are conducting on FHA's Title I Manufactured Home Loan program.[3] Specifically, I will discuss (1) trends in FHA's share of the home purchase mortgage market and factors underlying these trends; (2) likely program and budgetary impacts of proposed changes to FHA's single-family insurance program; (3) tools, resources, and risk-management practices important to FHA's implementation of the legislative proposals for its single-family insurance

[3]See GAO, *Federal Housing Administration: Decline in the Agency's Market Share Was Associated with Product and Process Developments of Other Mortgage Market Participants*, GAO-07-645 (Washington, D.C.: June 29, 2007) and GAO, *Federal Housing Administration: Modernization Proposals Would Have Program and Budget Implications and Require Continued Improvements in Risk Management*, GAO-07-708 (Washington, D.C.: June 29, 2007).

program, if passed; and (4) preliminary observations from our ongoing work on the Manufactured Home Loan program.[4]

In conducting this work, we analyzed loan data from 1996 through 2005 collected under the Home Mortgage Disclosure Act (HMDA) to assess trends in the overall market for home purchase mortgages and used 2005 HMDA data (the most current available) to examine the effect of raising loan limits on demand for FHA-insured single-family loans. We estimated the effects of risk-based pricing on borrowers' eligibility for FHA single-family insurance and the premiums they would pay by analyzing Single Family Data Warehouse (SFDW) data on FHA's 2005 home purchase borrowers. We also analyzed data from the Manufactured Home Loan program, Census data from the Manufactured Housing and American Housing Surveys, and other sources. We interviewed officials from FHA, Ginnie Mae, Fannie Mae, and Freddie Mac; FHA lenders, private mortgage insurers, and mortgage and real estate industry groups; and academic researchers. We conducted this work from September 2006 to July 2007 in accordance with generally accepted government auditing standards.

In summary, we found that:

- From 1996 through 2005, FHA's share of the market for home purchase mortgages declined from 19 to 6 percent, while the prime and subprime shares increased 3 and 13 percentage points, respectively. The agency experienced a sharp decrease among minority and lower-income populations where it traditionally has had a strong presence. This decline in market share was associated with a number of factors—including FHA's product restrictions and product innovations in the conventional market, particularly in the subprime market—and has been accompanied by higher ultimate costs for certain conventional subprime borrowers.

- FHA's proposed changes to its single-family insurance program could affect borrower demand and the cost and availability of its insurance as well as the budgetary costs of the program. Based on our analysis of 2005 HMDA data, we estimated that the number of FHA-insured loans in 2005 could have been from 9 to 10 percent greater had the higher, proposed mortgage limits been in effect. In addition, our analysis of data for FHA home purchase borrowers in 2005 showed that, under FHA's risk-based pricing proposal, about 43 percent of those borrowers would have paid the same or less than they actually paid, 37 percent would have paid more, and

[4]Home purchase mortgages do not include mortgages for refinancing existing loans.

20 percent would not have qualified for FHA insurance based on FHA's plans as of May 2007. The 20 percent were borrowers with expected lifetime claim rates more than 2.5 times greater than the average claim rate. Finally, while to be viewed with caution, FHA has made estimates indicating that the loans it expects to insure in 2008 would result in negative subsidies of $342 million if the major legislative changes were enacted, rather than requiring an appropriation of $143 million absent any program changes.

- FHA has taken or has planned steps to enhance the tools and resources important to implementing the proposed changes to its single-family insurance program—and help address risks and challenges associated with the proposals. However, it does not intend to use a common industry practice, piloting, to mitigate the risks of any zero-down-payment product it is authorized to offer. To implement its risk-based pricing proposal, FHA would rely on statistical models that estimate the performance of loans and its mortgage scorecard (an automated tool that evaluates the default risk of borrowers). In response to our prior recommendations, FHA has improved its loan performance models by incorporating additional variables and is in the process of addressing a number of limitations in its mortgage scorecard. Although FHA has taken actions to enhance key tools and resources, the legislative proposals would introduce new risks and challenges. The proposal to lower down-payment requirements is of particular concern given the greater default risk of these loans and the difficulty of setting prices for new products whose risks may not be well understood. FHA plans to take steps, such as instituting stricter underwriting standards, to mitigate these risks. However, while other mortgage institutions use pilot programs to manage the risks associated with changing or expanding their product lines, FHA has indicated that it does not plan to pilot any zero-down-payment product it is authorized to offer.

- In response to the dramatic decline in FHA-insured manufactured home loans, legislative proposals for the Manufactured Home Loan program would increase loan limits, insure each loan made, incorporate stricter underwriting requirements, and establish up-front and adjust annual insurance premiums. According to FHA and some industry officials, the potential benefits of proposed changes for borrowers include obtaining larger loans and additional financing with lower interest rates as more lenders likely would participate because a greater portion of their portfolios could be insured. The Congressional Budget Office (CBO) and FHA also noted potential costs, such as expanded liability for the General Insurance Fund. Additionally, risk factors unique to manufactured home lending affect loan performance. But, FHA has not yet articulated which

borrowers would be targeted or undertaken risk assessments to estimate the effects of the proposed legislation on the volume of lending and claims and the overall financial soundness of the program.

While the two reports I have summarized make no new recommendations, they include observations about how developments in the different segments of the mortgage market could affect FHA's market share in the future and the need for careful implementation of the legislative proposals, if passed. We noted that, notwithstanding the actions of conventional providers, FHA could be a vehicle to provide lower-priced and more sustainable mortgage options for some borrowers who are considering or struggling to maintain higher-priced subprime loans. However, careful assessment and management of the risks associated with serving these borrowers would be necessary to avoid exacerbating problems in the financial performance of FHA's single-family insurance program. We also acknowledged that FHA has performed considerable analysis to support its legislative proposals for the single-family insurance program and has made or planned enhancements to many of the specific tools and resources that would be important to its implementation of them, but stated that the proposals present risks and challenges and should be viewed with caution. Continued management attention to our prior recommendations, including piloting new products and improving its mortgage scorecard, could help FHA address these risks.

Background

Congress established FHA in 1934 under the National Housing Act (P.L. 73-479) to broaden homeownership, protect and sustain lending institutions, and stimulate employment in the building industry. FHA's single-family program insures private lenders against losses from borrower defaults on mortgages that meet FHA criteria for properties with one to four housing units. FHA has played a particularly large role among minority, lower-income, and first-time homebuyers and generally is thought to promote stability in the market by ensuring the availability of mortgage credit in areas that may be underserved by the private sector or are experiencing economic downturns. In fiscal year 2006, 79 percent of FHA-insured home purchase loans went to first-time homebuyers, 31 percent of whom were minorities. The Title I Manufactured Home Loan program was created to reduce the risk to lenders through insurance or a guarantee, and thereby expand access to funding for buyers of manufactured homes. According to data from FHA, the majority of its Title I borrowers from 2004 to 2007 were lower-income and 34 years of age or younger.

FHA insures most of its single-family mortgages under its Mutual Mortgage Insurance Fund, which is supported by borrowers' insurance premiums. The single-family insurance program has maintained a negative overall credit subsidy rate, meaning that the present value of estimated cash inflows from premiums and recoveries exceeds estimated cash outflows for claim payments (excluding administrative costs). In addition to insuring mortgages on single-family homes, FHA has insured loans for manufactured housing since 1969. FHA insures its manufactured home loans under the General Insurance Fund, which is supported by lenders' insurance premiums (currently an annual premium of 1 percent, based on the initial loan amount).

Borrowers insured under FHA's single-family program are required to make a cash investment of a minimum of 3 percent. FHA allows down-payment assistance from third-party sources, including nonprofit organizations that receive contributions from property sellers. When a homebuyer receives down-payment assistance from one of these organizations, the organization requires the property seller to make a financial payment to their organization. These nonprofits are commonly called "seller-funded" down-payment assistance providers.

Partly in response to changes in the mortgage market, HUD has proposed legislation intended to modernize FHA. Provisions in the proposal relating to its single-family insurance program would among other things authorize FHA to change the way it sets insurance premiums, reduce down-payment requirements, and insure larger loans. The proposed legislation would enable FHA to depart from its current, essentially flat, premium structure and charge a wider range of premiums based on individual borrowers' risk of default. HUD's proposal also would eliminate the minimum cash investment requirement and enable FHA to offer some borrowers a no-down-payment product. FHA is subject to limits in the size of the loans it can insure. For example, for a one-family property in a high-cost area, the FHA limit is 87 percent of the limit established by Freddie Mac. In a low-cost area, the limit is 48 percent of the Freddie Mac limit. The legislative proposal would raise these limits to 100 percent and 65 percent of the Freddie Mac limit, respectively. In addition, Congress has proposed changes to FHA's Title I Manufactured Home Loan program that would increase loan limits and index them annually; insure each loan made instead of capping insurance at 10 percent of the value of a lender's portfolio; incorporate stricter underwriting requirements; and establish up-front and annual premiums.

Decline in FHA's Market Share Was Associated with Product and Process Developments of Other Mortgage Market Participants

In a report we issued in June 2007, we noted that a combination of factors created conditions that favored conventional mortgages over FHA products resulting in FHA losing a considerable market share to the conventional market, especially to the subprime market.[5] Based on our analysis of HMDA data, FHA's share of the market for home purchase mortgages (in terms of numbers of loans) declined 13 percentage points from 1996 through 2005, while the prime share increased slightly, and the subprime share grew 13 percentage points.[6] In addition, the agency experienced a sharp decrease among minority and lower-income populations where it traditionally has had a strong presence.

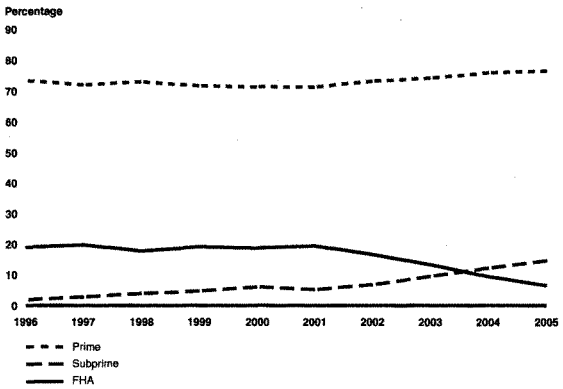
Specifically, we found that:

- From 1996 through 2005, FHA's share of the home purchase mortgage market declined while the conventional share increased. As shown in figure 1, FHA's market share fell from almost 19 percent (about 583,000 loans) in 1996 to about 6 percent (about 295,000 loans) in 2005, with almost all of the decline occurring after 2001. Over the 10-year period, the market share for conventional mortgages rose from almost 75 percent (about 2.3 million loans in 1996) to about 91 percent (about 4.2 million loans in 2005), with much of the increase due to growth in subprime lending. More specifically, prime market share increased from 73 percent to 76 percent overall, falling somewhat from 1996 through 2000 but then increasing about 5 percentage points after 2000. Subprime market share increased substantially over the 10- year period, from 2 percent to 15 percent, with most of the increase occurring after 2001 (growing from 5 percent in 2001 to 15 percent in 2005).

[5]GAO-07-645.

[6]HMDA data capture about 80 percent of the mortgage loans funded each year according to estimates by the Board of Governors of the Federal Reserve System and are one of the most comprehensive sources of information on mortgage lending.

Figure 1: Market Shares for Home Purchase Loans, 1996-2005



Source: GAO analysis of HMDA data.

- FHA traditionally played a major role among minority borrowers. However, over the 10-year period, FHA's share of this submarket fell substantially. Specifically, FHA's market share dropped from 32 to 7 percent among minority borrowers. In contrast, prime market share increased from 59 to 65 percent among minority borrowers and subprime market share increased from 2 to 26 percent.

- Lower-income (that is, low- and moderate-income) borrowers historically relied heavily on FHA products, but FHA's market share dropped in this submarket as well.[7] From 1996 through 2005, FHA's market share decreased among borrowers of all income levels, but particularly among lower-income borrowers, where it declined from 26 to 10 percent. Over the same period, prime market share increased from 65 to 72 percent and subprime market share increased from 1 to 15 percent.

[7]We defined low income as less than 80 percent of the median income for the census tract, moderate income as at least 80 percent but less than 120 percent, and upper income as 120 percent and above.

The decline in FHA's market share was associated with a number of factors and has been accompanied by higher ultimate costs for certain conventional borrowers. FHA's lack of process improvements and product restrictions relative to the conventional market provided conditions that favored conventional over FHA-insured mortgages. According to mortgage industry officials that we interviewed, processing FHA-insured loans is more costly, time consuming, and labor intensive than processing conventional mortgages. FHA and mortgage industry officials with whom we spoke also cited FHA loan limits as a factor that contributed to the decline in FHA market share. In some areas of the country, particularly in parts of California and the Northeast, the loan limits were significantly lower than the median home price. Some mortgage industry officials also pointed to other product restrictions as a reason why FHA loans have been less competitive than conventional loans. For example, many borrowers do not or cannot make a down payment, and unlike FHA, in recent years members of the conventional mortgage market have been increasingly active in supporting low- and no-down-payment mortgages.

During the 10-year period we examined, several developments occurred in the conventional market that contributed to FHA's declining market share. I will discuss four of these developments. First, the conventional market offered products that increased consumer choices for borrowers, including those who may have previously chosen an FHA-insured loan. These products—interest-only loans, no- and low-documentation mortgages, piggyback loans, and hybrid adjustable rate mortgages (ARM)—became popular, especially during the subprime market's rapid growth after 2001, because they featured flexible payment and interest options that increased initial affordability.[8] In combination with historically low interest rates, these products made it easier for homebuyers to purchase homes in a period of strong house price appreciation.

Second, advances in underwriting technology, particularly mortgage scoring and automated underwriting systems, allowed conventional mortgage providers to process loan applications more quickly and

[8]Interest-only loans allow borrowers to defer the principal payments for some period and hybrid ARMs allow borrowers to pay a lower interest rate for a specified time, usually between 2 and 5 years, before the loan resets to the fully indexed interest rate. Piggyback loans are simultaneous second mortgages that allow borrowers to make little or no down payment. No- and low-documentation loans allow for less detailed proof of income or assets than lenders traditionally require.

consistently than in the past and broaden their customer base. FHA implemented its own mortgage scoring tool, called the Technology Open to Approved Lenders (TOTAL) scorecard, in 2004. However, in prior work we found that the way FHA developed TOTAL may limit the scorecard's effectiveness.[9] To the extent that conventional mortgage providers were better able than FHA to use scoring tools to identify lower-risk borrowers in FHA's traditional market segment, these borrowers may have migrated toward conventional products, contributing to the decline in FHA's market share.

Third, there was an increase in mortgage originations through third parties such as loan correspondents and mortgage brokers, particularly in the subprime market. This trend has been associated with the decline in FHA's market share because the third-party originators primarily market non-FHA products. Finally, the growth in private mortgage securitization (the bundling of mortgage loans into bond-like securities that can be bought and sold on the secondary market), particularly for subprime loans, allowed lenders to sell loans from their portfolios, transferring credit risk to investors, and use the proceeds to make more loans.

As a result of these developments and lower interest rates, more homebuyers—especially minority and lower-income families—were able to obtain conventional loans, but many of these loans had high ultimate costs. As previously discussed, much of the increase in mortgages to minorities and lower-income borrowers was due to the growth in subprime lending, and many of these loans offered lower initial costs through their interest-only features and low introductory interest rates. However, these mortgages became more costly as the interest rates on many of these loans reset to higher rates, typically 2 to 3 percentage points higher in a relatively short period.

Highly leveraged and weaker credit borrowers—the typical subprime borrowers who have obtained nontraditional mortgage products such as hybrid ARMs—are the most vulnerable to payment shocks. As a result, borrowers who obtained subprime mortgages have experienced relatively high rates of default (defined as payments more than 90 days past due) and foreclosure (in any stage of the foreclosure process). According to the Mortgage Bankers Association, as of December 31, 2006, the cumulative

[9]GAO, *Mortgage Financing: HUD Could Realize Additional Benefits from Its Mortgage Scorecard*, GAO-06-435 (Washington, D.C.: Apr. 13, 2006).

default and foreclosure rates for all subprime mortgages were 7.78 and 4.53 percent, respectively.[10] Some mortgage industry researchers predict that subprime default and foreclosure rates likely will worsen as the loans age; a substantial portion of these loans have yet to reach the age when loans tend to experience the highest rates of default and foreclosure—between 4 and 7 years. Furthermore, because most recent subprime loans have adjustable-rate features, default and foreclosure rates for ARMs are in particular danger of increasing as resetting interest rates cause monthly mortgage payments on the loans to rise.

Single-Family Modernization Proposals Likely Would Affect Program Participation and Costs

In our June 2007 report on FHA's modernization efforts, we noted that FHA's proposed legislative changes to its single-family insurance program likely would affect program participation and costs.[11] For example, we estimated that raising the FHA loan limits could increase demand for FHA-insured loans, all other things being equal. The risk-based pricing proposal would decrease premiums for lower-risk borrowers, increase them for higher-risk borrowers, and disqualify other potential borrowers. In addition, FHA estimates that the legislative proposals would have a favorable budgetary impact.

Raising Loan Limits Likely Would Increase Demand for FHA Loans

Our analysis indicated that raising the loan limits for FHA's single-family insurance program likely would increase the number of loans insured by FHA by making more loans eligible for FHA insurance. In some areas of the country, median home prices have been well above FHA's maximum loan limits, reducing the agency's ability to serve borrowers in those markets. For example, the 2005 loan limit in high-cost areas was $312,895 for one-unit properties, while the median home price was about $399,000 in Boston, Massachusetts; about $432,000 in Newark, New Jersey; and about $646,000 in San Francisco, California. If the limits were increased, FHA insurance would be available to a greater number of potential borrowers.

[10]For subprime ARMs, the corresponding figures were 9.16 and 5.62 percent. In comparison, as of the same date, the default and foreclosure rates for FHA-insured loans were 5.78 and 2.19 percent, respectively (6.62 and 2.54 percent for ARMs) and for prime loans, 0.86 and 0.50, respectively (1.45 and 0.92 for ARMs).

[11]GAO-07-708.

Our analysis of HMDA data indicated that the agency could have insured from 9 to 10 percent more loans in 2005 had the higher mortgage limits been in place.[12] The greatest portion of this increase resulted from raising the loan limit floor in low-cost areas from 48 to 65 percent of the conforming loan limit. In particular, 82 percent of the additional loans that would have been insured by FHA were in areas where the loan limits were set at the floor. Only 14 percent of the new loans would have resulted from increasing the loan limit ceiling. Our analysis also found that the average size of an FHA-insured loan in 2005 would have increased from approximately $123,000 to about $132,000 had the higher loan limits been in place.

Risk-Based Pricing Could Help Address Adverse Selection but Would Affect the Cost and Availability of FHA Insurance for Some Borrowers

To help address the problem of adverse selection, FHA has sought authority to price insurance premiums based on borrower risk, which would affect the cost and availability of FHA insurance for some borrowers. Currently, all FHA-insured borrowers pay the same premium rates. Under this flat pricing structure, lower-risk borrowers subsidize higher-risk borrowers. In recent years, innovations in the mortgage market have allowed conventional mortgage lenders and insurers to identify and approve relatively low-risk borrowers and charge fees based on default risk. As relatively lower-risk borrowers in FHA's traditional market segment have selected conventional financing, FHA has been left with more high-risk borrowers who require a subsidy and fewer low-risk borrowers to provide that subsidy. FHA has proposed risk-based pricing as a solution to the adverse selection problem.

As of May 2007, FHA's risk-based pricing proposal established six different risk categories, each with a different premium rate, for purchase and refinance loans.[13] FHA used data from its most recent actuarial review to establish the six risk categories and corresponding premiums based on the relative performance of loans with various combinations of loan-to-value (LTV) ratio (loan amount divided by sales price or appraised value) and

[12]Our analysis considered the number of additional loans that would have been eligible for FHA insurance if the loan limits in 2005 had been raised to 100 percent of the local median home price, with a floor in low-cost areas of $233,773 and a ceiling in high-cost areas of $359,650. We made different assumptions about the share of newly eligible loans that likely would be insured by FHA, all of which yielded similar results.

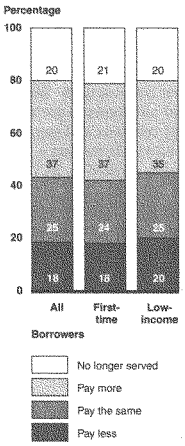
[13]Different pricing would apply to refinances of existing FHA-insured mortgages.

credit score.[14] Borrowers in categories with higher expected lifetime claim rates would have higher premiums than those in categories with lower claim rates. If FHA were granted the authority to implement its risk-based pricing proposal, the agency would publish a pricing matrix that would allow borrowers to identify their likely premiums based on their credit scores and LTV ratios. However, FHA would use its TOTAL mortgage scorecard to make the final determination of a borrower's placement in a particular risk category. Because TOTAL takes into account more borrower and loan characteristics than LTV ratio and credit score (such as borrower reserves and payment-to-income ratio), a borrower's TOTAL score could indicate that a borrower belongs in a higher risk category than would be suggested by LTV ratio and credit score alone.

Our analysis of how the proposed pricing structure would affect home purchase borrowers similar to those insured by FHA in 2005 found that approximately 43 percent of borrowers would have paid the same or less while 37 percent would have paid more. Twenty percent would not have qualified for FHA insurance had the risk-based pricing proposal been in effect. As shown in figure 2, risk-based pricing would have had a similar impact on first-time and low-income homebuyers FHA served in 2005.

[14]The Omnibus Budget Reconciliation Act of 1990 requires an annual independent actuarial review of the economic net worth and soundness of the Mutual Mortgage Insurance Fund.

Figure 2: Impact of FHA's Risk-Based Pricing Proposal on Borrowers' Premiums, Including First-Time and Low-Income Homebuyers



Sources: GAO, SFDW.

Note: We analyzed Single Family Data Warehouse data on 2005 home purchase borrowers. The figure shows how these borrowers would have fared under FHA's risk-based pricing proposal. Low-income homebuyers are those whose incomes are less than or equal to 80 percent of the area median income. The figure excludes the approximately 2 percent of borrowers for whom SFDW did not contain either an LTV ratio or credit score (the two variables FHA would use to determine risk-based premiums).

Risk-based pricing also would affect the availability of FHA insurance for some borrowers. Approximately 20 percent of FHA's 2005 borrowers would not have qualified for FHA mortgage insurance under the parameters of the risk-based pricing proposal we evaluated. FHA determined that the expected claim rates of these borrowers were higher than it found tolerable for either the borrower or the Mutual Mortgage Insurance Fund. Those borrowers who would not have qualified had high LTV ratios and low credit scores. Their average credit score was 584, and

their expected lifetime claim rates are more than 2.5 times higher than the average claim rate of all FHA loans.[15] FHA officials stated that setting risk-based premiums for potential future FHA borrowers with similar characteristics would require prices higher than borrowers might be able to afford.

Legislative Proposals Likely Would Have a Beneficial Budgetary Impact

According to FHA's estimates, the three major legislative proposals would have a beneficial impact on HUD's budget due to higher estimated negative subsidies. According to the President's fiscal year 2008 budget, the credit subsidy rate for the Mutual Mortgage Insurance Fund would be more favorable if the legislative proposals were enacted. Absent any program changes, FHA estimates that the fund would require an appropriation of approximately $143 million. If the legislative proposals were not enacted, FHA would consider raising premiums to avoid the need for appropriations. If the major legislative proposals were passed, FHA estimates that the fund would generate $342 million in negative subsidies.

FHA's subsidy estimates for fiscal year 2008 should be viewed with caution given that FHA has generally underestimated the subsidy costs for the Mutual Mortgage Insurance Fund. To meet federal requirements, FHA annually reestimates subsidy costs for each loan cohort dating back to fiscal year 1992.[16] The current reestimated subsidy costs for all except the fiscal year 1992 and 1993 cohorts are higher than the original estimates. For example, the current reestimated cost for the fiscal year 2006 cohort is about $800 million higher than originally estimated. As discussed below, FHA has taken some steps to improve its subsidy estimates.

[15]Additionally, the vast majority of these borrowers (90 percent) received down-payment assistance from nonprofits, most of which received funding from property sellers.

[16]Agencies are required to reestimate subsidy costs annually to reflect actual loan performance and expected changes in estimates of future loan performance. Essentially, a cohort includes the loans insured in a given year.

FHA Has Enhanced Tools and Resources Important to Implementing Single-Family Proposals but Does Not Intend to Mitigate Risks by Piloting New Products

FHA has planned or taken steps to enhance the tools and resources that would be important to implementing the legislative proposals for its single-family insurance program. For example, we found that:

- FHA has improved the loan performance models it would use to implement risk-based pricing by adding factors that have been found to influence credit risk. In a September 2005 report, we recommended that FHA study and report the impact (on the forecasting ability of its loan performance models) of variables that have been found in other studies to influence credit risk, such as payment-to-income ratios, credit scores, and the presence of down-payment assistance.[17] In response, HUD's contractor subsequently incorporated the source of down-payment assistance in the fiscal year 2005 actuarial review and borrower credit scores in the fiscal year 2006 review.

- FHA is in the process of addressing a number of limitations in its mortgage scorecard that could reduce its effectiveness for risk-based pricing. For instance, as we reported in April 2006, the scorecard does not include a number of important variables included in other mortgage institutions' scorecards, such as the source of the down payment, whether the loan is an adjustable-rate mortgage, and property type.[18] An FHA contractor is helping the agency test additional variables to include in the scorecard and is scheduled to issue a final report on its work in August 2007.

- FHA has identified changes in information systems needed to implement the legislative proposals and has obligated or requested a total of $11 million for this purpose.

- To address human capital needs, the President's fiscal year 2008 budget requests 21 additional staff for FHA to help analyze industry trends, align the agency's business processes with current mortgage industry practices, and promote new FHA products.

Although FHA has taken actions to enhance key tools and resources, the legislative proposals would introduce new risks. Our past work has shown

[17]See GAO, *Mortgage Financing: FHA's $7 Billion Reestimate Reflects Higher Claims and Changing Loan Performance Estimates*, GAO-05-875 (Washington, D.C.: Sept. 2, 2005). While loan performance models are critical to subsidy cost estimation, other factors such as assumptions about the losses per insurance claim and economic conditions influence subsidy estimates.

[18]GAO-06-435.

that FHA has not always utilized risk-management practices used by other mortgage institutions. For example, we reported in November 2005 that HUD needed to take additional actions to manage risks related to the approximately one-third of its loans with down-payment assistance from seller-funded nonprofits.[19] Unlike other mortgage industry participants, FHA does not restrict homebuyers' use of such assistance. Our 2005 analysis found that the probability that these loans would result in an insurance claim was 76 percent higher than for comparable loans without such assistance, and we recommended that FHA revise its underwriting standards to consider such assistance as a seller contribution (which cannot be used to meet the borrower contribution requirement).[20] Despite the detrimental impact of these loans on the Mutual Mortgage Insurance Fund, FHA did not act promptly to mitigate the problem by adjusting underwriting standards or using its existing authority to raise premiums. However, in May 2007, FHA published a proposed rule that would prohibit seller-funded down-payment assistance.[21]

While FHA plans to take some steps, such as instituting stricter underwriting standards, to mitigate the risks associated with lowering down-payment requirements, it does not plan to pilot any zero-down-payment product the agency is authorized to offer. The proposal to lower down-payment requirements is of particular concern given the greater default risk of low-down-payment loans, housing market conditions that could put borrowers with such loans in a negative equity position, and the difficulty of setting prices for new products whose risks may not be well understood. As we reported in February 2005, other mortgage institutions limit the availability of or pilot new products to manage risks associated with changing or expanding product lines.[22] We indicated that, if Congress

[19]GAO, *Mortgage Financing: Additional Action Needed to Manage Risks of FHA-Insured Loans with Down Payment Assistance*, GAO-06-24 (Washington, D.C.: Nov. 9, 2005).

[20]We reviewed a national sample of FHA-insured home purchase loans from 2000, 2001, and 2002.

[21]See 72 Fed. Reg. 27048 (May 11, 2007). FHA also has been anticipating a reduction in the number of loans with down-payment assistance from seller-funded nonprofit organizations as a result of actions taken by the Internal Revenue Service (IRS). IRS issued a ruling in May 2006 stating that these organizations do not qualify as tax-exempt charities, effectively making loans with such assistance ineligible for FHA insurance. According to FHA, as of June 2007, IRS had rescinded the charitable status of three of the 185 organizations that IRS is examining.

[22]GAO, *Mortgage Financing: Actions Needed to Help FHA Manage Risks from New Mortgage Loan Products*, GAO-05-194 (Washington, D.C.: Feb. 11, 2005).

authorizes FHA to insure new products, it should consider a number of means, including limiting their initial availability, to mitigate the additional risks these loans may pose. We also recommended that FHA consider similar steps for any new or revised products.

FHA Has Not Assessed the Effects of Proposed Changes to Its Manufactured Home Loan Program

Now I will make some preliminary observations based on our ongoing work for you and Senators Reed and Schumer on FHA's Manufactured Home Loan program. Our objectives are to (1) describe selected characteristics of manufactured housing and the demographics of the owners, (2) compare federal and state consumer and tenant protections for owners of manufactured homes, and (3) describe the proposed changes to the Manufactured Home Loan program and assess potential benefits and costs to borrowers and the federal government.

Currently, this is the only active federal loan program that includes an option for a "home-only" product; that is, a personal property loan for the purchase of a manufactured home without the land on which the home will be located. Available data on selected characteristics of manufactured homes and their owners in 2005 indicate that manufactured homes can be an affordable housing option, with monthly housing costs considerably lower than other housing types. In addition, we found most manufactured homes were located in rural areas and more were located in Southern states than in other regions. Further, owners of manufactured homes have more consumer protections if homes are considered real rather than personal property, but the laws in the eight states we visited provide varying protections.[23]

Legislative proposals for the Manufactured Home Loan program would increase loan limits, insure each loan made, incorporate stricter underwriting requirements, establish up-front insurance premiums, and adjust the annual premium. For instance, limits for a home-only loan would rise from $48,600 to $69,678, loan guarantees would apply to individual loans rather than be capped at 10 percent of the value of a lender's portfolio, and underwriting requirements would be revised with the stated intent of strengthening the financial soundness of the program.

[23]We selected the eight states (Arizona, Florida, Georgia, Missouri, New Hampshire, North Carolina, Oregon, Texas) based on factors including the volume of FHA Title I loans in the state from 1990 to 2007; the concentration of manufactured housing as a percentage of housing units in the state; information from our interviews of industry and consumer officials; and previous studies conducted on manufactured housing.

According to FHA and some industry officials, the potential benefits of proposed changes for borrowers include obtaining loan amounts sufficient to buy larger homes, additional financing with lower interest rates as more lenders would likely participate in a program where a greater portion of their portfolios could be insured, and an expansion of the secondary market that could provide more liquidity for lenders to make more loans.

According to FHA and CBO, the potential costs of the proposed changes could involve an expansion of the government's liability under the program because FHA would be insuring individual loans rather than a limited portion of a lender's portfolio. Additionally, industry officials identified risk factors unique to manufactured housing that affect loan performance, which in turn could affect claims to FHA's General Insurance Fund. For instance, the ability of the owner of a manufactured home to build equity may be limited when the land is leased, which also often increases the risks associated with the loan. If a borrower with a home on leased land were to default, lenders could face higher costs and lower recoveries (relative to site-built homes) in trying to repossess, move, and resell the personal property.

To gain an understanding of the effects of the proposed changes, we developed a model with various scenarios based on the experience of FHA loans and loan performance data from manufactured home lenders. Although risk factors unique to manufactured home lending (such as placement on leased land) as well as commonly used predictors of loan performance (such as credit scores) are associated with default risk, these data were not available. Instead, we presented low, medium, and high levels of borrower default risk and incorporated other factors (such as premiums and lender recovery) to illustrate how variations in these key factors affect potential gains and losses to FHA's General Insurance Fund. The preliminary results of our analysis show that in all cases when borrowers had medium or high default risk, the fund experienced a loss.

While our scenario analysis offers a very general illustration of how the proposed changes could affect the General Insurance Fund, the effects of the proposed changes are unclear because FHA has not articulated which borrowers would be targeted if the program were expanded, specified changes in its underwriting requirements, developed a risk-based pricing structure for the proposed legislation, or estimated costs to the General Insurance Fund. Our internal control standards for federal agencies

require that an agency identify risks that may be posed by new legislation.[24] FHA has stated that it has not yet made these risk assessments because the legislation has not yet passed and that they chose to focus their resources on the much larger single-family insurance program. As a result, FHA has yet to determine the effects the proposed legislation may have on the volume of lending and claims and the overall financial soundness of the program.

Mr. Chairman, this concludes my prepared statement. I would be happy to answer any questions at this time.

Contacts and Acknowledgments

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[24]GAO, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: Nov. 1, 1999).

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ENTITLED

"MODERNIZATION OF FEDERAL HOUSING ADMINISTRATION PROGRAMS"

WRITTEN TESTIMONY OF JOHN ANDERSON, ABR, CRS, CRB, GRI

NATIONAL ASSOCIATION OF REALTORS®
JULY 18, 2007

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EQUAL HOUSING OPPORTUNITY

Introduction

Chairman Dodd, Ranking Member Shelby, Members of the Committee, thank you for the opportunity to testify before the Committee. My name is John Anderson and I am a broker/owner of Twin Oaks Realty in Crystal, MN. I am a member of the National Association of REALTORS®® Federal Housing Policy Committee, past Chair of that Committee, and past chair of the NAR Regulatory Issues Forum. I work extensively with FHA and VA. In fact, I helped a client close on a house with an FHA loan just last week.

I am here to testify on behalf of 1.35 million members of the National Association of REALTORS®. We thank you for the opportunity to present our views on the importance of FHA mortgage insurance and the urgent need for reform. NAR represents a wide variety of housing industry professionals committed to the development and preservation of the nation's housing stock and making it available to the widest range of potential homebuyers. The Association has a long tradition of support for innovative and effective federal housing programs and we have worked diligently with the Congress to fashion housing policies that ensure federal housing programs meet their mission responsibly and efficiently.

Consumers Need a Safe, Affordable Mortgage Alternative

The current increase in foreclosures is troubling to all of us. In 2006, 1.2 million families entered into foreclosure, 42 percent more than in 2005[1]. Predatory lending, exotic mortgages

[1] *A Flood of Foreclosures, But Should You Invest?,* Market Watch, February 18, 2007.

and a dramatic rise in sub-prime lending – coupled with slowing home price appreciation - have all contributed to this crisis.

In 1934 the Federal Housing Administration was established to provide consumers an alternative during a similar lending crisis. At that time, short-term, interest-only and balloon loans were prevalent. Since its inception, FHA has insured more than 34 million properties. However, because it hasn't evolved, FHA's market share has been dropping. In the 1990s FHA loans were about 12 percent of the market. Today, that rate is less than 3 percent. This statistic is unfortunate given that FHA is needed now as much as it was in 1934. At the same time, the sub-prime market has skyrocketed. In 2003, the sub-prime market share was 8.5 percent. By 2005 it was at 20 percent. In 2006, FHA/VA market share dropped 37.8 percent; conventional loans dropped 9.8 percent; while sub-prime loans increased another 15.7 percent. In your home state of Connecticut, Mr. Chairman, FHA's purchase share declined more than 49% since 1997. This decline is not only bad for FHA, it is bad for borrowers. A GAO study reported that FHA's decline in market share "has been accompanied by higher ultimate costs for certain conventional borrowers and a worsening in indicators of credit risk among FHA borrowers."[2]

When formed, FHA was a pioneer of mortgage products. FHA was the first to offer thirty-year fixed-rate financing at a time when loans were generally for less than five years. Unfortunately, FHA has not changed with the times. Where they were once the innovator, FHA has become the lender of last resort. As conventional and sub-prime lenders have expanded their repertoire of loan products, FHA has remained stagnant. As a result, a large number of homebuyers have

[2] *Decline in the Agency's Market Share was Associated with Product and Process Developments of Other Mortgage Market Participants*, GAO report, June 2007, page 5.

decided to use one of several new types of non-traditional mortgages that let them "stretch" their income so they can qualify for a larger loan.

Non-traditional mortgages often begin with a low introductory interest rate and payment—a "teaser" rate —but the monthly mortgage payments are likely to increase significantly in the future. Some of these loans are "low documentation" mortgages that provide easier standards for qualifying, but also feature higher interest rates or higher fees. Mortgages such as interest-only and option adjustable rate mortgages (ARMs) can often be risky propositions for some borrowers. For many of these products, the borrower is only qualified on their ability to make the initial payment amount. When the introductory period expires and monthly payments increase by as much as 50 percent or more, or when their loan balances get larger each month instead of smaller, many borrowers ability to pay will be put at risk. Mortgage experts estimate that approximately $1.5 trillion worth of ARMs will reset by the end of 2007[3]. While some borrowers may be able to make the new higher payments, many will find it difficult, if not impossible.

Even absent the foreclosure risks, many borrowers paid higher costs for subprime loans than they would have for an FHA mortgage. GAO's recent analysis of 2005 HMDA data found that 90 percent of subprime loans were high priced, i.e. loans with APRs at least three percentage points higher that the rate on treasury securities of comparable maturity. GAO found that less than 2 percent of FHA loans were high priced.

[3] *Homeowners Brace For ARMs' New Rates*, The Seattle Times, February 17, 2007.

As the market has changed, FHA must also change to reflect consumer needs and demands. If FHA is enhanced to conform to today's mortgage environment, many borrowers would have available to them a safer alternative to the costly, riskier products that are currently marketed to them.

To Be Viable, FHA Must Reform

To enhance FHA's viability, legislation has been introduced that proposes a number of important reforms to the FHA single-family insurance program that NAR believes will greatly benefit homebuyers by improving access to FHA's safe and affordable credit.

The legislation proposes to increase the loan limits, eliminate the statutory 3 percent minimum cash investment and downpayment calculation, allow FHA flexibility to provide risk-based pricing, and move the condo program into the 203(b) fund. The National Association of REALTORS® strongly supports these reform provisions.

Loan Limits. FHA mortgages are used most often by first-time homebuyers, minority buyers, and other buyers who cannot qualify for conventional mortgages because they are unable to meet the lender's stringent underwriting standards. Despite its successes as a homeownership tool, FHA is not a useful product in high cost areas of the country because its maximum mortgage limits have lagged far behind the median home price in many communities. As a result, working families such as teachers, police officers and firefighters are unable to buy a home in the communities where they work. In Connecticut, Mister Chairman, FHA is virtually unusable due

to the loan limits. In Senator Allard's state of Colorado, which is not generally considered high cost, NAR projects that the loan limit change alone will increase FHA usage by 53 percent, resulting in a savings of over $34.8 million to Colorado homeowners over what they are paying for subprime loan products.

This is why NAR strongly supports proposals to change the FHA loan limits. Under the legislation, FHA's limits for single unit homes in high cost areas would increase from $362,790 to the 2006 conforming loan limit of $417,000. In non-high cost areas, the FHA limit (floor) would increase from $200,160 to $271,050 for single unit homes. This increase will enhance FHA's ability to assist homebuyers in areas not defined as high-cost, but where home prices still exceed the current maximum of $200,160. This includes states such as Arizona, Colorado, Florida, Georgia, Illinois, Maine, Minnesota, Nevada, North Carolina, Ohio, Oregon, Pennsylvania, Utah, Vermont, and Washington. While none of these states is generally considered "high cost", all have median home prices higher than the current FHA loan limit.

Down Payment Flexibility. The ability to afford the downpayment and settlement costs associated with buying a home remains the most challenging hurdle for many homebuyers. Eliminating the statutory 3-percent minimum downpayment will provide FHA flexibility to offer varying downpayment terms to different borrowers. Although our nation's homeownership rate is a record 69 percent, many deserving American families continue to face obstacles in their quest for the American dream of owning a home. Providing flexible downpayment products for FHA will go a long way to addressing this problem.

In 2005, 43 percent of first-time homebuyers financed 100 percent of their home. NAR research indicates that if FHA were allowed to offer this option, 1.6 million families could benefit. According to NAR's Profile of Homebuyers, 55 percent of homebuyers who financed with a zero-downpayment loan in 2005, had incomes less than $65,000; 24 percent of those who used a zero-downpayment product were minorities; and 52 percent of people who financed 100 percent of their home purchased homes priced at less than $150,000. It is important to note that FHA will require borrowers to have some cash investment in the home. This investment can be in the form of payment of the up-front premium or closing costs. No loan will be made for more than 103 percent the value of the home.

Risk-based Pricing. Another key component of the legislation is to provide FHA with the ability to charge borrowers different premiums based on differing credit scores and payment histories. Risk-based pricing of the interest rate, fees and/or mortgage insurance is used in the conventional and sub-prime markets to manage risk and appropriately price products based on an individual's financial circumstances. Currently, all FHA borrowers, regardless of risk, pay virtually the same premiums and receive the same interest rate.

FHA financing, with risk-based premium pricing, will still be a much better deal for borrowers with higher risk characteristics than is currently available in the "near prime" or sub-prime markets. Risk-based pricing makes total sense to the private market, and should for FHA as well. Giving FHA the flexibility to charge different borrowers different premiums based on risk will allow FHA to increase their pool of borrowers. If FHA is also given authority to

provide lower downpayment mortgages, premium levels will need to reflect the added risk of such loans (as is done in the private market) to protect the FHA fund.

Changes to the Fund Structures. The legislation also proposes to combine all single-family programs into the Mutual Mortgage Insurance Fund. The FHA program has four funds with which it insures its mortgages. The Mutual Mortgage Insurance (MMI) Fund is the principal funding account that insures traditional Section 203b single-family mortgages. The Fund receives upfront and annual premiums collected from borrowers as well as net proceeds from the sale of foreclosed homes. It is self-sufficient and has not required taxpayer bailouts.

The Cooperative Management Housing Insurance Fund (CMHI), which is linked to the MMI Fund, finances the Cooperative Housing Insurance program (Section 213) which provides mortgage insurance for cooperative housing projects of more than five units that are occupied by members of a cooperative housing corporation.

FHA also operates Special Risk Insurance (SRI) and General Insurance (GI) Funds, insuring loans used for the development, construction, rehabilitation, purchase, and refinancing of multifamily housing and healthcare facilities as well as loans for disaster victims, cooperatives and seniors housing. Currently, the FHA condominium loan guarantee program and 203k purchase/rehabilitation loan guarantee program are operated under the GI/SRI Fund.

NAR strongly supports inclusion of the FHA condominium loan guarantee program and the 203k purchase/rehabilitation loan guarantee program in the MMIF. Both of these programs provide

financings for single family units and have little in common with multifamily and health facilitates programs covered by the SRI and GI funds. In recent years programs operating under the GI/SRI funds have experienced disruptions and suspensions due to funding commitment limitations. Maintaining the single family condo and purchase/rehabilitation programs under the GI/SRI funds exposes these programs to possible future disruptions. Thus, from a conceptual and accounting standpoint, it makes sound business sense to place all single-family programs under the MMIF.

Program Enhancements. As well as combining the 203(k) and condominium programs under the MMIF, NAR also recommends key enhancements to increase the programs' appeal and viability. Specifically, NAR recommends that HUD be directed to restore investor participation in the 203(k) program. In blighted areas, homeowners are often wary of the burdens associated with buying and rehabilitating a home themselves. However, investors are often better equipped and prepared to handle the responsibilities related to renovating and repairing homes. Investors can be very helpful in revitalizing areas where homeowners are nervous about taking on such a project.

We also recommend that HUD lift the current owner-occupied requirement of 51 percent before individual condominium units can qualify for FHA-insured mortgages. The policy is too restrictive because it limits sales and homeownership opportunities, particularly in market areas comprised of significant condominium developments and first-time homebuyers. In addition, the inspection requirements on condominiums are burdensome. HUD has indicated that it would provide more flexibility to the condo program under the MMIF. We strongly support loosening

restrictions on FHA condo sales and 203k loans to provide more housing opportunities to homebuyers nationwide.

FHA Protects Borrowers

The universal and consistent availability of FHA loan products is the principal hallmark of the program that has made mortgage insurance available to individuals regardless of their racial, ethnic, or social characteristics during periods of economic prosperity *and* economic downturn.

The FHA program makes it possible for higher-risk, yet credit-worthy borrowers to get prime financing. According to a recent Federal Reserve Bank review,[4] the average credit score for sub-prime borrowers was 651. This is higher than FHA's median credit score borrower, which demonstrates that these borrowers are likely paying more than they need to pay. By offering access to prime rate financing, FHA provides borrowers a means to achieve lower monthly payments – without relying to interest-only or "optional" payment schemes. FHA products are safe, thanks to appropriate underwriting and loss-mitigation programs, and fairly priced without resorting to teaser rates or negative amortization.

When the housing market was in turmoil during the 1980s, FHA continued to insure loans when others left the market; following 9/11, FHA devised a special loan forbearance program for those who temporarily lost their jobs due to the attack; after Hurricanes Katrina and Rita, FHA provided a foreclosure moratorium for borrowers who were unable to pay their mortgages while recovering from the disaster. FHA's universal availability has helped to stabilize housing

[4] Federal Reserve Bank of St. Louis Review - January-February 2006

markets when private mortgage insurance has been nonexistent or regional economies have faltered. FHA is the only national mortgage insurance program that provides financing to all markets at all times. Simply put, FHA has been there for borrowers.

Now, more than ever, FHA needs to be strengthened to continue to be available to borrowers. In just the past few months, at least 25 sub-prime lenders have exited the business, declared bankruptcy, announced significant losses, or put themselves up for sale.[5] After making record profits, these lenders are simply bailing as the bad loans they made begin to fail. FHA, who is more careful with its underwriting standards, can be a safe alternative for buyers who have been lured into unnecessary sub-prime loans.

FHA is a leader in preventing foreclosures. FHA's loss mitigation program authorizes lenders to assist borrowers in default. The program includes mortgage modification and partial claim options. Mortgage modification allows borrowers to change the terms of their mortgage so that they can afford to stay in the home. Changes can include extension of the length of the mortgage or changes in the interest rate. Under the partial claim program, FHA lends the borrower money to cure the loan default. This no-interest loan is not due until the property is sold or paid off. In the year 2004 alone, more than 78,000 borrowers were able to retain their home through FHA's loss mitigation program; and two years later, nearly 90 percent of these borrowers are still in their homes. By encouraging lenders to participate in these loss mitigation efforts and penalizing those who don't, FHA has successfully helped homeowners keep their homes and reduced the level of losses to the FHA fund.

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[5] *The Mortgage Mess Spreads*, BusinessWeek.com, March 7, 2007.

Solvency and Strength of FHA

Critics of the reform proposals have argued that FHA isn't positioned to handle changes to the program. We respectfully disagree. Despite FHA's falling market share, the FHA fund is healthy and strong. Congress has mandated that FHA have a capitalization ratio of 2 percent to insure fiscal solvency. In 2006, the FHA cap ratio was far above that figure at 6.82 percent -- despite being the lender of last resort in today's marketplace. FHA's current economic value is over $22 billion. In simple terms, this indicates that if the MMIF stopped operations today, the current portfolio would be expected to generate $22 billion dollars over the remaining life of the loans in the portfolio above what it would pay out in claims. Since its inception in 1934, FHA has never needed a federal bailout, and has been completely self-sufficient. In fact, FHA has contributed a significant amount of money to the Federal Treasury each year. However, due to the dramatic loss in volume, FHA has estimated that it will need to increase premiums if reforms are not implemented that increase usage of FHA.

If FHA is allowed to adjust premiums based on risk, it will operate even more soundly than it does today. If FHA is to thrive and fully perform its intended function, a change to risk-based pricing is necessary. Average pricing in the portion of the credit spectrum where FHA operates is crucial if FHA is to sustain its operations in a financially solvent manner. Absent risk-based premiums, the risk profile FHA borrowers can decrease, causing either an increase in the average price or an ultimate shortfall in the insurance fund. This is why FHA has estimated that it will need to increase premiums if reforms are not implemented that increase usage of FHA.

FHA is often criticized for its default and foreclosure rate. That criticism is unwarranted, as FHA's mission is to serve people that aren't served by the conventional market, and therefore are more risky. However, FHA's foreclosure rate is substantially better than the sub-prime market, where many FHA-eligible borrowers currently have loans. A recent study by the Center for Responsible Lender reported that "FHA and sub-prime loans have quite different foreclosure rates. For example, sub-prime loans originated in 2000 in our sample had a 12.9% foreclosure rate within five years. In contrast, FHA loans originated in 2000 had a 6.29% foreclosure rate by year-end 2005."[6]

When FHA has seen problems with their default rates, they have tried to remedy them. FHA noticed that loans which utilized a gift downpayment had a higher default rate. These gifts included seller-funded downpayment assistance. FHA attempted to eliminate this program and faced legal challenges. At that time Congress supported downpayment gift providers, and challenged HUD's attempt to shut them down. Studies done by Government Accountability Office and others determined that this form of downpayment assistance in fact drove up the costs of homeownership, and generally made the loan a bigger risk. Although the IRS recently ruled that many seller-funded downpayment programs would lose their charitable tax status, they have yet to change the status of any organization. To avoid further delay, FHA has published a notice prohibiting gift downpayment loans from FHA eligibility. Such a prohibition should greatly improve FHA's default rate. It has been estimated that 29 percent of FHA borrowers in 2005 used seller-funded downpayment assistance.

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[6] *Losing Ground:Foreclosures in the Subprime Market and Their Cost to Homeowners*, Center for Responsible Lending, December 2006, page 26.

Instead, by providing FHA the ability to offer flexible downpayments, homeowners won't bear the increased home price costs and the loans will be safer. Allowing FHA to price low downpayment loans according to risk, they would be more in line with the conventional market. This will greatly decrease FHA's default rate.

Furthermore, FHA's operations have improved dramatically in the last several years. In 1994, HUD was designated as "high risk" by the Government Accountability Office, a longtime critic of the Department. Last month, that designation was removed. GAO said that "HUD had improved its oversight of lenders and appraisers and issues or proposed regulations to strengthen lender accountability and combat predatory lending practices."[7] HUD has also demonstrated their ability to estimate program costs and oversight for mortgage underwriting.

Can FHA Help with the Current Foreclosure Crisis?

The National Association of REALTORS® has provided HUD Secretary Jackson with a proposal that would allow FHA to help many families with recent or impending interest rate adjustments refinance into a loan they can afford. Our proposal is to allow credit-worthy borrowers who may not be "current" on their existing loan, refinance into an FHA loan.

Many homeowners who were able to make timely payments under their original terms of their loan are finding it difficult to make payments after rate adjustments. This is occurring and will continue to occur across a wide spectrum of ARM products including 2/28 and 3/27 products

[7] GAO, *High Risk Series: An Update*, GAO-07-310 (Washington, D.C.: January, 2007)

issued over the past few years. Many of these homeowners that would otherwise qualify for FHA insured mortgages will be preempted by guidelines that prohibit refinance when loans are not current and will eventually be subject to foreclosure. We believe FHA can design a mechanism where creditworthy borrowers could refinance subject to prudent guidelines and avoid losing their homes. NAR believes in a strong FHA and would support efforts to ensure that only borrowers who truly have the capacity to repay receive the opportunity to refinance under such changes.

NAR also believes that many homeowners aren't aware that FHA exists as a financing option. While FHA isn't useful to many without reforms, once reformed we believe a large public awareness campaign will be necessary to fully inform homeowners of all their options. NAR pledges to be a partner in such efforts and has already demonstrated its commitment by producing a joint FHA education brochure, "**FHA Improvements Benefit You**" with FHA and HUD distributing over 50,000 copies across the nation.

We believe this is just the beginning. REALTORS® believe that financial education is an important defense to helping prevent consumers from getting into abusive mortgages that will undoubtedly be financially destructive. NAR, in partnership with the Center for Responsible Lending, has issued three consumer education brochures, **"How to Avoid Predatory Lending," "Specialty Mortgages: What Are the Risks and Advantages?"** and **"Traditional Mortgages: Understanding Your Options**." The brochures emphasize how important it is for consumers to make sure they fully understand how traditional and non-traditional mortgages work before deciding which is the right choice and how to avoid the pitfalls and entrapments of predatory loans.

In addition to NAR's consumer education materials, many of our state and local associations have high-profile financial education programs in partnership with cities and community groups. Some examples include:

- In Maryland, a number of local REALTOR® associations, including in Anne Arundel County, Howard County, Prince George's County, and the Greater Baltimore Board of REALTORS® have partnered with Freddie Mac to develop CreditSmart, a credit education workshop. REALTOR® instructors teach the course to renters, homebuyers, students, and others, on how to manage critical money skills. The skills that course participants obtain help point them in the right direction to managing credit and saving to buy a home.

- In 1996, the Illinois Association of REALTORS® organized the Partnership for HomeOwnership, Inc. to help assist low-income rural Illinois residents achieve the dream of homeownership. The Partnership has administered several multi-million dollar mortgage programs (in excess of $130 million), provided pre-purchase homebuyer counseling to over 1,500 Illinois residents, and is a HUD approved housing counseling agency. The Partnership also recently oversaw the development of high school financial educational Web site at that is available both in English and in Spanish.

- In Arkansas, the Fort Smith Board of Realtors® and the city of Forth Smith have teamed up to create a homebuyer assistance program. Participants receive credit counseling and mortgage readiness education. The program also offers a five-week financial fitness

course on budgeting, money management, credit and avoiding predatory lending. Since 1997, more than 200 families have purchased a home as a result of the program.

NAR stands ready to work with the FHA to not only help Americans achieve the American Dream but to keep it as well.

Conclusion

Thank you again for the opportunity to testify on this important issue. Now is the time when the country needs FHA. As sub-prime loans reset and real estate markets are no longer experiencing double digit appreciation; a reformed FHA would be perfectly positioned to offer borrowers a safer mortgage alternative and bring stability to local markets and local economies. The National Association of REALTORS® stands ready to work with the Congress on passage of FHA reform.

Statement of David G. Kittle, CMB

Vice-Chairman,

Mortgage Bankers Association

Before the

Committee on Banking, Housing and Urban Affairs

United States Senate

Hearing on

Modernization of Federal Housing Administration Programs

July 18, 2007

Chairman Dodd, Ranking Member Shelby and members of the Committee, thank you for holding this hearing and inviting the Mortgage Bankers Association (MBA)[1] to share its views on modernizing the Federal Housing Administration (FHA). My name is David Kittle and I am the President of Principle Wholesale Lending, Inc. in Louisville, Ky. and Vice-Chairman of the Mortgage Bankers Association (MBA). I am here today because MBA believes Congress must act to make important legislative changes to the National Housing Act if the FHA is to continue to be a tool for lenders to use in serving the housing needs of American families who are not served or are underserved by conventional markets.

When I started in the mortgage business, the programs of FHA were invaluable in enabling us to serve families who otherwise would have no other affordable alternative for financing their home. In fact, my first home was financed with an FHA mortgage, and when I was a loan officer in1983, over 90 percent of the loans I closed were FHA loans (320 out of 343 loans made that year). Moreover, from 1994, when I started my first mortgage company, until 1999, FHA was about 38 percent of my business.

Today, though, the story is very different. For example, since 1999, my company's FHA volume has steadily declined and now represents less than 2 percent of the company's business. While most lenders, investors and insurers have been able to adapt quickly to changes in the mortgage markets, but FHA has been prevented from doing so. The needs of low- and moderate-income homebuyers, of first-time homebuyers, of minority homebuyers, and of senior homeowners have changed. FHA's programs, though, have not followed their historic path of adaptation to meet these borrowers' changing needs.

The numbers are troublesome. In 1990, 18 percent of total originations in the U.S. were FHA-insured mortgages. Currently, that number has dropped to under three percent.[2] More importantly, in 1990, 12.5 percent of new home sales were financed through programs at FHA; today that number has dropped to under 5 percent.

MBA cites these numbers not because we believe that there is a certain market share that FHA should retain, but rather because these numbers are consistent

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[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 500,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 3,000 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

[2] Source: *Inside Mortgage Finance, March 2, 2007.*

with many lenders' views that FHA has not kept up with changes in the market. These numbers point to a decline, not just in market share, but in FHA's potential to positively impact homeownership. This loss of impact does not stem from the fact that FHA is no longer relevant, but rather that statutory constraints prohibit FHA from adapting its relevance to consumer needs today.

A recent anecdote illustrates this point very well. A story ran in *RealtyTimes*® on June 21, 2005, in which a Baltimore, Md. real estate agent unabashedly advises homebuyers to avoid FHA financing. The agent states: "Approved FHA loan recipients, same notice to you, don't bother bringing it to the table during a sellers' market. More times than not, your offer will be rejected. We know that VA and FHA loans allow you the means of purchasing more home for the mortgage, but it only works if you are the only game in town." His advice was based on the often true notion that FHA-insured financing is slower and more laborious than conventional financing, which means FHA's valuable programs are not reaching the people they should.

FHA Background

FHA was created as an independent entity by the National Housing Act on June 27, 1934, to encourage improvement in housing standards and conditions, to provide an adequate home financing system by insurance of home mortgages and credit and to exert a stabilizing influence on the mortgage market. FHA was incorporated into the newly formed U.S. Department of Housing and Urban Development (HUD) in 1965. Over the years, FHA has facilitated the availability of capital for the nation's multifamily and single-family housing market by providing government-insured financing on a loan-by-loan basis.

FHA offers multifamily and single-family insurance programs that work through private lenders to extend financing for homes. FHA has historically been an innovator. Over the past several decades, the mission of FHA's single-family programs has increasingly focused on expanding homeownership for those families who would otherwise either be unable to obtain financing or unable to obtain financing with affordable terms. FHA's multifamily programs have allowed projects to be developed in areas that otherwise would be difficult to finance and provides needed rental housing to families that might otherwise be priced out of a community.

The Need for FHA Today and Tomorrow

The FHA single-family programs are vital to many homebuyers who desire to own a home but cannot find affordable financing to realize this dream. While the FHA has had a number of roles throughout its history, its most important role today is to give first-time homebuyers the ability to climb onto the first rung of the homeownership ladder and to act as a vehicle for closing the homeownership gap for minorities and low- and moderate-income families.

Despite this country's recent record high levels of homeownership, not all families share in this dream equally. As of the fourth quarter of 2006, the national homeownership rate stood at 68.7 percent, but only 51 percent of minorities owned their own home. Only 48.2 percent of African-Americans and 49.5 percent of Latinos owned their own homes. This compares with 76 percent of non-Hispanic white households.

At the end of 2006, 84.5 percent of families earning more than the median income owned their own home, while only 52.9 percent of families below the median income owned their own home.[3]

These discrepancies are tragic because homeownership remains the most effective wealth-building tool available to the average American family.

FHA's Record

More than any other nationally available program, during the 1990s, FHA's impact focused on the needs of first-time, minority, and/or low- and moderate-income borrowers.

In 1990, 64 percent of borrowers using FHA-insured mortgages to purchase a home were first-time homebuyers. Today, that rate has climbed to over 80 percent. In 1992, about one-in-five FHA-insured purchase loans went to minority homebuyers. That number in recent years has grown to more than one-in-three. Minorities make up a greater percentage of FHA borrowers than they do conventional market borrowers.

FHA is particularly important to those minority populations experiencing the largest homeownership gaps. According to recent data provided by HUD, both first-time homebuyers and minorities continue to make up a significant portion of FHA's customer base. To date in FY 2007, FHA has insured 184,399 purchase mortgages and 147,121 of them, or 79.8 percent, went to first-time homebuyers. Minorities have received 46,083 FHA-insured mortgages, or 31.3 percent.[4]

Data also demonstrates FHA's tremendous service to those American families earning near or below the national median income. Ironically, as the above numbers reveal, FHA's mission to serve underserved populations has become increasingly focused during the same period as the decline in FHA's presence in the market. FHA's impact is being lost at the very time when it is needed most. The result is that American families are either turning to more expensive financing or opting not to buy a home.

It is crucial that FHA keep pace with changes in the U.S. mortgage markets. While FHA programs can be the best and most cost-effective way of expanding

[3] Source: U.S Census Bureau, Housing and Household Economic Statistics Division
[4] Source: *FHA Outlook*, June 1-15, 2007

lending to underserved communities, we have yet to unleash the full potential of these programs to help this country achieve important societal goals.

To be effective in the 21st century, FHA should be empowered to allow it to develop products and programs to meet the needs of today's homebuyers and anticipate the needs of tomorrow's mortgage markets, while at the same time being fully accountable for the results it achieves and the impact of its programs.

Under the strong leadership of its current Commissioner, Brian Montgomery, FHA has undertaken significant changes to its regulations and operations in a very short time. In just a little more than one year, FHA streamlined the insurance endorsement process, improved appraisal requirements and removed some unnecessary regulations. By doing so, Commissioner Montgomery has also instilled a spirit of change and a bias for action within FHA.

MBA compliments the Commissioner on his significant accomplishments to date, though we recognize that more work lies ahead. MBA is confident in the Commissioner's ability to address those issues that are within his control. There is much, though, that is beyond FHA's control and needs Congressional action.

Single-family FHA-insured mortgages are made by private lenders, such as mortgage companies, banks and thrifts. FHA insures single-family mortgages with more flexible underwriting requirements than might otherwise be available. Approved FHA mortgage lenders process, underwrite and close FHA-insured mortgages without prior FHA approval. As an incentive to reach into harder-to-serve populations, FHA insures 100 percent of the loan balance as long as the loan is properly underwritten.

FHA has a strong history of innovating mortgage products to serve an increasing number of homebuyers. FHA was the first nationwide mortgage program; the first to offer 20-year, 25-year, and finally 30-year amortizing mortgages; and the first to lower downpayment requirements from 20 percent to ten percent to five percent to three percent. Today, FHA's Home Equity Conversion Mortgage (HECM) has spawned a growing reverse mortgage market, which will pave the way for the private market in serving the needs of senior homeowners.

FHA's primary single-family program is funded through the Mutual Mortgage Insurance Fund (MMIF), which operates similarly to a trust fund and has been completely self-sufficient. This allows FHA to accomplish its mission at little or no cost to the government. In fact, FHA's operations have transferred surplus funds to the U.S. Treasury each year, thereby reducing the Federal deficit. FHA has always accomplished its mission without cost to the taxpayer. At no time in FHA's history has the U.S. Treasury ever had to "bail out" the MMIF or the FHA.

Unleashing FHA's Potential

In reviewing the status of FHA over the past decade, MBA has come to the conclusion that FHA faces severe challenges in managing its resources and programs in a quickly changing mortgage market. These challenges have already diminished FHA's ability to serve its public purposes and have also made it susceptible to fraud, waste and abuse. Unaddressed, these issues will cause FHA to become less relevant, and will leave families served by its programs with no alternative for homeownership or affordable rental housing.

In the fall of 2004, MBA formed a *FHA Empowerment Task Force* comprised of MBA member companies experienced in originating single-family and multifamily FHA loans. The Task Force discussed the long-term issues confronting FHA with the goal of developing legislative proposals that would empower it to manage its programs and policies more effectively.

The Task Force identified FHA's inability to efficiently develop products, higher costs of originations, lessening prominence in the market, out-dated technology and adverse selection as problems for FHA. Per the Task Force's recommendations, MBA proposed the following three steps to unleash FHA from overly burdensome statutory processes and restrictions, and to empower FHA to adopt important private sector efficiencies:

1. FHA needs greater autonomy to make changes to its programs and to develop new products that will better serve those who are not being adequately served by others in the mortgage market.

2. FHA needs the ability to use a portion of the revenues generated by its operations to invest in the upgrade and maintenance of technology to adequately manage its portfolios and interface with lenders.

3. FHA needs greater flexibility to recruit, manage and compensate employees if it is to keep pace with a changing financial landscape and ensure appropriate staffing to the task of managing $450+ billion insurance funds.

Flexibility to Create Products and Make Program Changes

FHA programs are slow to adapt to changing needs within the mortgage markets. Whether it is small technical issues or larger program needs, it often takes many years and the expenditure of great resources to implement changes. This process overly burdens FHA from efficiently making changes that will serve homebuyers and renters better and protect FHA's insurance funds. Today's mortgage markets require agencies that are empowered to implement changes quickly and to rollout or test new programs to address underserved segments of the market.

A prime example of this problem can be found in the recent experience of FHA in offering hybrid adjustable rate mortgage (ARM) products. A hybrid ARM is a mortgage product which offers borrowers a fixed interest rate for a specified period of time, after which the rate adjusts periodically at a certain margin over an agreed upon index. Lenders are typically able to offer a lower initial interest rate on a 30-year hybrid ARM than on a 30-year fixed rate mortgage. During the late 1990s, hybrid ARMs grew in popularity in the conventional market due to the fact that they offer borrowers a compromise between the lower rates associated with ARM products and the benefits of a fixed rate period.

In order for FHA to offer this product to the homebuyers it serves, legislative approval was required. After several years of advocacy efforts, such approval was granted with the passage of Public Law 107-73 in November 2001. Unfortunately, this authority was not fully implemented until the spring of 2005.

The problem began when PL 107-73 included an interest rate cap structure for the 5/1 hybrid ARMs that was not viable in the marketplace. The 5/1 hybrid ARM has been the most popular hybrid ARM in the conventional market. As FHA began the rulemaking process for implementing the new program, they had no choice but to issue a proposed rule for comment with a 5/1 cap structure as dictated in legislation. By the time MBA submitted its comment letter on the proposed rule to FHA, we had already supported efforts within Congress to have legislation introduced that would amend the statute to change the cap structure. MBA's comments urged that, if passed prior to final rulemaking, the 5/1 cap fix be included in the final rule.

On December 16, 2003, Public Law 108-186 was signed into law amending the hybrid ARM statute to make the required technical fix to the interest rate cap structure affecting the 5/1 hybrid ARM product. At this point, FHA was ready to publish a final rule. Regardless of the passage of PL 108-186, FHA was forced to go through additional rulemaking in order to incorporate the fix into regulation. Thus, on March 10, 2004, FHA issued a Final Rule authorizing the hybrid ARM program, with a cap structure that made FHA's 5/1 hybrid ARM unworkable in the marketplace. It was not until March 29, 2005, that FHA was able to complete rulemaking on the amendment and implement the new cap structure for the 5/1 hybrid ARM product.

The hybrid ARM story demonstrates well the statutory straitjacket under which the FHA operates. A four-to-six-year lag in introducing program changes is simply unacceptable in today's market. Every month that a new program is delayed or a rule is held-up means that families who could otherwise be served by the program are prevented from realizing the dream of homeownership or securing affordable rental housing.

Ability to Invest Revenues in Technology

Technology's impact on mortgage markets over the past 15 years cannot be overstated. Technology has allowed the mortgage industry to lower the cost of homeownership, streamline the origination process, and has allowed more borrowers to qualify for financing. The creation of automated underwriting systems, sophisticated credit score modeling, and business-to-business electronic commerce are but a few examples of technology's impact.

FHA has been detrimentally slow to move from a paper-based process, and it cannot electronically interface with its business customers in the same manner as the private sector. During 2004 and 2005, over 1.5 million paper loan files were mailed back and forth between FHA and its approved lenders and manually reviewed during the endorsement process. Despite the fact that FHA published regulations in 1997 authorizing electronic endorsement of loans, FHA was not able to implement this regulation until January of 2006, eight years later. This delay occurred despite the fact that over the same eight years, FHA's operations generated billions of dollars in excess of program costs that were transferred to the U.S. Treasury.

MBA believes FHA cannot create and implement technological improvements because it lacks sufficient authority to use the revenues it generates to invest in technology. Improvements to FHA's technology will allow it to improve management of its portfolio, garner efficiencies and lower operational costs, which will allow it to reach farther down the risk spectrum to borrowers currently unable to achieve homeownership. MBA believes that such an investment would yield cost savings to FHA operations far in excess of the investment amount.

In fact, one member of the Senate has taken action to address this issue by introducing S. 947, the "21st Century Housing Act," which would authorize funding to pay for much needed technology improvements.

Greater Control in Managing Human Resources

FHA is restricted in its ability to effectively manage its human resources at a time when the sophistication of the mortgage market demands market participants to be experienced, knowledgeable, flexible and innovative. To fulfill its mission, FHA needs to be able to attract the best and brightest. Other Federal agencies, such as the Federal Deposit Insurance Corporation (FDIC), that interface with and oversee the financial services sector are given greater authority to manage and incentivize their human resources. MBA believes that FHA should have similar authority if it is to remain relevant in providing homeownership opportunities to those families underserved by the private markets. FHA should have more flexibility in its personnel structure than that which is provided under the regular Federal civil service rules. With greater freedom, FHA could operate more efficiently and effectively at a lower cost. Further, improvements to FHA's ability to manage its human capital will allow FHA to attract and manage the

talent necessary to develop and implement the strategies that will provide opportunities for homeownership to underserved segments of the market.

In addition to increasing funding for technological improvements to FHA, S. 947 would call on the Secretary to consult with, and maintain comparability with, the compensation of officers and employees of the FDIC, thereby giving the Secretary the tools to recruit and retain qualified and capable staff.

MBA believes the above three changes will allow FHA to become an organization that can effectively manage risk and self-adapt to shifting mortgage market conditions while meeting the housing needs of those families who continue to be not served or underserved today.

MBA Supported FHA Modernization Principles

MBA supported much of the FHA legislation before the 109th Congress, and I would like to take a moment to offer our perspective on various principles that should be contained in any FHA legislation this Committee considers.

Raising Maximum Mortgage Limits for High Cost Areas

There is a strong need for FHA financing to be relevant in areas with high home prices. MBA supports raising the FHA's maximum mortgage limits to 100 percent of an area's median home price (it is currently pegged at 95 percent) and raising the ceiling to 100 percent of the GSEs' conforming loan limits (currently limited to 87 percent) and the floor to 65 percent (currently 48 percent). Raising the FHA limits to the GSEs' limits in these areas strikes a good balance between serving a greater number of borrowers and taking on additional risk.

Additionally, in many low-cost areas, FHA's loan limits are not sufficient to cover the costs of new construction. New construction targeted to first-time homebuyers has historically been a part of the market in which FHA has had a large presence. MBA believes raising the floor will improve the ability of first-time homebuyers to purchase modest, newly constructed homes in low-cost areas since they will be able to use FHA-insured financing.

Downpayment Requirements

MBA supports the elimination of the complicated formula that is currently detailed in statute for determining the downpayment. The calculation is outdated and unnecessarily complex. The calculation of the downpayment alone is often cited by loan officers as the reason for not offering a FHA product.

MBA also supports improving FHA's products with downpayment flexibility. Independent studies have demonstrated two important facts: first, the downpayment is one of the primary obstacles for first-time homebuyers,

minorities, and low- and moderate-income homebuyers. Second, the downpayment itself, in many cases, is not as important a factor in determining risk as are other factors. Many borrowers will be in a better financial position if they keep the funds they would have expended for a large downpayment as a cash reserve for unexpected homeownership costs or life events.

We believe that FHA should be empowered to establish policies that would allow borrowers to qualify for FHA insurance with flexible downpayment requirements and decide the amount of the cash investment they would like to make in purchasing a home. To this end, the Secretary of HUD should be authorized to determine the appropriate level of downpayment requirements. We stand ready to work with Congress to ensure that such flexibility maximizes homeownership opportunities for underserved communities without compromising the safety and soundness of FHA.

Adjusting Mortgage Insurance Premiums for Loan Level Risk

MBA believes that FHA would be able to serve more borrowers, and do so with lower risk to the MMIF, if they are able to adjust premiums based on the risk of each mortgage they insure. A flexible premium structure could also give borrowers greater choice in how they utilize the FHA program.

It is a fact that some borrowers and loans will pose a greater risk to FHA than others. At some level, FHA should have the authority to adjust premiums based upon borrower or loan factors that add risk. Such adjustment for risk need not be a complicated formula. MBA believes FHA could significantly mitigate the risk to the MMIF by selecting a small number of risk factors that would cause an adjustment from a base mortgage insurance premium (MIP).

A current example of this would be the fact that borrowers receiving a gift of the downpayment on a FHA-insured mortgage are charged the same premium as a borrower who puts down three percent of their own funds, despite the fact that FHA's experience indicates that the former represents a higher risk loan. FHA could better address such a risk in the MMIF by charging a higher MIP to offset some of the additional risk that such a loan poses. In this manner, while a borrower receiving a gift of funds for the downpayment will still receive the benefits of FHA financing, they themselves would share some of the risk, rather than having the risk borne solely by those making a three percent downpayment.

Creating a risk-based premium structure will only be beneficial to consumers, though, if FHA considers lowering current premiums to less risky loans. We would not support simply raising current premiums for higher risk borrowers.

Lengthening Mortgage Terms

MBA supports FHA's ability to develop products with mortgage terms up to 40 years. Currently, FHA is generally limited to products with terms of no more than 30 years. Stretching out the term will lower the monthly mortgage payment and allow more borrowers to qualify for a loan while remaining in a product that continues to amortize. MBA supports lengthening the mortgage terms and believes FHA should have the ability to test products with these features and, based on performance and homebuyer needs, to improve or remove such products.

Improvements to the Reverse Mortgage Program

FHA modernization legislation should include changes to the FHA's Home Equity Conversion Mortgage (HECM) program, such as: the permanent removal of the current 250,000-loan cap and the creation of a single, national loan limit for the HECM program. The HECM program has proven itself to be an important financing product for this country's senior homeowners, allowing them to access the equity in their homes without having to worry about making mortgage payments until they move out. The program has allowed tens of thousands of senior homeowners to pay for items that have given them greater freedom, such as improvements to their homes that have allowed them to age in place, or to meet monthly living expenses without having to move out of the family home.

MBA believes it is time to remove the program's cap because the cap threatens to limit the HECM program at a time when more and more seniors are turning to reverse mortgages as a means to provide necessary funds for their daily lives. MBA further believes that the HECM program has earned the right to be on par with other FHA programs that are subject only to FHA's overall insurance fund caps. Additionally, removing the program cap will serve to lower costs as more lenders will be encouraged to enter the reverse mortgage market.

Additionally, authorizing the HECM program for home purchase will improve housing options for seniors. In a HECM for purchase transaction, a senior homeowner might sell a property they own to move to be near family. The proceeds of the sale could be combined with a reverse mortgage, originated at closing and paid in a lump sum, to allow a senior to purchase the home without the future responsibility of monthly mortgage payments. Alternatively, a senior homeowner may wish to take out a reverse mortgage on a property that is less than one year old, which is defined as "new construction" by FHA.

Finally, the HECM program should have a single, national loan limit equal to the conforming loan limit. Currently, the HECM program is subject to the same county-by-county loan limits as FHA's forward programs. HECM borrowers are disadvantaged under this system because they are not able to access the full value of the equity they have built up over the years by making their mortgage payments. Currently, a senior homeowner living in a high-cost area is able to access more equity than a senior living in a lower cost area, despite the fact that

their homes may be worth the same and they have the same amount of equity built up. Reverse mortgages are different than forward mortgages and the reasons for loan limits are different, too. FHA needs the flexibility to implement different policies, especially concerning loan limits.

Improvements to FHA Condominium Financing

MBA supports moving FHA's coverage of condominium units from the General Insurance Fund to the Mutual Mortgage Insurance Fund. It is unfortunate to note that FHA insurance on condominium units has dropped at a higher rate than the overall decline in FHA's originations. This decline contradicts the fact that in costly markets, condominium units are typically the primary type of housing for first-time homebuyers. FHA should have a much bigger presence in the condominium market.

As this Committee moves the process of FHA reform forward, there are issues that I would like to bring to your attention that warrant particularly close consideration.

The Definition of "Higher-Risk" Borrowers

If this Committee wishes to craft a provision defining "higher-risk" borrowers, MBA suggests giving the Secretary authority to set underwriting and corresponding pricing standards for a "higher-risk" category so that borrowers in the future will not have to wait on the sometimes cumbersome Congressional process.

Treatment of FHA Non-Conveyable Properties

As you know, FHA provides credit insurance against the risk of foreclosure losses associated with loans originated according to FHA standards. FHA generally pays an insurance claim when it takes title (conveyance) to a property as a result of foreclosure. To convey a property and receive insurance benefits, however, FHA requires that the property be in "conveyance condition" (i.e., saleable condition). Properties that have sustained damage attributable to fire, flood, earthquake, tornado, hurricane, boiler explosion (for condominiums), or the lender's failure to preserve and protect are not eligible for insurance benefits unless they are repaired prior to conveyance of the property to the FHA. While HUD has in the past accepted properties in "as is" (damaged) condition on a case-by-case basis, this is rarely done. Moreover, HUD will deduct from the "as is" claim the estimated cost of repair. HUD should accept conveyance of damaged properties and not adjust the claim for the cost of repair when there was no failure on the part of the servicer to obtain hazard or flood insurance pursuant to federal law or if a borrower is eligible to apply for CDBG grant funds, but fails to do so. In addition, to the extent that a property is not conveyable (i.e.,

condemned, demolished by local, state, or federal government or deemed to be a Superfund site, etc), HUD should be permitted to pay the full claim without taking conveyance of the property. We do not believe HUD has the statutory authority to manage claims in this manner.

In March, the House passed H.R. 1227, the "Gulf Coast Hurricane Housing Recovery Act of 2007," which includes a provision dealing with this issue. Last month, Chairman Dodd introduced S. 1668, "The Gulf Coast Housing Recovery Act of 2007," which also includes a fix to this serious problem. MBA applauds Congress' attention to this issue, especially in light of HUD's and Louisiana's actions to revamp the Road Home grant program in a manner that no longer promotes rebuilding. This decision exacerbates servicers' losses. These are losses for which FHA lenders never thought they were signing up, and represent another barrier to wide-scale use of the FHA in the marketplace.

Broker Supervision

FHA must approve all mortgage lenders and loan correspondents who wish to originate or underwrite FHA-insured loans. Non-supervised mortgagees (e.g. mortgage brokers) and loan correspondents outside of the federal regulatory regime must establish an ability to meet both FHA's financial and legal standards in order to be approved.

This is currently satisfied through a minimum net worth requirement and the submission of a yearly financial audit. These requirements demonstrate the mortgagee or loan correspondent has a certain level of financial solvency and employs necessary controls to provide reasonable assurance that FHA products are offered in compliance with all applicable regulations, such as laws governing fair housing and nondiscrimination.

Some industry participants have proposed amending this approval process by allowing mortgage brokers to substitute a surety bond in lieu of the existing annual net worth auditing requirements. It is important to note that the annual financial statement (AFS) is the federal government's only opportunity to ensure that the 7,500 non-supervised mortgagees, loan correspondents, and brokers who offer FHA-insured loans are doing so in accordance with all applicable laws and regulations. Kenneth Donohue, HUD's Inspector General, recently stated that "[t]he AFS is an integral part of FHA's monitoring of its approved mortgagees, and [the Inspector General] does not believe that its minimal cost...is sufficient cause to increase the risk of loss to the taxpayer that may result from its elimination." MBA believes that, especially in the current climate of rising FHA defaults, Congress should not loosen the supervision of entities offering products backed by FHA and the American taxpayer.

FHA Multifamily Programs

While the thrust of recent modernization efforts focus on FHA's single-family programs, it is important to underscore the critical role of FHA's multifamily programs in providing decent, affordable rental housing to many Americans. Approximately 30 percent of families and elderly citizens either prefer to rent or cannot afford to own their own homes. FHA's insurance of multifamily mortgages provides a cost-effective means of generating new construction or rehabilitation of rental housing across the nation. FHA is also one of the primary generators of capital for healthcare facilities, particularly nursing homes.

While the FHA has implemented a number of significant improvements to its single-family program over the last two years, the same focus needs to be applied to improving the multifamily programs. MBA hopes that process improvements on the multifamily side of FHA will soon be discussed and implemented.

MBA supports raising the mortgage limits in high cost areas from 140 percent and 170 percent, respectively, to 170 percent and 215 percent. In the face of rapidly rising building costs in many of the nation's cities, this increase is necessary to allow developers to continue providing affordable housing in those areas that need it the most.

Additionally, MBA opposes any unnecessary increases in the Mortgage Insurance Premium (MIP) on FHA multifamily housing programs. Unfortunately, the Administration's FY 2008 budget proposes increases of more than 35 percent in the MIP on many key multifamily programs. This proposal will significantly increase the cost of, and in some cases prohibit, rehabilitating and developing rental housing for working families. An increase in premium fees will translate directly into higher rents and lead to the production of fewer affordable units, thereby reducing availability and affordability of rental housing. MBA encourages legislative language that would prohibit HUD from increasing the MIP unless the increase is necessary to cover the costs of the programs as calculated in accordance with the Credit Reform Act of 1990.

Response to Natural Disasters

Hurricane season is again upon us. The disasters of Hurricanes Katrina and Rita point to the need for a financially solvent FHA that is not restricted by onerous processes and procedures. The FHA program must be ready to assist homeowners and renters who lost everything amid the destruction of the hurricanes. It must have the necessary wherewithal to step in and help work out the existing mortgages in disaster areas. FHA must have the programs necessary to meaningfully assist in the rebuilding effort. Giving FHA the mechanisms to fund adequate technology improvements, flexibilities in managing human resources, and greater authority to introduce products will ensure FHA can step in to help communities when disasters occur. It is critical that Congress

act quickly to ensure that FHA is adequately prepared to help homeowners and renters before the next major disaster strikes.

Downpayment Assistance Programs

Without Congressional action this year, many families face a serious risk of being unable to access FHA financing due to a ruling last year by the Internal Revenue Service (IRS). On May 4, 2006, the IRS released Revenue Ruling 2006-27, which may lead the IRS to rescind the nonprofit status of a large number of organizations who receive funding from property sellers in providing downpayment assistance to FHA borrowers. FHA regulations require that nonprofits providing a downpayment gift have an IRS nonprofit exempt status. Due to the ruling, the IRS has indicated that it is investigating 185 organizations which provide downpayment assistance.

MBA expects the IRS ruling and, if adopted, FHA's Proposed Rule "Standards for Mortgagor's Investment in Mortgaged Property, to have a dramatic effect on FHA's purchase production. Before the ruling, more than one-third of FHA purchase loans had some type of downpayment assistance. Such programs currently serve tens of thousands of FHA's primary clientele: first-time homebuyers, low- and moderate-income families and minorities.

Conclusion

Finally, as Members of this Committee are well aware, recent market events and regulatory actions in the mortgage industry have led to a number of lenders either significantly tightening underwriting standards or leaving the business altogether. MBA believes the individuals who will be most directly impacted by these events are the consumers that FHA was created to serve: first-time homebuyers, low-income families and those with less than perfect credit histories. It is in light of these realities that we ask Congress to move quickly and empower FHA with the authority it needs to provide consumers with affordable, viable lending options needed to help them achieve homeownership.

On behalf of MBA, I would like to thank the Committee for the opportunity to present our views on the important programs offered by FHA. MBA looks forward to continuing to work with Congress and HUD to improve FHA's ability to serve aspiring homeowners and those seeking affordable rental housing.

Statement of

Kenneth D. Wade
Chief Executive Officer

Neighborhood Reinvestment Corporation
(now *doing business as* NeighborWorks® America)

Before the

Senate Banking Committee's

Hearing on FHA Modernization
July 18, 2007

Chairman Dodd, ranking member Shelby and Members of the Committee, my name is Ken Wade, CEO of NeighborWorks® America, and I appreciate the opportunity to talk with you today about the Federal Housing Administration's (FHA) modernization legislation and the benefits of foreclosure prevention counseling as well as pre- and post-purchase home-buyer counseling in helping Americans not only buy a home, but stay in their homes and build their futures.

By way of background, NeighborWorks® America was established by Congress in 1978 as the Neighborhood Reinvestment Corporation and is the original community/public/private partnership model, with locally-driven, highly-leveraged and efficient community development as its hallmark. Over the past 28 years, we have replicated this successful model in over 4,400 communities around the country through 238 affiliated community-based nonprofit organizations – known collectively as the NeighborWorks® network. Our affiliated NeighborWorks® organizations operate in all 50 states, the District of Columbia and Puerto Rico; in America's urban, suburban and rural communities. Our Board of Directors is comprised of the heads of the federal financial regulatory agencies (the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Federal Reserve System, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision) along with the Secretary of HUD; who has designated FHA Commissioner Montgomery as his designee to our Board..

NeighborWorks® America is working to expand opportunities for people to live in affordable homes (rental and homeownership), improve their lives and strengthen their communities.

Local NeighborWorks® organizations provide a wide variety of services that reflect the needs of their communities, and over the past five years, with the support of Congress, NeighborWorks® America and its network affiliates:

- Have directly assisted more than 100,000 families of modest means to become homeowners (of which, 91 percent are low-income and 53 percent are ethnic/racial minorities)
- Own more than 63,500 units of high quality affordable rental housing
- Provided quality homeownership counseling to more than 317,000 families
- Trained nearly 50,000 community development practitioners from over 5,000 organizations and municipalities nationwide; and
- Facilitated the investment of nearly $9 billion in distressed communities across the country.

From our experience, we know that FHA has played a key role in the mortgage market since its inception, but for a number of reasons over time, represents a shrinking percentage of the overall mortgage market. The Administration's proposed FHA Modernization legislation would bring about some much needed changes and would help assure that FHA can reassume its rightful place in the market-place and enable the FHA to help millions of additional low- and moderate-income families fulfill the American dream of homeownership.

We also believe that a modernized FHA could provide a meaningful alternative to some of the problematic mortgage products which have contributed to the nation's current alarming rate of foreclosures. And, for many families already facing foreclosure, refinancing with FHA could be a real option.

Let me just stress that we do not believe the current rate of foreclosure should cause any of us to retract from the desire to close the homeownership gap that currently exists between white Americans and minority Americans, or to end the dream of homeownership for anyone.

It's been demonstrated that high quality housing counseling can make a real difference in the selection of mortgage products by borrowers and in the loan performance of borrowers. In efforts to correct the rising trend of foreclosures, I would encourage that we look at successful models that are currently working – including a terrific example provided by the FHA-insured HECM reverse mortgage program which allows senior citizens to convert the equity in their home into monthly streams of income. To assist the homeowner in making an informed decision of whether this program meets their needs, they are required to receive consumer education and counseling by a HUD-approved HECM counselor.

The importance of quality consumer education and counseling cannot be overstated; particularly when working with low- and moderate-income and/or credit-impaired borrowers, or non-traditional mortgage products.

NeighborWorks® America, as a national public nonprofit organization working to expand affordable housing opportunities and revitalize communities, has a 30-year history of supporting lending to non-conforming borrowers – including lower income families, borrowers with impaired credit and others who would not normally qualify for a conventional mortgage. By providing quality pre-purchase housing counseling and working with borrowers to improve their credit rating, local NeighborWorks® organizations are typically able to prepare mortgage-ready borrowers who qualify for reasonably priced traditional mortgage loans and achieve sustainable homeownership.

NeighborWorks® America has been tracking the loan performance of the many low-income families assisted by NeighborWorks® organizations over the years, particularly with the overall rise in foreclosures in the broader marketplace. These loans continue to perform significantly better than subprime loans, and the overwhelming majority of families coming in for foreclosure assistance did not receive pre-purchase counseling.

From our experience, we know that the best defense against delinquency and foreclosure (or having a borrower obtain an inappropriate mortgage product, or a predatory loan) is objective education and advice before the borrower begins shopping for a home and selecting a mortgage product. And the best homeownership counseling is provided through third-party nonprofit agencies (including local NeighborWorks® organizations and other HUD-approved nonprofit housing counseling agencies) that put the consumers' and the communities' interests first. We also know that homeowners' odds of success are increased even further when they have access to post-purchase counseling and homeowner education.

NeighborWorks America's commitment to quality, objective homeownership education and counseling is evidenced through the founding of the NeighborWorks Center for Homeownership Education and Counseling (NCHEC) to train and certify housing counseling practitioners.

Since its launch in 2004, NCHEC has issued more than 17,000 certificates of completion to housing counseling professionals in pre and post purchase education courses, including more than 4,500 staff from HUD-Approved counseling agencies.

In May of this year, together with our lender and housing partners, including HUD, we announced National Industry Standards for Homeownership Education and Counseling. Working together to develop a set of uniform guidelines that industry professionals are encouraged to incorporate into everyday practice, these standards help ensure consistency in housing counseling services. These efforts play a vital role in advancing the counseling profession, and making this service more broadly available will help borrowers make informed choices.

The rise in mortgage foreclosures has the potential to undermine the significant homeownership gains made by lower-income and minority consumers during the 1990's.

While housing counseling before the purchase of a home is definitely the best defense against foreclosure, unfortunately that advice comes too late for families already in a problematic mortgage product or currently facing foreclosure. Here too counseling is vital to those who are facing foreclosure.

Our experience demonstrates a strong need to strengthen capacity, specialized training and service delivery protocols for HUD-Approved Counseling Agencies. Foreclosure prevention counseling requires an integral understanding of loss mitigation processes coupled with skilled customer service practices to achieve results.
Nonprofit organizations and state and local efforts are working hard to meet the increased demand for counseling services.

It is crucial to target delinquent borrowers earlier. Several recent reports cite that when borrowers contact a counselor earlier in the process, they are more likely to achieve a positive outcome. Proactive, direct contact by counseling agencies to delinquent borrowers is also a strategy that seems to be working.

NeighborWorks® America saw the problem of foreclosures coming over four years ago and, with the strong support of our Board of Directors, created the NeighborWorks® Center for Foreclosure Solutions, to preserve homeownership in the face of rising foreclosure rates.

As part of its efforts to assist homeowners facing foreclosure, NeighborWorks® America, in partnership with the Homeownership Preservation Foundation has established a national toll-free hotline for delinquent borrowers **(888-995-HOPE)** that is available 24/7 around the clock to provide callers with high quality telephone-based assistance (in English and in Spanish). Individuals needing more intense service than can be provided over the phone are referred to local HUD-approved housing counseling agencies.

In closing, let me state that the availability of high quality pre-purchase and post purchase housing counseling continues to be a critically important element – and funding this important service continues to be an industry-wide challenge.

It is our strong belief that an informed consumer/homebuyer, knowledgeable of all of the options available, (included the additional options that would become available through a reinvigorated FHA) is the key to sustaining and strengthening both the family and the community.

I thank you again for the opportunity to speak with you, and stand ready to answer any questions you may have.

Testimony of

David A. Crowe

On Behalf Of the

National Association of Home Builders

Before the

United States Senate

Committee on Banking, Housing and Urban Affairs

Modernization of Federal Housing Administration Programs

July 18, 2007

Introduction

Chairman Dodd, Ranking Member Shelby, distinguished Members of the Committee on Banking, Housing and Urban Affairs, on behalf of the more than 235,000 members of the National Association of Home Builders (NAHB), thank you for this opportunity to testify today on the important subject of the modernization of the Federal Housing Administration's (FHA's) single family mortgage insurance programs. My name is David Crowe, and I am NAHB's Senior Staff Vice President for Regulatory and Housing Policy.

The ongoing turmoil in the subprime mortgage market has greatly increased the urgency for enactment of FHA revitalization legislation. While subprime mortgage programs have been a valuable tool in efforts to expand homeownership opportunities, some borrowers have received loans with unfavorable terms that are beyond the household's capacity to repay. The unfortunate experiences of such borrowers are having broader adverse effects on the housing finance system and, therefore, provide a compelling reason why FHA needs the tools to meet its mission objectives more effectively.

The adverse effects of the subprime market have not only affected the financial markets, but also the housing markets and the economy. Growth of the Gross Domestic Product is off about 1 percentage point because of the slowdown in home construction and its attendant economic impacts. In addition, tightened lending standards mean that some borrowers who had planned to seek conventional loans will shift their focus to FHA instead. If granted the proper authority by Congress, FHA could insure fixed-rate, adjustable-rate, and hybrid adjustable-rate mortgage loans to borrowers with limited cash

reserves and/or slightly tarnished credit and at far better terms than the subprime loans that are so frequently in the news.

FHA's Importance

Since its creation in 1934, FHA has established a strong track record of innovation and achievement when insuring mortgage loans for millions of American families, many of whom would not have otherwise been able to own a home. The concepts of the 30-year mortgage and loans with low downpayments were the result of FHA's pioneering efforts in years past. More recently, FHA has broken new ground in the area of reverse mortgages, which allow seniors to tap home equity to address housing, health or other living needs.

Beyond innovation, FHA, through its provision of the full faith and credit of the U.S. Government, has assured that affordable mortgage credit is available throughout the country during good as well as challenging economic times. FHA, as a result of more lenient loan qualification standards, also has the strongest record of serving minorities and lower income households, who have greatest difficulty in securing home financing. However, the role of FHA has declined significantly in recent years.

FHA's reticence has relegated the major government-backed mortgage finance program to an increasingly insignificant role in efforts to overcome housing affordability and financing obstacles and expand homeownership opportunities. FHA's current limitations have multiple impacts on the new home market. In addition to the support FHA's mortgage insurance can provide directly for the purchase of moderately priced new homes by first-time and other buyers of relatively modest incomes, FHA also has the

potential to spur sales of existing homes, enabling more move-up buyers to acquire new homes.

FHA's lack of responsiveness to market needs has placed some borrowers in highly risky and inappropriate loan structures in the conventional mortgage market, which carry unreasonably high fees and interest rates, and demand onerous prepayment terms. Many of these borrowers, despite limited cash resources and/or tarnished credit, could have qualified for market-rate FHA-insured loans. In numerous instances, statutory constraints have limited FHA's ability to respond to the needs of borrowers who might have otherwise chosen FHA. Improving the FHA program would be a highly effective, and possibly the most appropriate, means for Congress to address problems in the subprime mortgage market.

Declining Role of the Federal Housing Administration

The popularity and relevance of FHA's single family mortgage insurance programs have diminished over the past two decades as they have failed to keep pace with mortgage market developments and needs. FHA's share of the market, in terms of number of loans, fell from 18 percent in 1990 to less than 4 percent in 2006. The fall-off in FHA's business is also striking in absolute terms, with its number of mortgages insured falling from 742,000 in 1990 to 302,000 in 2006. FHA's descent accelerated in the latter part of this same period as competing conventional (non-FHA) subprime mortgage loan programs lured many borrowers into less advantageous mortgages. The share accounted for by conventional subprime loans had surged to 20 percent by 2005.

All too often, significant differences between FHA's requirements and those for conventional mortgages have been viewed by lenders, appraisers and borrowers as a disincentive to use FHA programs. Likewise, FHA's unique and often burdensome requirements, particularly for condominium units, have caused many home builders to decline to go through the hoops that are necessary to make newly constructed homes eligible for FHA-insured mortgage financing. FHA's share of the new home market was only 5 percent in 2006, down from 13 percent in the early 1990s.

The decline in FHA mortgage insurance activity, both in real terms and when measured against conventional loan programs, is problematic in other respects as well. For example, FHA-insured loans serve as collateral for mortgage-backed securities guaranteed by the Government National Mortgage Association (Ginnie Mae), which, like the FHA, is part of the U.S. Department of Housing and Urban Development (HUD). Ginnie Mae serves a vital role in America's housing finance system by providing liquidity for lenders to offer mortgages that are insured or guaranteed by FHA and other government agencies. Because the bulk of Ginnie Mae securities are backed by FHA-insured loans, the declining trend in FHA-insured loan originations, if unabated, could call into question the viability of the Ginnie Mae program.

Congress Should Act Quickly to Empower FHA With the Right Tools

The Administration has proposed modernization changes for the FHA single family program in the form of greater flexibility on downpayment programs, authority to offer risk-based pricing, and increases in mortgage loan limits. NAHB supports these

recommendations and believes there are several other areas that should be altered or updated.

Borrower Cash Requirements

One of the most common factors preventing potential home buyers from achieving their dream of homeownership is the lack of financial resources to pay the downpayment and closing costs. FHA's current statutory requirement for a cash contribution of 3 percent was innovative when downpayments of 10 percent or more were the norm. To be competitive and meet increasing market needs, FHA must have greater flexibility in establishing downpayment requirements. In addition, the present structure for determining the amount of cash a borrower would have to invest to qualify for an FHA-insured loan is unnecessarily complex and often confusing.

Significant advances have occurred in mortgage credit analysis that have allowed conventional lenders to reduce upfront cash requirements while sustaining favorable loan performance. FHA needs similar tools to remain a meaningful participant in ongoing efforts to expand homeownership opportunities and in more recent forays to find appropriate financing solutions for borrowers with less than pristine credit records.

Mortgage Insurance Premiums

NAHB believes FHA should have the authority to set mortgage insurance premiums at whatever levels are deemed necessary to maintain actuarial soundness while striving to serve borrowers with a wide variety of risk profiles. Accordingly, NAHB believes that FHA can effectively serve a broad range of borrowers while acknowledging

that the risk of default varies widely. In fact, some delineation in credit risk is necessary if FHA is going to prudently provide an alternative to subprime borrowers who cannot currently get reasonable loan terms on conventional mortgages. The authority to set insurance premiums that are commensurate with credit risk, while retaining the principle of actuarial soundness, would open the FHA program to the growing ranks of potential home buyers who currently are shut out of the mortgage market by a tightening of qualification criteria or are facing onerous and possibly predatory terms on alternative forms of financing. A flexible premium structure also would allow FHA to offer more attractive pricing to lower-risk borrowers and improve the overall risk profile of its portfolio while slowing the decline in its market share.

Regardless of what cash requirement and mortgage insurance premium options are eventually adopted by this Committee, I encourage the Committee to retain a mortgage insurance premium structure that rewards higher-risk borrowers who establish a track record of timely payments.

Condominium Loans

In many communities, condominiums increasingly represent the most affordable path to home ownership. Data from the American Housing Survey show that in 2005 almost half of condominium purchasers were first-time home buyers, up from one-third in 1997. Unfortunately, FHA's requirements for condominium loans are burdensome and differ significantly from the requirements for mortgage loans that are secured by detached single family homes. For a condominium unit to be eligible to be sold to a purchaser who uses an FHA-insured loan, FHA requires the condominium developer to provide

documentation related to historical and environmental reviews for the entire project. In contrast, on conventionally-financed condominiums, requirements of this nature are commonly dealt with at the state or local level. Moreover, it is common to have town homes that are sold as part of a condominium located near town homes that are part of a planned unit development (PUD). In early 2003, FHA found that its PUD approval process was redundant with local governmental review practices and subsequently dropped its PUD approval requirement. FHA's condominium approval processes are similarly redundant; however, FHA has been forced to retain these because of statutory requirements.

These different requirements exist because condominiums and detached single family homes are authorized under different sections of the National Housing Act and insurance for these loans is backed by different insurance funds. NAHB has been told by its members who develop condominiums that the burden of the additional and unnecessary requirements, and the delays encountered in attempting to comply with FHA's requirements, have caused these builders who once served the FHA market to abandon FHA in favor of conventionally financed borrowers. NAHB has urged HUD to move condominium unit financing and the processes for accepting such loans for insurance under FHA's single family mortgage insurance program. I encourage the Committee to consider provisions that would unify the coverage of all of the FHA's single family mortgage insurance programs under the Mutual Mortgage Insurance Fund.

Single Family Mortgage Limits

The limit for FHA-insured mortgages is established in statute as 95 percent of the median home price of an area, within the bounds of a national ceiling and floor. FHA's single family loan limit for the 48 contiguous states is currently capped at $362,790, which is 87 percent of the Fannie Mae / Freddie Mac conforming loan limit. This limit is too low to enable deserving potential home buyers to purchase a home in many high-cost areas. Likewise, the FHA "floor" of $200,160, which is indexed at 48 percent of the conforming loan limit, is too low.

The artificially low FHA loan limits restrict choices for home buyers who use FHA-insured mortgage loans to the lowest echelon of available homes throughout much of the country. In many areas, FHA borrowers are precluded from considering the purchase of a new or recently-constructed home. NAHB does not believe that Congress created the FHA in 1934 with the intent of constraining borrowers to homes priced only at the lowest end of the market. In fact, NAHB's Board of Directors adopted specific policy in 2005 in support of increasing the national FHA loan ceiling up to the conforming loan limit. NAHB supports recalibrating local loan limits to 100 percent of the area median from the current 95 percent and increasing the national floor for FHA loan limits. We believe it is entirely reasonable to allow FHA borrowers access to *at least* the lower half of homes in a local market.

Multifamily Loan Limits

NAHB also supports providing the HUD Secretary additional flexibility to increase the FHA multifamily mortgage loan limits in high cost areas. Currently, there

are some areas of the country where construction costs are so high that use of the FHA programs is not possible. NAHB believes that providing this additional flexibility to the HUD Secretary would greatly improve the FHA multifamily mortgage insurance programs. With severe shortages of affordable rental housing in most of the high cost markets, this change would enable developers to provide much-needed new affordable housing to low- and moderate-income families.

Loan Maturities

One underlying theme of FHA's revitalization is based upon the need to increase the affordability of the home financing process for prospective home buyers. By extending the maximum loan maturity to 40 years, FHA will enable borrowers' monthly loan payments to be reduced and would match a trend toward longer maturities that is being seen with conventional conforming loans. Unlike the interest-only loans that are currently popular, an FHA-insured mortgage loan with a 40-year maturity will ensure that some part of the borrower's monthly payment is used to reduce the outstanding loan balance. NAHB believes that 40-year maturities will become commonplace in the not-to-distant future and that FHA should be well-positioned to meet emerging market needs.

Borrower Protections

Many borrowers who obtain FHA-insured mortgage loans are considered relatively unsophisticated regarding financial matters. Research has shown that pre- and post-purchase home buyer counseling can result in improved loan payment performance. If counseling requirements are placed in statute, it is vital that sufficient funds are

appropriated on an ongoing basis for the development and maintenance of an adequate and stable, nationwide system of counselors. The Administration has proposed that $50 million in HUD's FY2008 budget be earmarked for housing counseling. Housing counseling agencies, which are predominately non-profit organizations, need grants from HUD to provide counseling services for prospective borrowers as well as borrowers who are having difficulty meeting their financial obligations. I realize that this is primarily an issue for the Appropriations Committee, however, I encourage Members of this Committee to take whatever steps are needed to ensure that sufficient funds are appropriated on an ongoing basis for housing counseling.

Home Equity Conversion Mortgages

FHA's Home Equity Conversion Mortgages (HECMs) allow homeowners who are at least 62 years old to access the equity in their homes without having to make mortgage payments until they move out of their home. HECMs have found increasing acceptance among seniors as a financial alternative, however, the current program cap and the unrealistically low loan limits keep FHA from serving this growing segment of the population. NAHB urges the Committee to remove the existing 275,000 loan volume cap permanently while increasing the maximum loan to the Freddie Mac / Fannie Mae conforming loan limit. These changes would also permit a borrower to purchase another home without incurring the costs and delays of multiple mortgage transactions, which currently is one impediment preventing seniors from using an FHA-insured HECM in the purchase of a more suitable home. NAHB also feels there should be legislative language to clarify that FHA is permitted to insure loans secured by homes less than one-year old,

which are currently not eligible. These changes would help expand seniors' housing options with lower maintenance and operating costs. NAHB also supports the proposal to shift the insurance for HECMs from the General Insurance Fund to the more stable Mutual Mortgage Insurance Fund.

Conclusion

In closing, I would like to reiterate NAHB's strong support for FHA and its revitalization. The current leadership team at HUD has worked hard at re-establishing FHA's relevance while keeping the program financially sound, but they need Congress to empower HUD with improved tools to pursue their mission and to keep the Mutual Mortgage Insurance Fund solvent without requiring Congressional appropriations. FHA needs programs and processes now more than ever to be in the best position to assist the many thousands of borrowers who desperately need alternatives to existing subprime loans. With the Senate's help, FHA will resume its long record of leadership in serving America's home buyers. Thank you, once again, for this opportunity. I welcome any questions you may have for me.

TESTIMONY

Modernization of Federal Housing Administration Programs

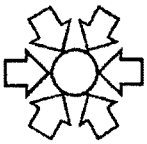
Basil N. Petrou
Managing Partner
Federal Financial Analytics, Inc.

Before the

Committee on Banking, Housing and Urban Affairs

United States Senate

July 18, 2007



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

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[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.

Testimony of
George Hanzimanolis, CRMS, President

National Association of Mortgage Brokers

on

"Modernization of Federal Housing Administration Programs"

before the

U.S. Senate Committee on Banking, Housing, and Urban Affairs

United States Senate

Wednesday, July 18, 2007

Chairman Dodd, Ranking Member Shelby and members of the Committee, thank you for inviting NAMB to testify today on the Administration's proposals to modernize Federal Housing Administration ("FHA") programs. In particular, we appreciate the opportunity to address: (1) the need to reform the FHA program to eliminate barriers that restrict mortgage broker participation; (2) the positive effects on FHA's market share and profitability that will result from increased mortgage broker participation; (3) the importance of adjusting the current FHA loan amounts for high-cost areas; (4) the need to develop risk-based pricing for mortgage insurance on FHA loans; and (5) the need to grant FHA flexibility in offering borrowers 100%

financing products.

NAMB is the only national trade association exclusively devoted to representing the mortgage brokerage industry, and as the voice of the mortgage brokers, NAMB speaks on behalf of more than 25,000 members in all 50 states and the District of Columbia. NAMB members are typically small business men and women with 4 to 7 employees, who adhere to a strict code of ethics and best lending practices when presenting consumers with an array of mortgage financing options from which they can choose. Mortgage brokers typically maintain business relationships with various lenders so they can offer a variety of loan products for their customers to choose from. Our members play a critical role in helping the American economy and in making the dream of homeownership a reality for American families.

Making FHA a Real Choice for Subprime Borrowers

NAMB supports many of the proposed reforms to the FHA program, but believes we should first make certain that the FHA program is a **real choice** for prospective borrowers. Regardless of how beneficial a loan product may be, it requires an effective distribution channel to deliver it to the marketplace. The need to make the FHA loan product a viable option is even more acute today given recent developments in the subprime market, which is leading to less liquidity and increased costs.[1] Unfortunately, today many prospective borrowers are being denied access to the benefits of the FHA program because mortgage brokers – one of the most widely used distribution channels in the mortgage industry – are limited in their ability to offer FHA loan products to their customers.

[1] The federal banking agencies recently issued the *Statement on Subprime Mortgage Lending,* which is expected to further tighten underwriting guidelines and restrict volume of credit to the subprime markets. Ultimately, this will curtail the availability of subprime products for many borrowers who are, or will be, in need of refinancing into affordable loans. *See* Inside Regulatory Strategies, *Fewer Loans Expected in Wake of Guidance*, p. 1 (July 9, 2007).

A stated objective of the FHA is to increase origination of FHA loan products and expand homeownership opportunities for first-time, minority and low to moderate-income families. NAMB supports increased access to FHA loans so that prospective borrowers who have slightly blemished credit histories, or who can afford only minimal down payments, have increased choice of affordable loan products. These prospective borrowers should not be forced by default into the subprime market. FHA must be modernized so that it can become an effective vehicle to provide borrowers, especially subprime borrowers, with affordable financing choices that can be sustained over the long-term.

A recent *Inside Mortgage Finance* publication estimated the current FHA market share at 2.7%.[2] NAMB believes the solution to increasing FHA loan origination and market share is increasing the number of origination sources responsible for delivering FHA loan products directly to consumers. Today, the most effective and efficient origination source is through mortgage brokers. Mortgage brokers originate over 50% of all home loans, yet brokers are responsible for just 10% of FHA's origination volume, or .27% of all home loans. This is due, in large part, to the fact that mortgage brokers are discouraged from participating in the FHA program by the unnecessarily burdensome financial audit and net worth requirements. These requirements erect a formidable barrier and prevent a significant majority of mortgage brokers from participating in the program.

NAMB estimates that less than 18% of all mortgage brokers are approved to originate FHA loans under the current requirements; however, recent NAMB surveys indicate that roughly 80%

[2] *See* Inside Mortgage Finance, *Mortgage Originations by Product*, p.7 (March 2, 2007).

of "non-participating" mortgage brokers would offer FHA loans to their customers if there were no financial audit or net worth requirement. NAMB predicts that such a change would increase mortgage broker participation in the FHA program from 18% to roughly 85%. This, in turn, would increase FHA's loan origination volume and market share by nearly 40%.

For example, in 2006, FHA's origination volume was roughly $80 billion.[3] All things being equal, the 67% increase in broker participation would increase FHA's origination volume to nearly $112 billion, and FHA's total market share from 2.7% to 3.78%. This increase of $32 billion and 1.08% total market share will be directly tied to an increase in mortgage broker participation in the FHA program.

Mortgage Broker Participation in FHA Programs

As a prerequisite to originating FHA loans, mortgage brokers currently are required to satisfy cost prohibitive and time consuming annual audit and net worth requirements. These requirements place serious impediments in the origination process, and functionally bar mortgage brokers from delivering FHA loans into the marketplace.

As small businesses men and women, most mortgage brokers find the costs involved with producing audited financial statements an unbearable burden. FHA audits must meet government accounting standards and only a small percentage of certified public accountants ("CPAs") are qualified to conduct these audits. Moreover, because many auditors do not find it feasible to audit such small entities to government standards, many qualified CPA firms are reluctant to audit mortgage brokers. Cost however, is not the only factor. A mortgage broker

[3] See Inside Mortgage Finance, *Mortgage Originations by Product*, p.7 (March 2, 2007).

can also lose valuable time – up to several weeks – preparing for and assisting in the audit process.

Because of the burdens imposed by the current financial audit and net worth requirements, many mortgage brokers do not engage in the FHA program. In this regard, the impediments stated herein have actually served to limit the utility and effectiveness of the FHA program and seriously restrict the range of choice available for prospective borrowers who can afford only a small down payment. At a minimum, NAMB believes annual bonding requirements offer a better way to ensure the safety and soundness of the FHA program than requiring originators to submit audited financial statements.

Some have expressed concerns over allowing mortgage brokers to post a surety bond instead of meeting current FHA net worth and audit requirements. We strongly believe these concerns are unwarranted for several reasons.

First, annual audit and net worth requirements are unnecessary. Today, mortgage brokers participate in the FHA program typically through a large lender responsible for underwriting the loan. Replacing net worth and audit requirements with a surety bond will not change the framework set to ensure responsibility and accountability. Rather, it will simply encourage brokers to participate thereby increasing the amount of FHA loans offered. The larger FHA-approved lenders will continue to submit to the standards deemed necessary by FHA (*i.e.*, audits, net worth, underwriting standards, etc.) before being approved to offer FHA loans through retail or wholesale channels. This affords the U.S. Department of Housing & Urban Development's ("HUD") adequate protection against loss to the FHA program. Brokers who choose to offer

FHA loan products will also continue to be governed by contract agreements with these respective FHA-approved lenders. Again, the surety bond does not alter this current allocation of risk. FHA approved lenders are currently the backstop liability under the FHA program as the delegated underwriter and will remain the backstop under a surety bond construct.

Second, brokers who participate in the FHA program will remain state-licensed entities subject to any state bond requirements, criminal background checks and education requirements (requirements that mortgage bankers do not have to adhere to in many states)[4] *in addition* to any FHA-required surety bond. This, in effect, creates a dual-layer of protection for both the FHA program and the consumer.

Last, the surety bond actually enhances the current laws governing broker originated FHA loans. The process of obtaining a surety bond itself involves stringent pre-qualification standards and review. Surety companies pre-qualify their customers to determine whether they are financially sound and have the baseline to conduct their business, *i.e.* ability to pay out upon a loss, before issuing a surety bond. Therefore, the surety bond reflects not only the quality of the originator, but also his/her ability to participate and sustain business successfully. In addition, the stringent process in place for obtaining a surety bond involves a diligent underwriting process that includes an evaluation of the applicant's net worth. In this current environment, there are mortgage lenders declaring bankruptcy quite often and their net worth has disappeared in a short period of time. A surety bond is reliable and is a guarantee of funds, which is not the case for the current net worth requirements.

[4] Over the past five years, many states' regulation and oversight of mortgage brokers has eclipsed that of mortgage bankers and lenders.

Increase FHA Mortgage Amounts in High-Cost Areas

In an environment of rising interest rates and shrinking liquidity, many first-time, minority, and low to moderate-income homebuyers need the safer and less-expensive financing options that the FHA program can provide. For this reason, NAMB uniformly and unequivocally supports increasing FHA loan limits in high-cost areas. The benefits of the FHA program should be available equally to all taxpayers; especially those residing in high-cost areas, where borrowers are most often in need of affordable mortgage financing options.

For example, in California, twenty-nine of the fifty-eight counties are currently at the FHA ceiling of $362,790, with another six counties approaching the ceiling. These twenty-nine counties represent approximately eighty-five percent of California's population, many of whom are struggling to become or remain homeowners in an area where the median house price is currently $534,470. California is not alone. High-cost areas exist in many states. Maryland, for example, has five of twenty-four counties currently at the $362,790 FHA maximum with another seven counties within $1,885 of the limit. Again, these counties represent a great majority of the population for Maryland. Additional states that currently feature counties at or approaching the maximum FHA loan limit include Pennsylvania, Massachusetts, Connecticut, New York, and New Jersey among others.

Recognizing high-cost areas with regard to FHA loan limits is not new. Congress already recognizes high-cost areas for FHA loan limits in Hawaii, Alaska and various United States Territories. These areas feature an exception that takes their available loan limit to one hundred and fifty percent of the current FHA loan limit.

Congress must act to ensure that FHA loan programs continue to serve as a permanent backstop for all first-time homebuyer programs. We believe that Congress should allow for FHA loan limits to be adjusted up to 100% of the median home price, thereby establishing a logical loan limit that will benefit both the housing industry and consumers. Tying the FHA loan limit to the median home price for an individual county, and letting it float with the housing market, allows the FHA loan limits to respond to changes in home prices instead of an esoteric number derived from a complicated formula. In this fashion, the FHA loan limit will reflect a true home market economy.

FHA Risk-Based Premiums

The ability to match borrower characteristics with an appropriate mortgage insurance premium has been recognized as essential by every private mortgage insurer ("PMI"). PMI companies have established levels of credit quality, loan-to-value, and protection coverage to aid in this matching process. These companies also offer various programs that allow for upfront mortgage insurance premiums, monthly premiums, or combinations of both. This flexibility has enabled lenders to make conventional loans that are either not allowable under FHA or present a risk level that is currently unacceptable to FHA.

FHA is essentially a government mortgage insurance provider. Where FHA mortgage insurance is not available, PMI companies are free to increase premiums without fear of losing market share to a more competitively priced FHA loan product. FHA should be permitted to balance risk with premiums charged in order to increase competition and ultimately drive down costs for consumers. Since FHA is not required to make a suitable profit or demonstrate market growth to shareholders, it is likely that FHA can afford to assume greater risk levels than PMI companies

can currently absorb. This increased capacity to assume and manage risk will allow FHA to not only serve borrowers who presently do not have PMI available as a choice, but also those borrowers whose premiums will be reduced because of the increased competition in the market.

The Elimination of the Down Payment Requirement

NAMB supports eliminating the down payment requirement and granting FHA the flexibility to offer 100% financing to aid in the effort to increase homeownership for first-time, minority, and low to moderate-income families.

Homeownership is a dream that many wish to experience, but for years barriers have existed that prevent many low-income and minority families from purchasing a home. In fact, a study published by the Center for Housing Policy[5] in 2006 revealed that many working minority families with children are less likely to achieve the dream of homeownership today than in the 1970s. A principal barrier to achieving homeownership for these families is financial – the lack of money for a down payment and closing costs. Elimination of the down payment requirement will help break down this financial barrier to homeownership for many low to moderate-income and minority families.

Future of FHA

Changes must be made to the FHA program to sustain its viability and to fulfill its stated objective of increasing origination of FHA loan products and expanding homeownership opportunities for first-time homebuyers, low and moderate-income families, and borrowers with slightly blemished credit. Without substantial reform of the FHA program, deserving

[5] The Center for Housing Policy recently released a study entitled "Locked Out: Keys to Homeownership Elude Many Working Families with Children," in 2006 which showed that the cost of homeownership outpaced income growth for many low to moderate-income working families with children.

homeowners will be locked out of FHA products and forced into subprime. We support efforts to restore FHA programs to a position of being able to respond to the changing needs of the marketplace with flexibility and innovation. To make FHA programs a real choice for borrowers, we must: (1) expand the distribution channels delivering FHA loan products to the marketplace (*i.e.*, allow for greater mortgage broker participation); (2) increase FHA loan limits to serve those borrowers residing in high-cost areas; (3) institute risk-based pricing to allow for marginal pricing of risk; and (4) grant FHA the flexibility to offer zero-down products to assist first-time homebuyers with the financial hurdle of downpayments. It is possible that without these reforms, FHA's pool of loans will grow too small to effectively manage risk, and FHA could ultimately be unable to fulfill is function of being a helping hand for those who need it the most. The ripple effects could easily extend to the homebuilding industry and even to the economy at large.

Congress has the opportunity to revitalize the FHA program by increasing its profitability and ensuring that borrowers across the country have an equal opportunity to obtain a better loan at a lower interest rate. Congress also has the opportunity to meet the needs of the many subprime borrowers that are facing, or will soon face, resets and are now unable to find affordable credit options in the private subprime marketplace.

NAMB appreciates this opportunity to offer our perspective on the need to modernize FHA programs. I am happy to answer any questions.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM KENNETH WADE

Q.1. Despite the decline in writing F.H.A. loans, has homeownership increased or decreased over the last few years? What about minority homeownership in particular?

A.1. Since 1994, the homeownership rate for all households in the United States has increased by nearly 5%, from 64% in 1994—reaching a historic high of 69% in 2004, before falling slightly, to 68.8%, in 2005. As of the second quarter of 2007, the homeownership rate had slipped to 68.2 percent.

The homeownership rate for White households has increased from 70% in 1994 to 75.8% in 2005.

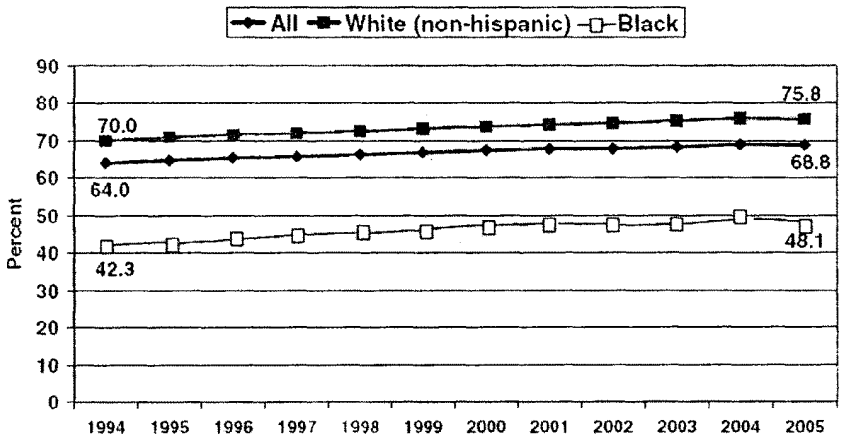
The homeownership rate for African-American households has increased from 42.3% in 1994 to 48.1% in 2005.

During this same time frame, the homeownership rate for Hispanic/Latino households has increased from 41.2% in 1994 to 49.5% in 2005.

Homeownership rates have risen for all racial groups over the past decade, but a persistent homeownership gap between Whites and Minorities has remained.

See chart below.

Figure 1. Homeownership by Race, 1994-2005



Q.2. What borrowers should F.H.A. programs help?

A.2. FHA's purpose is to serve low to moderate income homebuyers, including those who have less-than-perfect credit and little savings for a downpayment. FHA's focus should be primarily on providing mortgage insurance for first-time homebuyers and on serving communities and/or populations that have been underserved by the conventional mortgage markets.

Q.3. What kind of profits do lenders and brokers make on F.H.A. insured loans? How does the taxpayer backstop affect market discipline?

A.3. I am not at all familiar with the profits that lenders and brokers make on FHA insured loans, other than to know that they are reportedly competitive with industry norms.

In terms of whether the taxpayer backstop affects market discipline:

Lenders are able to offer homebuyers an FHA-insured loan at a prime interest rate, knowing that the loan is backed by the full faith and credit of the U.S. government, thereby providing an affordable alternative to some of the subprime mortgage products that have contributed to the current rise in foreclosures. Since FHA underwriting is aimed at offering mortgage insurance only to qualifying borrowers that can repay both the mortgage itself and the FHA insurance premiums, the FHA program should operate entirely from self-generated income—at little or no cost to the taxpayer.

Q.4. Are there any mortgage products that FHA should not be allowed to insure?

A.4. FHA should not be allowed to insure "teaser rate" mortgages, or high-cost/predatory loans. They should also not insure mortgages for non-resident owners (meaning speculators, investors, or vacation homes), nor should they insure "cash-out" mortgages.

Q.5. Are there better options other than a guarantee program to help appropriate borrowers who are unable to find financing?

A.5. I'm not sure. There are other/additional options that include things like direct subsidies, low-intrest loan programs, and tax credits, among others. Consumers and affordable housing practitioners have tended to use a range of approaches, depending on the specific needs of the borrower.

Q.6. If we were to increase the loan limits to G.S.E. levels, why do we need both GSE's and FHA? Will that make it harder for Fannie and Freddie to meet their affordable housing goals?

A.6. In my view, the roles of the GSEs and FHA are quite different, and aren't either duplicative or competitive. Lifting the FHA loan limits shouldn't make it harder for Fannie Mae and Freddie Mac to meet their affordable housing goals.

But an increase in the FHA loan limits would enable FHA to serve as an important refinance vehicle—making it possible for homeowners who are facing high mortgage payments as their adjustable-rate mortgages reset, to refinance into a more affordable FHA mortgage. Also, because of current FHA loan limits soem deserving borrowers in high cost areas of the country are not currently being served by FHA and have had to get their financing from the subprime market.

Q.7. Will expanding FHA programs drive up housing prices?

A.7. I don't believe so. Although FHA its niche in serving homebuyers, its portion of the overall mortgage market, even in its high volume periods, has only been about 15 percent of the market.

Q.8. How can financial education for reverse mortgage borrowers be improved?

A.8. NeighborWorks America has minimal experience with reverse annuity mortgages, since we focus primarily on pre-purchase homebuyer education and counseling, and post-purchase counseling, including foreclosure intervention and counseling. But my under-

standing is that the reverse mortgage counseling that is provided is quite good.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM DAVID CROWE

Q.1. Despite the decline in writing FHA loans, has homeownership increased or decreased over the last few years? What about minority homeownership in particular?

A.1. According to information that has been compiled by the U.S. Department of Commerce, Bureau of the Census, since the beginning of the current decade, the national homeownership rate for the entire population has ranged from a low of 67.1 percent during the first quarter of 2000 to a high of 69.2 percent during the fourth quarter of 2004. In the second quarter of 2007, the latest period for which these data are available, the national homeownership rate stood at 68.2 percent.

During the same time frame, the homeownership rate for all minorities ranged from 47.6 percent during the second quarter of 2000 to a high of 51.7 percent during the third quarter of 2006 and stood at 50.3 percent during the second quarter of 2007. By comparison, the rate for white homeowners ranged from a low of 73.4 percent in the first quarter of 2000 to a high of 76.2 in the fourth quarter of 2004 and presently stands at 75.4 percent. NAHB views narrowing and, eventually, eliminating the gap in homeownership rates for minorities as a key mission of a revitalized FHA.

Q.2. What borrowers should FHA programs help?

A.2. The single family mortgage insurance programs of the Federal Housing Administration were created by Congress in 1934 to help those who could not afford the short term, high downpayment loans that were the norm for home buyers at the time. For several decades after its creation, FHA was the driving force for innovations in residential mortgage lending. A few examples of such innovations are 30-year repayment terms, downpayments as low as three percent, and the 1-year adjustable rate mortgage loan, all of which have been adopted by conventional mortgage lenders and mortgage investors.

Because of the private sector's successful adaptation of FHA's innovations, the majority of borrowers who are currently being served by FHA are those whose credit experiences are not as positive as those who would qualify for conventional mortgages. In addition, FHA borrowers, who are more typically first-time homebuyers, frequently lack the cash reserves necessary to make downpayments greater than three percent, which conventional mortgage programs require for borrowers with even the slightest tarnishes on their credit histories.

Because FHA is a self-sustaining mutual mortgage insurance fund, it is important for FHA to insure better performing mortgages as well as higher-risk, low downpayment loans to more credit-challenged individuals. Allowing FHA to vary mortgage insurance premiums according to risk is an important tool in maintaining the financial health of FHA.

Q.3. What kind of profits do lenders and brokers make on FHA-insured loans? How does the taxpayer backstop affect market discipline?

A.3. A specific assessment of profits received by lenders and brokers is beyond the purview of the National Association of Home Builders. In general, however, NAHB has found the mortgage marketplace to be a highly competitive arena, and such vigorous competition tends to enforce market discipline. In addition, FHA has implemented measures in recent years that hold loan servicers more accountable to ensure that FHA-insured loans are properly serviced. For example, FHA has implemented programs that track the early performance of FHA-insured loans. Lenders whose loans suffer excessively high early defaults are subject to revocation of their authority to submit loans for FHA insurance.

Q.4. Are there any mortgage products that FHA should not be allowed to insure?

A.4. Some of the mortgage products that have led to the current meltdown in the subprime markets, such as loans that have prepayment penalties, loans that reset to significantly higher interest rates after a brief fixed-rate period, and loans on which the loan originators receive compensation that far exceeds the norm should not be insured by the FHA or any other government-affiliated mortgage loan program. The FHA single family mortgage insurance program operates, and should remain, within the bounds of prudent mortgage lending standards established by the federal banking regulators.

Q.5. Are there better options other than a guarantee program to help borrowers who are unable to find financing?

A.5. For nearly eight decades, the FHA's single family mortgage insurance program has provided an efficient mechanism for insuring single family mortgage loans without a cost to the taxpayers. The 100 percent insurance coverage that is provided for FHA-insured mortgage loans ensures that borrowers who use this program pay interest rates that are comparable to prime quality borrowers who receive conventional financing.

Other models exist for providing government guaranteed loans or loans made directly by government agencies to home buyers. However, these programs have carried a cost to taxpayers and have not functioned as well as FHA's.

Q.6. If we were to increase the loan limits to GSE levels, why do we need both GSEs and FHA? Will it make it harder for Fannie and Freddie to meet their affordable housing goals?

A.6. There is a key difference between the loan limits for Fannie Mae/Freddie Mac (the conforming loan limit) and the ceiling for FHA. The conforming loan limit is a national maximum that is the same in all areas of the country (with the exception of Alaska, Hawaii, Guam and the Virgin Islands where higher limits are allowed). FHA's ceilings are established based on the median home price in each locality. The FHA ceiling only applies in the very limited number of high-costs areas where the median home price approaches or exceeds the conforming loan limit. Even in the few markets where the proposed limit increase would bring FHA to the

conforming loan level, FHA and the GSEs would serve distinctly different borrowers, with FHA focusing on the credit needs of those with less than outstanding credit backgrounds and other borrowing challenges. On that basis, increasing the FHA maximum to the conforming loan limit should not present a measurable impediment to the GSEs in meeting their affordable housing goals.

Q.7. Will expanding FHA programs drive up housing prices?

A.7. The expansion of FHA programs will have little, if any, impact on housing prices, but will significantly benefit home buyers. The key factors contributing to the rise in home prices during the 2003 2005 housing boom were extremely low interest rates, heightened demand by investors/speculators, lax mortgage underwriting and rising land prices. It is noteworthy that FHA experienced a sharp decline in market share during this period. All of these have largely been reversed during the current housing slump. In particular, it was the lax lending standards during the housing boom that lured some home buyers into the more risky mortgage products, taking customers away from FHA.

As noted previously, FHA's more prudent lending standards, and the additional flexibilities Congress has proposed to grant the FHA, would make it possible for more families to purchase homes. FHA's ability to offer alternatives to conventional subprime loans that often carry onerous terms will greatly benefit home buyers during times when mortgage credit is tight. FHA's business is heavily weighted toward existing home transactions and a more vibrant FHA program, in addition to generating more demand for homes, will also boost the supply as more owners are incented to sell their homes. Moreover, the FHA program is restricted to only owner-occupied mortgages, which ameliorates any concerns about heavy investor use of FHA mortgages putting upward pressure on home prices.

Q.8. How can financial education for reverse mortgage borrowers be improved?

A.8. I have not surveyed the educational programs that are currently offered for seniors who are considering a reverse mortgage. However, it stands to reason that each potential borrower should fully understand the costs and terms of the loan being contemplated. In addition, there should be sincere efforts to determine that the reverse mortgage is the best means of addressing the financial needs of the borrower. NAHB supports reasonable requirements for mortgage disclosures and counseling for reverse mortgage borrowers.