**California Association of Mortgage Brokers**

**Prepared Testimony of**

**Ed Smith, Jr., Vice President, Government & Industry Relations**

**Vice President, Board of Directors,**

**California Association of Mortgage Brokers**

**On FHA Modernization: H.R. 1852**

**Before the**

**House Financial Services Committee, Subcommittee on Housing and Community Opportunity**

**United States House of Representatives**

**April 19, 2007**

Good morning Chairwoman Waters and members of the subcommittee, I am Ed Smith, Jr., Government Affairs Committee Chair and Vice President of the Board of Directors of the California Association of Mortgage Brokers ("CAMB"). Thank you for inviting me to testify today on the Federal Housing Administration Modernization legislation, H.R. 1852. In particular, we appreciate the opportunity to address the need to: (1) increase Federal Housing Administration (FHA) loan amounts for high-cost areas, (2) develop risk-based pricing for mortgage insurance on FHA loans, and (3) reform the FHA program to reduce the barriers to mortgage broker participation.

Since its inception in 1990, the California Association of Mortgage Brokers has promoted the highest standards of professional and ethical conduct, among which are expert knowledge, accountability, fair dealing, and service to the consumer and our community. The Association provides education, legislative and regulatory representation, and public relations for its 4,000 plus membership of mortgage brokers and affiliated service providers across California, while serving as a forum for the development of common business interests across the industry. CAMB has led the mortgage industry by being the first organization to define predatory lending, as well as creating a best practices handbook that has set the standard for best practices in the industry.

CAMB has also raised the bar for consumer protection by creating the Consumer Protection and Education Worksheet, a document which allows both borrower and broker to sign at the bottom to affirm that they have been educated and fully understand all terms of their loan. CAMB has a proactive legislative agenda which recently passed into law two CAMB sponsored bills, AB 790 and 2890, which outlaw the misrepresentation of training and professional certifications by loan originators in the state of California. As you can see, CAMB has aggressively pushed for best practices in the industry and is dedicated to being a solution to curb predatory lending practices, standardize the industry from within, and provide the best products available to our customers, including alternative loan products.

The utilization of non-prime mortgage products rose exponentially, especially in high-cost areas such as California, as FHA programs became less and less accessible to the public. CAMB believes that the proposed reforms to the FHA program in H.R. 1852 are critical to expanding homeownership opportunities for prospective first-time, minority, and low to moderate-income homebuyers, and vital to solving the liquidity crisis in the marketplace caused by the recent turmoil in the non-prime marketplace.

## **Increase FHA Mortgage Amounts for High-Cost Areas**

CAMB strongly believes the formula used to calculate FHA maximum loan amounts should be revised to make the FHA program accessible to those homebuyers living in high-cost areas. The benefits of the FHA program should belong equally to all taxpayers; especially those residing in high-cost areas that often are most 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 when one factors in the latest escalation in home prices. 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 $535,470. California is not alone. High-cost areas exist in many states across the country. 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, Connecticut, New York, and New Jersey among others.

Recognizing high-cost areas with regard to FHA loan limits is not new to this legislative body. 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.

We must not forget that the FHA program was created by the National Housing Act of 1934 with the intent of increasing homeownership and assisting the home building industry. Since its inception, FHA has insured over 33 million loans and is the largest insurer of mortgages in the world. FHA insured loans are the staple for first-time homebuyers. FHA insured loans are more accommodating to first-time homebuyers than other types of loan programs. The program is designed to incorporate flexibility for debt-ratios, income and credit history items not included in the government sponsored enterprise (*i.e.,* Fannie Mae and Freddie Mac) guidelines.

**FHA Risk-Based Premiums are Relevant to the Market**

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. They also offer various programs that allow for upfront mortgage insurance premiums, monthly premiums or combinations of both. This program flexibility has enabled lenders to make conventional loans in the private marketplace that either are not allowable under FHA or that present a risk level that is currently unacceptable to FHA.

Unfortunately, where FHA is not available as a viable competitor, PMI premiums are quite expensive. Should FHA decide to enter this market, it will increase competition for these programs and ultimately, drive down costs for borrowers.

For example, many mortgage products that require minimal or no down payment or equity do not use PMI insurance. Rather, these loans are split into two—a first mortgage, which is offered at a lower interest rate, and then a second mortgage offered at a considerably higher interest rate. This "combo" or "80/20" type of mortgage product is commonly offered to borrowers with less than perfect credit. Borrowers who are unable to adequately prove their income also commonly utilize "combo" mortgages. In this market, PMI may not be offered or is offered at a prohibitively high premium. Again, FHA could act as a competitor to drive down costs for these types of products.

PMIs have demonstrated the ability to balance risk with the premiums charged and the FHA program should be afforded the same opportunity. If the risks are assessed appropriately, the premiums charged should ensure that the Mutual Mortgage Insurance Fund ("MMIF") will not be adversely affected. FHA is not required to make a suitable profit or demonstrate market growth to shareholders; therefore, it is likely that

FHA can afford to assume even greater risk levels than PMIs can currently absorb. This increased capacity to assume and manage risk will allow FHA to serve even those borrowers who presently do not have PMI available as a choice.

H.R 1852 allows FHA to offer lower premiums to lower credit risk homebuyers, which will have the net effect of reducing the overall default rates at FHA. Recent changes made by HUD such as permitting formerly non-allowable fees to be charged and utilizing Fannie Mae appraisal guidelines have had the effect of modernizing the FHA program. These advances make the FHA program easier to use, which in turn attracts more borrowers who would not otherwise tolerate the red-tape long-associated with origination of FHA loans. Real estate agents, sellers and mortgage companies who have not viewed FHA financing as a viable alternative to the private marketplace would also return to the program, bringing with them suitable borrowers that would make FHA's default rate comparable to that of conventional loans.

This legislation is not intended to be a change to the FHA program that will create losses. Rather, it is designed to avoid losses to the MMIF. The legislation contains needed reforms that will help FHA meet its chartered mandate of increasing homeownership opportunities for first-time, minority and low to moderate-income homebuyers, and which may actually have the side effect of improving the solvency of the MMIF.

All insurance constructs involve assumption of risk. When an insurer can use sound actuarial data and price in a manner that is responsive to trends revealed by such data, the risk is spread over a sufficiently large base to minimize the chance of loss. Because FHA's share of the market is approaching marginal levels, the risks to the program are likely to be greater under the status quo than with the legislation proposed in H.R. 1852.

## Benefits to Consumers, Particularly First-Time HomeBuyers, Minority and Low to Moderate-Income Families

Lenders and insurers tend to demand a higher proportional return when they enter a riskier market. It has been demonstrated that the return demanded is considerably higher for sub-prime loan products than for prime loans because of the inherent risks presented by the sub-prime market. At the same time, consumer advocates have claimed that fees and rates for many sub-prime borrowers are too high. FHA has the ability to enter into the sub-prime market safely and still offer significant savings to prospective borrowers. The benefits received by expanded FHA entry into the sub-prime market would be particularly useful for first-time, minority and low to moderate-income homebuyers who could receive prime interest rates on their loans by using FHA insurance.

The FHA program also possesses many attributes that are particularly friendly to prospective borrowers who may have less money available for closing costs, temporary income, or a limited credit history. For example, FHA Direct Endorsement Underwriters are given considerable latitude to make loans that they believe should be made, but may not have all of the requisite attributes conventional guidelines require. FHA servicing is far less likely to quickly send a loan to foreclosure and must follow borrower-friendly practices whereas some conventional lenders have been cited for questionable loan servicing practices. FHA loans usually offer fixed interest rates compared to the adjustable rates offered on most sub-prime mortgages.

## Complements the Private Sector

As discussed earlier, America is built on the concept that competition is healthy for the market. It improves efficiency and quality while offering more competitively-priced products to consumers. Making FHA more competitive will improve the services and products provided by other lenders and insurers in the industry. Consumers will be offered FHA programs that serve a similar purpose but are certainly not identical to conventional programs now available. This healthy level of competition should drive down the cost of programs that serve those with minimal down payments or who need flexible underwriting to obtain home financing.

Borrowers who can afford larger down payments or who have reasonable equity levels do not find the FHA program to be a reasonable alternative to conventional financing. Nearly all FHA borrowers have a loan-to-value ratio in excess of ninety percent. Since 1980, FHA has never served more than fifteen percent of the total housing market but, at times, it insured nearly fifty percent of urban mortgages. Clearly, this legislation will not make the FHA program a threat to the overall mortgage market. At most, H.R. 1852 will help to restore FHA loan product origination to levels of previous years.

Nevertheless, the possibility that FHA could supplant certain conventional loans does exist. Such a result is inevitable if FHA regains market share. However, the conventional loans most likely to be supplanted are those made to borrowers who fall just short of receiving A-grade conventional loans. Many first-time, minority and low to moderate-income homebuyers find themselves in this situation but are forced to turn to the sub-prime market to achieve homeownership. This legislation makes FHA loan products a viable alternative for these prospective borrowers.

## FHA Utilization of Mortgage Brokers

CAMB supports the proposed reforms to the FHA program outlined in H.R. 1852, but believes that the FHA program must first be a viable option for prospective borrowers. Regardless of how beneficial a loan product may be, it requires an effective distribution channel to deliver it to the marketplace. Unfortunately, many prospective borrowers are denied the benefits offered by the FHA program because mortgage brokers—the most widely used distribution channel in the mortgage industry—are limited in offering FHA loan products.

According to Wholesale Access, mortgage brokers originated 38.6 percent of all FHA loans for a total of $110 billion in 2003. Mortgage brokers want to further increase origination of FHA loan products for first-time, minority and low to moderate-income homebuyers. However, current financial audit and net worth requirements create a formidable barrier to mortgage broker participation in the FHA program. This barrier makes it difficult for mortgage brokers to offer FHA loan products to those borrowers that could clearly benefit by participating in the FHA program.

CAMB supports increased access to FHA loans so that prospective borrowers who may have blemished or almost non-existent credit histories, or who can afford only minimal down payments, have increased choice of affordable loan products and are not forced by default to the sub-prime loan market. In this spirit, CAMB believes the audit and net worth requirements should be eliminated for mortgage brokers that want to offer FHA loan products to consumers.

First, current FHA requirements impose cost prohibitive and time consuming annual audit and net worth requirements on mortgage brokers that want to originate FHA loans. These requirements place serious impediments in the origination process that functionally bar mortgage brokers from distributing FHA loans to the marketplace, leaving sub-prime loan products as the only other option for many borrowers.

Most small businesses find the cost to produce audited financial statements a significant burden. An audit must meet government accounting standards and only a small percentage of certified public accountants ("CPAs") are qualified to do these audits. Moreover, because many auditors do not find it feasible to audit such small entities to government standards, even qualified CPA firms are reluctant to audit mortgage brokers. Cost is not the only factor. A mortgage broker can also lose valuable time—up to several weeks—preparing for and assisting in the audit. Between the cost of hiring an accountant who meets government auditing standards and is willing to conduct the audit and the hours needed to compile and report the needed data, it is simply impractical for a small business to conduct this type of financial audit.

The net worth requirement for mortgage brokers is also limited to liquid assets because equipment and fixtures depreciate rapidly and loans to officers and goodwill are not permitted assets. To compound this, a broker who greatly exceeds the net worth requirement is forced to keep cash or equivalents of 20% of net worth up to $100,000. There has been no evidence presented by FHA that loans originated by high net worth originators perform better than those with a lower net worth.

Moreover, annual audit and net worth requirements are unnecessary. Originators are already governed by contract agreements with their respective FHA-approved lenders, affording HUD adequate protection against loss. FHA-approved lenders already submit to audits, thereby ensuring that customers are protected and can seek relief from dishonest originators.

In sum, the audit and net worth requirements are prohibitively expensive for a large majority of mortgage brokers and as a direct result, many brokers have been left with little choice but to originate loans other than FHA. As a result, the audit and net worth requirements actually 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 minimal down payment. At a minimum, CAMB 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.

A stated objective of the FHA program is to increase origination of FHA loan products and expand homeownership opportunities for first-time, minority, and low to moderate-income families. CAMB believes the solution to increase FHA loan production is simple—allow more avenues, such as mortgage brokers, to offer FHA loan products directly to consumers. As stated previously, mortgage brokers originate the majority of all residential loans and therefore, would provide HUD with the most viable and efficient distribution channel to bring FHA loan products to the marketplace.

Congress must ensure that FHA insured loan programs continue to serve as a permanent backstop for all first-time homebuyer programs. For this reason, we believe that Congress should create the ability for FHA loan limits to be adjusted up to 100% of the median home price, thereby providing a logical loan limit that will benefit both the housing industry and the consumer. 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 some esoteric number computed through a complicated formula. In this fashion, the FHA loan limit will reflect a true home market economy. Rather than restrict purchases of new homes through a legislatively mandated ceiling, the FHA loan limit can automatically adjust under current guidelines established for increasing the FHA loan limit on a county-by-county basis.

**Future of the FHA Program If Legislation is Enacted or Not Enacted**

The proposed changes outlined in H.R. 1852 are needed to the FHA program to meet its chartered mandate, which is to help the underserved and underprivileged obtain the dream of sustainable homeownership. PMI will dominate the low and zero down payment market with little competition among the few players in that industry. The sub-prime mortgage market will fulfill the needs of those unable to obtain PMI insurance. Foreclosure rates could escalate. Minority families and first-time homebuyers may be underserved or even shut out of the housing market entirely. It is possible that FHA will have a pool of loans too small to effectively manage risk. Ultimately, FHA could be removed as a helping hand to those who need it the most. The ripple effect of negative consequences could easily extend to the homebuilding industry and to the general economy as well.

On the other hand, Congress has the opportunity to revitalize the FHA program with this legislation. Borrowers will receive better loan programs at lower interest rates. We strongly urge this committee to support H.R. 1852.

**Conclusion**

CAMB appreciates the opportunity to offer our views on the FHA program and the legislation before us, H.R. 1852. I am happy to answer any questions.