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United States House of Representatives



“FHA Oversight of Loan Originators”

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On behalf of the Federal Housing Administration (FHA), I'd like to thank you for the opportunity to speak about FHA's comprehensive lender oversight and monitoring practices. I am Phillip Murray, the Deputy Assistant Secretary for Single Family Housing and I am responsible for managing all single family business for FHA. I have been with the U.S. Department of Housing and Urban Development (HUD) for 29 years, 17 of those with FHA, and am pleased to appear before you today.

Let me begin by stating that prior to my current position, I was the Director of the Office of Lender Activities and Program Compliance, responsible for administering various risk management activities of FHA approved lenders, which included sanctioning lenders and related parties who failed to comply with HUD and FHA requirements. Therefore, I take issue with recent press accounts suggesting that FHA is vulnerable to the same type of unsavory business practices as we've seen in the subprime mortgage market. These stories misrepresent a well-respected federal program that has provided untold benefits to millions of Americans, as well as the efforts of hundreds of HUD employees who administer it. The comparison of a safe, affordable FHA-insured mortgage to a subprime loan and the insinuation that such unsavory practices as were seen in the subprime market would be tolerated in FHA programs reveals a deep lack of understanding regarding the fundamental differences in the products and practices of these two segments of the market.

FHA-insured loans are neither high-cost nor high-risk for homeowners. Rather, they are stable products designed to provide homeownership opportunities to Americans prepared for such responsibility. Before FHA insures any mortgage, a lender must verify a borrower's employment, fully documenting their income as evidence of the borrower's capacity to meet their monthly mortgage obligation. Further, FHA prohibits underwriting based on "teaser" rates, requires that lenders escrow for taxes and insurance, and will not tolerate any prepayment penalties or balloon mortgages. In addition to these types of consumer safeguards, FHA-approved lenders are required to work with borrowers to resolve any delinquencies and avoid foreclosure at the first sign of difficulty. It is the combination of all of these protective features that makes FHA products safe and give homebuyers confidence in these products and in FHA.

Turning now to the specific topic of today's meeting, since its inception in 1934, FHA's single-family insurance program has been able to meet the costs of claims through up-front and annual insurance premiums paid by borrowers obtaining FHA mortgage loans, and earnings on insurance fund assets. To safeguard its ability to extend homeownership opportunities to Americans, the Department takes an aggressive stance to ensure that its FHA insurance funds are financially sound and adequately protected. The Mutual Mortgage Insurance Fund, the largest FHA insurance fund, is subject to an annual actuarial review and is required to meet a statutory minimum 2 percent capital reserve ratio. This ratio has been exceeded by the Department every year since its establishment.

FHA also conducts an annual actuarial review and maintains credit subsidy models that annually review each book of business and its underlying policy parameters and risk factors. These procedures assist FHA in estimating the cost to the government of insured loans and in making any necessary forward adjustments to credit subsidy models. Such analysis identified "seller-funded down payments" as an unacceptable risk to FHA and Congress subsequently prohibited FHA from

accepting future loans with a seller-funded down payment. FHA has also implemented Credit Watch and Appraiser Watch processes that monitor lenders and appraisers associated with unacceptably high default and claim rates for the purpose of terminating their FHA program participation. Between Fiscal Year (FY) 2004 and 2008, 455 appraisers and 354 FHA lender branches of 333 FHA approved lenders were terminated from FHA program participation by these processes.

The Department's efforts to protect FHA insurance funds and serve homebuyers and homeowners are best demonstrated by the thoroughness of its approval and monitoring standards. Lenders applying for participation in FHA's insurance programs are subject to rigorous initial approval requirements in addition to those standards imposed by the states in which they operate. Lender applications for FHA approval undergo an evaluation of: 1) the company's financial capacity and resources; 2) its possession of appropriate state licensing; 3) the eligibility of the company, and its principals, owners and officers to participate in government programs; and, 4) the company's quality control and compliance plans and procedures.

Additionally, lenders renew their approval annually to ensure ongoing adherence to FHA lender approval requirements. The renewal process requires lenders to certify their continued compliance with FHA guidelines, and to submit audited financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP) and in compliance with the U.S. Government Accountability Office (GAO) Audit Guide. HUD has established the HUD Inspector General's (OIG) Consolidated Audit Guide as a supplement to the GAO Audit Guide, which contains specific requirements for audits on various types of HUD programs participants. Audit statements are evaluated to ensure compliance with FHA net worth and liquidity requirements and to discover potential prohibited business arrangements or practices. The audit submission also includes a report by the CPA regarding the company's internal financial controls and its compliance with applicable laws and HUD regulations. Lenders that fail to meet the annual renewal requirements are not recertified. The FHA lender approval and recertification processes provide great assurance that HUD partners with entities that are financially and professionally sound.

FHA is constantly monitoring loan level compliance, lender performance, and portfolio performance. While all loans are required to pass a number of verification checks prior to insurance endorsement, FHA staff routinely perform rigorous reviews on a sample of the insured portfolio. For example, FHA staff conducts Post Endorsement Technical Reviews (PETR) of loans with an emphasis on compliance with FHA requirements to ensure that loans do not pose a risk to the FHA insurance funds. For the period of FY 2004 through FY 2008, FHA staff conducted such reviews on 322,000 loans. These case level reviews resulted in 1,448 indemnification agreements.

FHA also has a nationwide Quality Assurance Division that comprehensively monitors lenders for performance and compliance, complementing other FHA risk management strategies. All FHA approved lenders are eligible for monitoring by HUD's Single Family Quality Assurance Division, which continually refines its targeting methodology to incorporate various changes in mortgage industry business practices as well as advances in its targeting tools. Since FY 2000, FHA has made significant changes to reduce risk in its insurance operations in the areas of lender approval and recertification, loan origination, and servicing. Similarly, the Quality Assurance Division has changed its targeting approach and how it executes lender monitoring. Prior to the start of each

fiscal year, an annual Lender Targeting Plan is prepared. The Plan is risk-based and is prepared using a combination of data from HUD's systems. A list of lenders for review is generated by analyzing and evaluating data regarding default and claim rate levels, lender insurance processing, product types, and origination and servicing volumes.

Quality Assurance Division offices located in the field conduct HUD Lender Monitoring Reviews that include on-site loan level review of lender files as well as a review of lenders' compliance with FHA program requirements. These reviews are conducted in order to discover findings of deficiencies related to the origination or servicing of loans. Functional areas (retail, wholesale, servicing, direct lending, quality control/compliance, etc.) are also carefully reviewed to determine how the lender monitors its activities and decreases risk throughout its FHA portfolio. This methodology requires the review of a reasonable number of loans in each of the lender's operational areas and interviews with senior management to understand the policies and procedures the lender uses to minimize risk, to both HUD and the lender. Common deficiencies include missing or fraudulent documentation utilized in originations; inappropriate or prohibited business practices on the part of a lender; or insufficient or inadequate loss mitigation. From FY 2004 through FY 2008, this group conducted 2,988 monitoring reviews, evaluating 64,468 loans. These case level reviews resulted in 4,446 indemnification agreements. It should be noted that HUD staff also identifies potential evidence of fraud and refers such findings to the HUD OIG and during the period FY 2004 through FY 2008, FHA referred 2,257 loans to the OIG.

Further, the HUD Headquarters Quality Assurance Division conducts the highly effective Credit Watch Termination Initiative, which identifies underwriting lenders and originators with excessive default rates relative to other lenders. FHA currently performs a quarterly analysis of the default and claim rate for each lender branch (approximately 25,000 branches), comparing it with average rates for all lenders located in each HUD field office jurisdiction. Those lenders with a relative compare ratio of greater than 200 percent are subject to proposed termination. Credit Watch protects the integrity of the FHA insurance funds and sanctions those lenders who demonstrate imprudent or possible abusive lending practices. The list of lender branches terminated as a result of the Credit Watch Termination Initiative is published quarterly in the *Federal Register* and is also available on the Internet at <http://www.hud.gov/offices/hsg/sfh/lender/lendterm.cfm>. The default rates of all FHA lenders are displayed on the Internet at <https://entp.hud.gov/sfnw/public> to serve as a source of information by which other lenders and interested parties can judge a lender's performance.

Evidence of program violations is referred to the Department's Enforcement Center and/or the Mortgagee Review Board (MRB) for possible administrative action. The mission of the MRB is to protect the FHA and its mortgage insurance funds from fraud and program abuse, and encourage compliance by FHA approved lenders. When there is adequate evidence of serious violations, the Board hears cases against FHA approved single family and multifamily mortgagees relating to loan origination and servicing activity. The Board can impose civil money penalties and administrative sanctions against Title I and Title II FHA approved lenders and mortgagees who knowingly and materially violate FHA program statutes, regulations and handbook requirements. A lender is afforded due process in that they are given a notice of violation and an opportunity to respond and rebut. Given that MRB action is subject to the Administrative Procedures Act (APA), HUD's Office of General Counsel thoroughly reviews MRB cases for legal sufficiency. Challenges to

MRB actions are subject to APA, which requires an on the record evidentiary hearing before an Administrative Law Judge.

The Board responds to referrals from HUD field and program offices, the Office of Inspector General, and Ginnie Mae. While the MRB is not a court of law and operates under certain statutory constraints, the Board uses a variety of tools to ensure that mortgagees originate and service FHA-insured mortgages in compliance with the Department's requirements. Mortgagees that violate statutes, regulations, and policies governing HUD/FHA programs are subject to administrative sanctions by the MRB. The sanctions include reprimand, probation, suspension, and withdrawal of approval. As mentioned above, the MRB may issue cease-and-desist orders and impose civil money penalties against mortgagees. Also, the MRB may enter into Settlement Agreements, which protect the Department while avoiding litigation against a mortgagee. The Mortgagee Review Board took action against 219 lenders between FY 2004 and FY 2008.

The extensive and continual efforts of FHA to monitor and ensure the compliance of its partners are unparalleled in the industry. As its business grows, FHA is evolving to meet the challenge, improving its programs through hiring, technological, regulatory and programmatic reforms, as well as constant improvements to monitoring and enforcement efforts. Insuring mortgages inherently involves a degree of risk. For decades, FHA has successfully taken measured steps to help more Americans enjoy the opportunities of homeownership, while consistently modernizing its programs to protect taxpayers and ensure the integrity of its insurance funds.

While I can assure you that FHA is fully committed to continuing aggressive oversight of its programs, I restate FHA's long-standing need for investments to further bolster the agency's monitoring and oversight capabilities. The issue became urgent once the subprime mortgage crisis began to grow larger and Congressional actions to expand FHA's role were legislated. HUD has been vocal in recent years about its needs for FHA, particularly in the area of information technology (IT) systems. This is a critical need—FHA data is stored on 35 separate legacy systems, **which have been obsolete for nearly two decades.**

Finally, I want to address a topic I feel is pertinent to today's discussion of FHA's continued strength and vitality in the current market, which is the possible provision of authority to bankruptcy judges to "cram-down" or otherwise modify mortgages. It has been the longstanding policy of this Administration to oppose any such legislation. Providing authority to bankruptcy judges to modify mortgages will add uncertainty for investors and the mortgage markets, which will lead to higher interest rates for borrowers. Specifically, however, HUD feels it important that the Congress consider the implications of any legislation granting such authority to bankruptcy courts on the operations of both FHA and Ginnie Mae.

FHA and Ginnie Mae do not have the legal authority to reimburse lenders for the "cram-down" amounts that are forgiven through the bankruptcy process but still must be paid to the investors under the terms of the securities. Therefore, any legislation in this area would likely create a powerful disincentive to doing business with FHA and Ginnie Mae. Loss of guarantee and premium fees and impairment of mission capability would occur at FHA and Ginnie Mae. If issuers are unable to make up the difference on "cram-down" terms, Ginnie Mae could be forced to take over portfolios and incur the costs of additional "cram-downs" as well as the costs of servicing those

portfolios. As the Congress contemplates this matter, I strongly urge careful consideration of the points I am raising today so that FHA and Ginnie Mae can continue to play a leading and stabilizing role both during the current market distress and in the future.

Again, I want to thank you for the opportunity to explain FHA's comprehensive lender oversight and monitoring efforts.