NATIONAL COMMUNITY REINVESTMENT COALITION NCRC

Testimony

Testimony of
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The FHA Reform Act of 2010: HUD's Proposals Strike Balance between Access and Safety and Soundness

Before The
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House Financial Services Committee
Housing and Community Opportunity Subcommittee

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Introduction

Good morning, Chairman Waters, Ranking Member Capito**,** and other distinguished members of the Subcommittee. My name is John Taylor and I serve as President and CEO of the National Community Reinvestment Coalition (NCRC). I am honored to testify today before the Housing and Community Opportunity Subcommittee of the House Financial Services Committee on behalf of NCRC on the topic of the Federal Housing Administration (FHA) program and suggestions for reform.

NCRC is an association of more than 600 community-based organizations that promotes access to basic banking services, including credit and savings, to create and sustain affordable housing, job development, and vibrant communities for America's working families.

NCRC applauds you for holding this important hearing on the FHA because the success of the FHA remains important for the housing market and the broader economic vitality of our country. When it was created in 1934, FHA's original mission was to promote homeownership widely and to build economic prosperity. FHA successfully achieved its mission by standardizing a safe, sound, and straightforward product – the 30 year fixed-rate mortgage with a downpayment requirement. FHA's role in the current economic crisis is similar to its original role. The crisis has sharply curtailed the amount of private sector loans to the point where FHA and the Government-Sponsored Enterprises (GSE) now own or guarantee around 80 to 90 percent of the new mortgage loans being made. By the end of 2008, almost one half of the home purchase loans and one quarter of the refinance loans were FHA or VA insured.[1] FHA is thus performing a vital countercyclical role of preventing housing markets from crashing and preserving and promoting economic stability and growth.

Currently, a broader range of applicants are using the FHA program. Middle- and upper-income borrowers as well as the traditional FHA first-time homebuyers are using the program in heavy

[1] Robert B. Avery, Neil Bhutta, Kenneth P. Brevoort, Glenn B. Canner, Christa N. Gibbs, *The 2008 HMDA Data: The Mortgage Market during a Turbulent Year*, in the Federal Reserve Board Bulletin, September 30, 2009, p. 20, see http://www.federalreserve.gov/pubs/bulletin/2009/pdf/hmda08draft.pdf.

volumes.[2] The broader use is most likely a short-term aberration and the FHA Commissioner has spoken about how he wants to return FHA to its focus on first-time homebuyers and underserved communities. Today's widespread use of FHA, however, illustrates that it has broad benefits for the U.S. population as a whole.

In this context, the Department of Housing and Urban Development's efforts to shore up the safety and soundness of the FHA are welcome steps. NCRC is supportive of the discussion draft bill, FHA Reform Act of 2010, which incorporates HUD's legislative suggestions regarding underwriting and enforcement authority.

The previous Administration allowed the FHA to be understaffed and had not updated underwriting criteria in some time.[3] This inattention, combined with the overall foreclosure crisis, contributed to the FHA's secondary reserves being lower than the Congressionally mandated level. NCRC is supportive of the proposed changes to underwriting standards that aim to reduce delinquencies and bolster safety and soundness. At the same time, it is important that HUD does not overreact to the crisis and implement unnecessarily tight standards that do not contribute to safer mortgages but that constrict credit. FHA clearly has an important countercyclical role, bolstering consumer demand for mortgages in steep recessions and serving underserved communities. If the tightening goes too far, the countercyclical role is endangered. In addition to supporting the steps so far on underwriting, NCRC heartily applauds the increased enforcement HUD has taken against unscrupulous lenders participating in the FHA program. The enforcement will be very beneficial to promoting responsible lending for communities and restoring the health of the reserve fund.

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[2] Lisa Nelson of the Cleveland Federal Reserve finds an increase in upper-income usage of FHA loans. See Lisa Nelson, *A Look Behind the Numbers: FHA Lending in Ohio*, December 2009, via http://www.clevelandfed.org/Community_Development/publications/ALBTN/V2_5/index.cfm

[3] Dina Elboghdady and Dan Keating, *The Next Hit: Quick Defaults – More FHA-Backed Mortgages Go Bad Without a Single Payment* in The Washington Post, Sunday, March 8, 2009.

FHA's Lending Trends and Focus

For many decades, FHA had a prominent role in the marketplace, ranging from guaranteeing 30 percent of the loans in the 1970's to 15 to 20 percent in most of the 1990's.[4] With the rise of subprime lending, however, FHA's market share shrank while subprime market share increased. In 2005, the share of mortgages insured by FHA was only about 4.5 percent while subprime loans constituted about 18 percent of home purchase loans. The inverse relationship between the FHA and subprime market share is due in part to the similar group of borrowers both types of lending were serving. The credit profiles of borrowers of these loan types are not identical but both FHA and subprime loans were serving a population that was not the mainstay of traditional banks.

Ultimately, FHA lending proved to be more sustainable than the loosely underwritten subprime loans. After the crash of subprime lending in 2007 and 2008, FHA's market share is now 25 to 30 percent of mortgage loans.[5]

Loan performance data shows that FHA lending is more durable than subprime lending. According to the Office of the Comptroller of the Currency and the Office of Thrift Supervision, 8.3 percent, 16 percent, and 20.1 percent of government-guaranteed mortgages, option Adjustable Rate Mortgages (ARMs), and subprime loans, respectively, were seriously delinquent as of the third quarter 2009. In addition, 2.5 percent of government-insured mortgages as opposed to 11.9 percent of option ARM mortgages were in the process of foreclosure as of the third quarter 2009.[6] The Cleveland Federal Reserve Bank reveals that as of second quarter in 2009, 13 percent of FHA loans in Ohio were 60 plus days delinquent compared to 29 percent for subprime loans.[7]

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[4] Dan Immergluck, *From Minor to Major Player: The Geography of FHA Lending During the U.S. Mortgage Crisis*, Georgia Tech, December 2009, p. 6.
[5] Immergluck, p. 8.
[6] OCC and OTS Mortgage Metrics Report, Third Quarter 2009, December 2009, p. 5 available at http://www.occ.gov/ftp/release/2009-163a.pdf
[7] Lisa Nelson, Cleveland Federal Reserve Bank.

FHA lending has performed better than subprime lending most likely due to more rigorous underwriting. FHA loans were typically fixed-rate, plain vanilla loans offered to borrowers whose income was verified.[8] In contrast, a significant percentage of subprime loans had variable interest rates, high loan-to-value ratios, and did not fully document borrower income. In many cases, borrowers of subprime ARM loans were not prepared to cope with adjustments in the interest rates.

Recent data indicates that FHA loan performance should continue to improve as a result of reduction in loan risk characteristics. In their review of the 2008 Home Mortgage Disclosure Act data, the Federal Reserve Board finds that the share of FHA home purchase loans with loan-to-value (LTV) ratios exceeding 95 percent fell from 72.3 percent in 2007 to 67.4 percent in 2008. The share of FHA home purchase loans to prime borrowers (with FICO scores greater than 660) increased from 30 percent in 2007 to 50 percent in 2008. In addition, while one third of the 2007 FHA home purchase loans went to borrowers with LTVs greater than 95 percent and FICO scores below 620, this share declined to 15 percent in 2008.[9]

Before the advent of subprime lending, a fair lending concern involved the concentration of FHA loans in communities of color. When subprime lending surged, subprime lending supplanted FHA lending in minority communities. Fair lending concerns shifted to the concentration of subprime loans in minority communities. In fact, research shows that during the years of heavy subprime volumes, African-Americans and Hispanics were significantly more likely to receive subprime home purchase loans than FHA loans, after controlling for borrower and lender characteristics.[10]

Now, after the shrinkage of subprime lending, FHA lending is once again increasing substantially in minority communities. In their zip code level analysis, the Cleveland Federal Reserve Bank shows that the increase in FHA lending was correlated with a decrease in subprime lending. In contrast, there is no correlation between prime and FHA lending trends on

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[8] Written Testimony of Secretary Shaun Donovan - Hearing before the House Committe on Financial Services - FY09 FHA Actuarial Report, December 2, 2009, see http://portal.hud.gov/portal/page/portal/HUD/press/testimonies/2009/2009-12-02
[9] Avery, Bhutta, et. al. in Federal Reserve HMDA article, pp. 26 & 27.
[10] Immergluck, p. 10 and 11.

a zip code level. In other words, it appears that FHA lending is substituting for the withdrawal of subprime lending on a zip code level. Immergluck finds that after controlling for a series of borrower and neighborhood characteristics, FHA lending is more likely in African-American than white neighborhoods. Moreover, in 2008, the most recent year for which HMDA data is available, more than 50 percent of home purchase loans for African-Americans and 45 percent of the loans for Hispanics were FHA compared with just 27 percent for whites, according to the Federal Reserve Board.[11]

Because FHA loans are more expensive than conventional loans, disparities by race of borrower or neighborhood raises fair lending concerns. Conventional loans with higher LTVs require private mortgage insurance, which is paid monthly just as FHA has monthly premiums. In contrast to FHA loans, however, conventional loans have no up-front premium. Also FHA loans may have higher rates or fees than conventional loans due to FHA processing requirements. Immergluck finds the average interest rate on a FHA loan to be 6.15 percent compared to a conventional rate of 5.86 percent --- 29 basis point difference.[12] FHA lending has become an important source of credit in minority communities because of the drying up of conventional credit. FHA lending, however, is more expensive than conventional loans. Fair lending investigations and enforcement need to uncover whether any redlining or avoidance by traditional banks and/or any targeting or steering by FHA lenders is causing these disparities. Increased fair lending enforcement should help bolster FHA’s important role in minority communities by increasing competition among responsible FHA and conventional lenders and thus narrow the interest rate differential between FHA and conventional loans.

FHA has also had an important countercyclical and stabilizing role in economically disadvantaged communities. Immergluck shows that FHA lending is more likely in communities experiencing high unemployment, smaller metropolitan areas, metropolitan areas experiencing large home price declines, and zip codes with lower median home values. In other words, FHA lending has increased while conventional lending has decreased in communities hardest hit by the current severe recession.

[11] Avery, Bhutta, et. al in Federal Reserve HMDA article, p. 29 and p. 56 table 16
[12] Immergluck, p. 14.

FHA has also historically been focused on low- and moderate-income (LMI) borrowers. In 2006, 11.4 percent of the home purchase loans issued to LMI borrowers were FHA loans as opposed to 2.6 percent for upper-income borrowers. By 2008, 37.6 percent of the home purchase loans issued to LMI borrowers were FHA loans as opposed to 20.6 for upper-income borrowers.[13] While the gap narrowed between LMI and upper-income borrowers, LMI borrowers still received almost twice the percentage of FHA loans as upper-income borrowers. Even in this crisis, FHA's focus is on the modest-income, first-time homebuyer that has more difficulty than their upper-income counterparts in accessing credit.

HUD's Proposed Reforms

The challenge for HUD is to improve the FHA program with tighter underwriting so that delinquency rates decline but that FHA does not retrench from the communities in most need. While FHA delinquencies are lower than subprime, they are higher than prime delinquencies. HUD's proposals seek to strike the right balance between reducing risk through tighter underwriting while still maintaining access for traditionally underserved neighborhoods.

These proposals include:

Adjustments to Up-Front Premium and Annual Premiums: Currently, HUD charges an up-front premium of 1.75 percent and annual premiums of .55 percent of the loan amount. HUD is proposing to increase the upfront premium to 2.25 percent. If HUD receives legislative authority per the draft statutory language it just sent to the House Financial Services Committee, it would reduce the upfront premium charge and increase the annual charge to as much as 1.5 percent of the loan amount. For some borrowers that do not have much cash for closing, shifting the fees to the annual premium makes the up-front premium more affordable. Other borrowers may prefer the higher upfront charge because monthly payments would be lower. It would seem that HUD should offer a menu of options regarding the upfront and annual premium charges.

[13] Federal Reserve's review of HMDA data, p. 56, Table 16A. LMI and upper-income definitions are the CRA income definitions of up to 80 percent of area median income for LMI borrowers and 120 percent or more of area median income for upper-income borrowers.

Combination of FICO scores and Downpayment Requirements: HUD proposes to require a minimum FICO score of 580 and above to qualify for a 3.5 percent downpayment. For borrowers with FICO scores below 580, the downpayment requirement would be 10 percent of the loan amount. According to HUD, the delinquency rate for borrowers with FICO scores above 580 and 3.5 percent downpayments was 7.5 percent compared to 31 percent for borrowers with FICO scores below 580 and 3.5 percent downpayments. HUD will allow the borrowers with FICO score below 580 to make a downpayment of 10 percent and receive FHA loans because HUD states that borrowers with low FICO scores but higher downpayments perform better. Given the data trends, HUD's proposal makes sense in shoring up the FHA reserves while still maintaining opportunities for borrowers with less than 580 FICO scores to receive FHA loans. It should also be noted that traditional lenders making conventional loans regard a FICO score of 620 a hard cut-off for lower downpayment loans, meaning that FHA is preserving access in the market for borrowers with imperfect credit.

Reduction of Allowable Seller Concessions: HUD is proposing to reduce allowable seller concessions from 6 percent to 3 percent. This reduction is appropriate because the higher level of seller concessions contributed to appraisal fraud and other abuses.

Indemnification by Lenders: In legislative language sent to the House Financial Services Committee (which was incorporated in the discussion draft of the FHA Reform Act of 2010), HUD is asking Congress to allow the agency to require indemnification from all lenders participating in the FHA program for acts of fraud and misrepresentation in addition to the lenders that have FHA's permission to approve loans without pre-endorsement review by the FHA. It would seem that all lenders participating in the FHA program should be on a level playing field and subject to sanctions should they engage in fraud. In addition, this change should assist FHA reduce delinquencies and defaults.

Credit Watch: HUD is proposing that Congress enact legislation providing it with flexibility in defining geographical areas for review and termination of fraudulent lenders from FHA lending under the Credit Watch initiative. This proposal makes sense in that rigidities in the current law may allow a lender to switch unscrupulous operations from one branch to another branch just over a state border and remain as a FHA lender in those two states.

Neighborhood Watch: HUD has enhanced Neighborhood Watch that provides publicly available data on FHA loan performance in geographical areas and for individual lenders. Just like Home Mortgage Disclosure Act (HMDA) data, this publicly available FHA loan performance data holds lenders accountable.

FHA- HAMP: NCRC supports HUD's implementation of its FHA-HAMP program to assist borrowers at risk of imminent default due to loss of income. FHA-HAMP allows principal forbearance or a partial claim in the form of a subordinate mortgage that is paid off when the homeowner sells the home. HUD and the Treasury Department should increase their efforts to persuade lenders to use FHA HAMP. NCRC's counselors report that they have not experienced lenders using this program.

NCRC Recommendations

Increase the Role of Nonprofit Counselors: NCRC understands that HUD has the authority to reduce the upfront premium if the borrower receives counseling from a HUD-approved counselor. HUD, however, does not have the authority to reduce annual premium amounts if a borrower has counseling. NCRC recommends that Congress grant HUD this authority since counseling has proven to be effective and since reductions in premium amounts will assist in increasing the affordability of FHA loans for those borrowers receiving counseling.

Bolster Fair Lending Enforcement: HUD and the federal banking agencies must bolster their fair lending enforcement efforts. FHA has played an important role in preserving access to credit in this difficult economic environment. Yet, evidence suggests that when controlling for lender, borrower, and neighborhood characteristics, communities of color receive a disproportionate amount of FHA loans. FHA loans are not inherently abusive or risky like a significant amount of subprime loans. FHA loans, however, are more expensive than conventional loans. Increased fair lending enforcement would promote more competition among lenders and lower prices by prosecuting redlining by traditional lenders and any targeting of communities by FHA lenders. HUD and the federal banking agencies should consider the use of matched pair testers in its enforcement efforts. HUD is to be commended for its renewed focus on enforcement and termination of unscrupulous lenders such as Taylor, Bean, and Whitaker from the FHA program. Matched paired testing can aid HUD in these ongoing investigations. In addition, the results of fair lending review should be made publicly available just like CRA exams in order to increase the accountability of financial institutions.

FHA and state and local programs: State and local departments of housing and community development operate a number of CDBG and HOME-funded programs that provide second mortgages and other subsidies for first-time homebuyers and other underserved segments of the community. NCRC understands that HUD allows state and local agencies to use these programs for borrowers that receive FHA loans. NCRC recommends that HUD, lenders, and other stakeholders help state and local agencies to further promote these programs. These programs increase the affordability of FHA loans.

Tax Deductibility of FHA Premiums: The Mortgage Debt Forgiveness Act made FHA premiums fully tax deductible for households with incomes under $100,000 for the years 2008 through 2010. Congress ought to make FHA premiums deductible with no time limits just like private mortgage insurance payments. Congress ought to be taking steps to make FHA affordable for borrowers unable to receive conventional loans, and extending tax deductibility is one straightforward way to do this.

Frequent Reviews of FHA Pricing and Underwriting: HUD should undertake frequent reviews of FHA pricing and underwriting criteria in order to ensure that the program is promoting both safety and soundness and access. When loan performance warrants, HUD should adjust its underwriting criteria in order to promote access to the FHA program.

Conclusion

The changes proposed by the FHA attempt to navigate a prudent course without negatively impacting access to credit or contributing to a further slowing of the housing market in communities of color. While some borrowers will bear more of the costs of the government insurance program through higher premium charges, the additional revenue will help ensure that FHA remains solvent. The burden to the individual borrower is modest and should ensure, overall, that borrowers have access to responsible credit. While some less credit worthy borrowers will need higher down payments, this is a necessary move in difficult market conditions where a decline in home value can wipe out a new buyer's equity. We believe that the FHA has a difficult path to navigate, but we think they have successfully realized three core objectives simultaneously:

- First, to reduce the financial exposure of the FHA fund through tighter credit rules;
- Second, to sustain the flow of mortgage credit sufficient to make sure the housing market doesn't go into a renewed negative spin;
- And third, to avoid "balancing the FHA books" on the backs of credit worthy working families.

FHA was created in 1934 to heal the U.S. housing market during the Great Depression and for decades – due to a stable housing market - it has turned a profit for taxpayers. Today, it is more critical than ever that FHA remain a strong gateway for responsibly underwritten credit in the communities that we serve, while also ensuring a healthy and sustainable mortgage marketplace beneficial to all.