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Comments of the Center for Responsible Lending

on
Federal Housing Administration Risk Management Initiatives: Reduction of Seller Concessions and New Loan-to-Value and Credit Score Requirements

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We appreciate the opportunity to comment on these proposed changes to FHA policy "designed to preserve both the historical role of the Federal Housing Administration (FHA) in providing a home financing vehicle during periods of economic volatility and HUD's social mission of helping underserved borrowers."[1]

The Center for Responsible Lending (CRL) is a nonprofit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help, a nonprofit community development financial institution that consists of a credit union and a non-profit loan fund. For close to thirty years, Self-Help has focused on creating ownership opportunities for low-wealth families, primarily through financing home loans to low-income and minority families who otherwise might not have been able to get affordable mortgages. In total, Self-Help has provided over $5.65 billion of financing to 64,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across America.

As stated in the proposal, one of FHA's many important roles is to serve as a shelter in the storm – to offer a path to homeownership at times when the private market is unwilling or unable to provide affordable credit.[2] Historically, the housing sector has led

[1] Department of Housing and Rural Development, Docket No. FR–5404–N–01, Federal Housing Administration "Risk Management Initiatives: Reduction of Seller Concessions and New Loan-to-Value and Credit Score Requirements," 75 Fed. Reg. No. 135 (Thursday, July 15, 2010) 41217-41225 at 41217, *available at* http://edocket.access.gpo.gov/2010/pdf/2010-17326.pdf , hereinafter "FHA July 2010 Proposal"

[2] As noted in the policy proposal, mortgage lenders instituted credit overlays of 580 and 620 in 2008 and 2009, choosing not to provide access to credit for borrowers below 620. The impact of these decisions is disproportionally felt by minority and low-wealth loan applicants. *See* FHA July 2010 Proposal at 41219.

the way out of economic downturns,[3] and FHA continues to play a vital role in ensuring the health of that market. Now more than ever, access to affordable, sustainable credit is critical. We support FHA's efforts to maintain a stable portfolio and properly manage risk by implementing policies that will help replenish the MMIF capital reserve account while at the same time preserving its critical role in minority and low-wealth home ownership. African-American and Latino families have lost $350 billion as a result of the "spillover" effect from foreclosures (i.e. the loss of wealth due just to being in proximity to foreclosures).[4] While low-wealth and minority communities have suffered and continue to suffer catastrophic losses from the current foreclosure crisis, there is a historic opportunity to help these communities rise up from the wreckage and regain an opportunity to take advantage of homeownership and asset-building.

While this notice requests comments specifically about proposed changes to underwriting guidelines, we will provide additional comments below on the four critical areas identified in the FHA proposal as vital areas for replenishing the MMIF capital reserve account: increasing mortgage insurance premiums, tightening underwriting guidelines, strengthening enforcement measures to reduce claims, and enhancing loss mitigation.[5] We agree that a response balanced with prudent underwriting, accountability for shoddy origination and servicing practices, and aggressive efforts to salvage underperforming loans can successfully inoculate the FHA portfolio, ensure adequate reserves and allow continued success.

The FHA should pursue a multi-pronged effort to properly manage the risk in its portfolio and ensure that low-wealth and minority borrowers have sufficient access to credit:

- Conduct rigorous oversight and enforcement of originators.

- Improve origination standards, including guidance and safeguards for origination costs and fees (immediately institute prohibition on yield spread premiums and affirmatively limit allowable fees).

- Better enforce FHA mandatory loss mitigation rules (including making failure to follow those rules a defense against foreclosure), augment oversight and enforcement of servicers, and increase loan modifications to transition underwater and underemployed borrowers to sustainable loans while options still exist.

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[3] *See, e.g.*, "Housing Starts and Vacant Units: No 'V'-Shaped Recovery," Calculated Risk (Nov. 15, 2009), *available at* http://www.calculatedriskblog.com/2009/11/housing-starts-and-vacant-units-no-v.html; Dean Baker, testimony before the Congressional Oversight Panel, "The Failures of TARP" (Nov. 19, 2009).
[4] *See* Debbie Gruenstein Bocian, Keith Ernst and Wei Li, *Foreclosures by Race and Ethnicity:The Demographics of a Crisis*. Center for Responsible Lending, June, 2010
[5] FHA July 2010 Proposal at 41218.

(1) Increase the premium income generated while monitoring impact on access to credit.

In April of this year, FHA up-front premiums were increased by 30% from levels set in 2008 (from 1.75% to 2.25%) and annual premiums were increased by 10% (from .50% to .55%), restoring premiums to their highest level in fifteen years. H.R. 5981 (signed into law on August 11, 2010) permits further increase in annual premiums (from .55% to .85% and .90%).[6] This most recent proposed increase is projected to generate an additional $300 million dollars per month, and these successive premium increases will serve to bolster the MMIF account and should rapidly restore account reserves to more comfortable levels.[7]

However, even though the recent Congressional act allows for a 1% reduction in upfront fees to offset the increase in monthly fees, the aggregate impact of the changes in premiums and any future increases allowable under H.R. 5981 should still be carefully monitored to assess affordability of FHA products for prospective homeowners. A solid base of information should be created before considering any additional premium hikes.

(2) Reduce losses by tightening underwriting guidelines.

The current crisis has underscored the need to restore common sense underwriting standards and practices. Proper guidance and oversight of origination practices will enhance the stability of the market and promote sustainable, responsible lending. Several recent changes and proposed changes are set to have a significant impact on the stability of FHA's portfolio.

The FHA already has taken the prudent step of banning seller-funded down payment assistance programs, which had claim rates are almost three times as high as other loans.[8] The risks were a byproduct of fraudulently exaggerated values, inflated payment schedules and associated subpar origination practices. This change has helped to reduce the incentives to artificially inflate purchase prices (and corresponding origination fees) and the number of loans that carried higher risks of poor performance, recognizing the importance of protecting borrower equity and originating fair, sustainable loans.

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[6] This new law gives the FHA discretion to increase annual premiums as well as reduce upfront premiums to 1% to off-set the costs to the borrower. *See* H.R. 5981 (passed on August 4, 2010, became Public Law No: 111-229 on August 11, 2010), *available at: http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h5981enr.txt.pdf*

[7] As Commissioner Stevens stated, "With this authority, FHA is in a better position to address the increased demands of the marketplace and return the MMI fund to its congressionally mandated level without disruption to the housing market." *See* Statement by FHA Commissioner David H. Stevens on Passage of H.R.5981
(Thursday, August 5, 2010) *available at*
http://portal.hud.gov/portal/page/portal/HUD/press/speeches_remarks_statements/2010/statement-080510.

[8] U.S. Department of Housing and Urban Development, **"**FHA MMIF Programs Quarterly Report to Congress for FY 2010 Q", *available at (http://www.hud.gov/offices/hsg/comp/rpts/rtc/fhartc_q3_2010.pdf)*

Now, the FHA should immediately implement the yield-spread premium limitations and steering bans contained in the Dodd-Frank Act[9] and the just-announced Federal Reserve rules. While the rules do not go into effect market-wide until April 2011, FHA has the authority now to prohibit the types of perverse incentives that resulted in so many of the toxic loans that caused the crisis. Such a move would have an immediate impact on the ever-growing FHA portfolio and, when coupled with a hard limit on allowable origination fees, could greatly reduce the level of abusive practices and risk from the entire portfolio.

Similarly, FHA should immediately issue rules defining a "qualified mortgage" under the Dodd-Frank minimum mortgage standards. This definition should contain the same caps on originator points and fees contained in the general provisions for the entire market. Since the FHA currently has no cap on origination fees and no list of acceptable (or unacceptable) charges, the FHA arena is at great risk for predatory fee packing and other risky practices. Such an environment creates unnecessary risk for the portfolio and can cause irrevocable wealth-stripping from borrowers. Providing safeguards against abusive pricing and fees, as well as establishing clear pricing guidelines for lenders, would be an invaluable step forward in dictating the quality and soundness of FHA-insured loans. The FHA would do more to serve its mission if it established even more aggressive caps or thresholds on points and fees than those outlined in the Dodd-Frank bill.

FHA has also proposed several changes to its current underwriting standards which could significantly impact lender behavior and borrower access to sustainable home financing.

- **Tighten underwriting standards for manually underwritten loans.**
  We support prudent underwriting standards, practices and oversight. Providing a loan that a borrower has no ability to repay is a disservice to all. Manual underwriting policies, including appropriate measurements of debt-to-income ratios and reserves, are important components of a proper assessment of ability to repay. Such a change signifies a return to sound underwriting policies that will serve both the originator and the borrower. We note that this more diligent underwriting should be used to facilitate access to credit and not as a rationalization to fail to offer affordable options to low-wealth and minority borrowers.

- **Reduce allowable seller concessions from six to three percent.**
  Seller concessions have the unfortunate history of being well-intentioned but too often used in an abusive fashion, contributing to the current wave of homeowners who are underwater. We agree that reducing seller concessions will help combat appraised value inflation and reset incentives in the transactions. We support setting a more appropriate level to allow the concessions to be used as intended to make houses affordable for FHA borrowers. Nevertheless, to ensure the primary tenant of affordability is maintained, the interplay between reduced seller concessions and any future changes to down payment requirements or policies

[9] *See Title XIV,* "Dodd-Frank Wall Street Reform and Consumer Protection Act" *available at:* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf

regarding allowable closing costs should be considered. Maintaining reasonable downpayment requirements is a critical element of meaningful access to housing finance options.

Finally, while we appreciate the need to balance maintaining adequate fund reserves and portfolio performance with the broader FHA mission, we urge against drastic changes to credit score policies. When considering the most effective way to safeguard the FHA, it is critical to acknowledge that an overreliance on credit scores in the underwriting process is likely to have a disparate impact on the availability of credit to both low-wealth and minority borrowers. Recent changes to FHA underwriting policies as well as outside market forces have already made a significant change in the portfolio as a whole. "The average credit score on current [FHA] insurance endorsements is just under 700. Until the middle of FY 2008, the average tended to be in the range of 620 to 630." [10] We caution against any further expansion of heightened down payment or credit score requirements. A decision to exclude borrowers with scores below 620 would adversely impact the ability of the FHA to vigorously pursue its mission of lending to low-wealth and minority borrowers and have a devastating impact on minority access to housing, as would further increases to down payment requirements.[11]

Relying solely on credit scores as indicators of risk ignores other factors such as the quality of the lenders (lender performance, underwriting practices, pricing), the performance of the loan servicers, and other mitigating underwriting factors that could indicate that a borrower with a lower credit score might provide an opportunity for a well-performing loan. Responsible lenders in the subprime market have demonstrated the viability of a portfolio of loans made to low-wealth and minority borrowers.
It would be short-sighted to penalize potential borrowers for poor vintages of loans at a time when neighborhoods are devastated and first-time homeownership is desperately needed.

With the termination of the downpayment assistance program, heightened poor-performing lender actions and the recent increases to premiums, MMIF reserves are projected to be significantly bolstered. The full impact of these policy changes will take time to evaluate and quantify. Adequate time should be given to evaluate these significant changes before further restrictions are made on consumer access.

(3) Strengthen enforcement measures to reduce unwarranted claim payments.

[10] U.S. Department of Housing and Urban Development, "FHA MMIF Programs Quarterly Report to Congress for FY 2010 Q", *available at (http://www.hud.gov/offices/hsg/comp/rpts/rtc/fhartc_q3_2010.pdf)*

[11] Indeed, the entire credit market in the US is shifting as well. Recent FICO reports indicate that more than 25% of the US population has a credit score below 600 and that number is predicted to increase over time. This suggests that the impact of credit-score requirements on access to credit could have far-reaching implications. *See* "FICO scores drift down as economic factors weigh on consumer credit risk," *Available at:* http://www.fico.com/en/Company/News/Pages/07-13-10.aspx.

The foreclosure crisis and the resulting economic crisis were caused by reckless and predatory lending practices and toxic financial products, not by any policy goal aimed at increasing homeownership. For years, many in the mortgage industry have evaded responsibility and fended off government efforts to intervene by blaming homeowners for mortgage failures, saying that lower-income borrowers were not ready for homeownership or not able to afford it.[12] Yet empirical research shows that the elevated risk of foreclosure was an inherent feature of the defective nonprime and exotic loan products that produced this crisis. And communities of color were disproportionately targeted by non-bank subprime mortgage lenders who provided them with higher-cost, risk-layered, less sustainable loans than they qualified for.[13] Typically, these homeowners paid more for their loans than comparably qualified white homeowners, eroding the financial stability of minority families and placing entire communities at grave risk.[14] The predatory lending practices and toxic products characteristic of the past decade occurred for one reason and one reason only: for mortgage brokers, lenders and investors to make money.

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[12] It is popular, although incorrect, to blame the Community Reinvestment Act (CRA) and Fannie Mae and Freddie Mac (the GSEs) for the foreclosure crisis. For a complete discussion of why CRA and the GSEs did not cause the crisis, *see* Testimony of Eric Stein, Center for Responsible Lending, before the Senate Committee on Banking (Oct. 16, 2008), *available at* http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/senate-testimony-10-16-08-hearing-stein-final.pdf.

[13] Vertical Capital Solutions, Historical Performance of Qualified vs. Non-Qualified Mortgage Loans, February 2010 (on file with CRL) (30 percent of the borrowers in the sample, which included all types of loans and borrowers, could have received a safer loan); *see also* Rick Brooks and Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy As Housing Boomed, Industry Pushed Loans To a Broader Market*, Wall Street Journal at A1 (Dec. 3, 2007) (61 percent of subprime loans originated in 2006 "went to people with credit scores high enough to often qualify for conventional [i.e., prime] loans with far better terms.").

[14] Higher-rate conventional mortgages were disproportionately distributed to borrowers of color, including African-American, Latino, American Indians, Alaskan Natives, Native Hawaiians, Pacific Islanders, and Hispanic borrowers. *See* R.B. Avery, G.B. Canner, and R.E. Cook, Summer 2005. "New Information Reported under HMDA and Its Application in Fair Lending Enforcement," Federal Reserve Bulletin (available at http://www.federalreserve.gov/pubs/bulletin/2005/summer05_hmda.pdf); R.B. Avery, K.P. Brevoort, and G.B. Canner, September 2006. "Higher-Priced Home Lending and the 2005 HMDA Data," Federal Reserve Bulletin (available at http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf); R.B. Avery, K.P. Brevoort, and G.B. Canner, December 2007. "The 2006 HMDA Data" Federal Reserve Bulletin (available at http://www.federalreserve.gov/pubs/bulletin/2007/pdf/hmda06final.pdf); R.B. Avery, K.P. Brevoort, G.B. Canner, December 2008. "The 2007 HMDA Data", Federal Reserve Bulletin (available at http://www.federalreserve.gov/pubs/bulletin/2008/pdf/hmda07final.pdf); R.B. Avery, K.P. Brevoort, G.B. Canner, September 2009, "The 2008 HMDA Data", forthcoming in Federal Reserve Bulletin (available at http://www.federalreserve.gov/pubs/bulletin/2009/pdf/hmda08draft2.pdf);
See also Debbie Gruenstein Bocian, Keith Ernst and Wei Li, "Race, Ethnicity and Subprime Loan Pricing." Journal of Economics and Business, Vol. 60, Issues 1-2, January-February 2008, at 110-124; *see also* "Debbie Gruenstein Bocian and Richard Zhai, "Borrowers in High Minority Areas More Likely to Receive Prepayment Penalties on Subprime Loans,"January 2005, available at http://www.responsiblelending.org/mediacenter/press-releases/archives/rr004-PPP_Minority_Neighborhoods-0105.pdf

These were not “availability” products designed to help renters become homeowners: the overwhelming majority of subprime mortgages made from 1998 through 2006 went to borrowers who already owned their own homes – 60 percent were refinances, and 30 percent were for families who were moving from one home to another.[15] In fact, far from expanding homeownership to people who otherwise could not afford it, subprime lending actually resulted in a net *reduction* in homeownership.[16] Rather, these mortgages existed to make money for originators, who benefited from the repeated refinancings required by these products, and for Wall Street, which wanted ever increasing numbers of mortgages – the riskier the better – to bundle into “risk-free” securities.[17]

Conversely, FHA continued to offer sustainable, affordable mortgage products before, during, and after the foreclosure crisis. As the crisis deepened, the FHA endeavored to fill the gap with counter-cyclical lending. Unfortunately, with the increase in FHA loan activity came the unwelcome reality that some of the brokers and lenders from the subprime heyday migrated over to the FHA market, seeking a new arena to display reckless and predatory practices.[18] For the FHA to maintain a robust portfolio and continue to serve its mission, it must continue to diligently root out the poorly performing actors and inadequately underwritten loans that represent a continuation of the dangerous practices that precipitated the housing finance crisis.

We applaud FHA’s most recent efforts to increase lender accountability and enforcement measures, including increased lender liability for brokered loans and an increased minimum net worth requirement.[19] And the redoubled enforcement efforts signal a promising shift: actions taken by the Mortgagee Review Board in the past year include the suspension of six lenders, withdrawal of approval from 354 lenders, and an additional 1,500 administrative sanctions taken against lenders. [20][21] These efforts signal significant commitment on the part of FHA leadership to weed out the bad actors as well as recognition that unscrupulous lenders create a more significant risk for the MMIF fund than do minority and low wealth borrowers who have been the core consumer of FHA products for decades.

More must be done to identify fraudulent lenders earlier in the process. Case in point: according to FHA’s 2009 annual Report to Congress, one of FHA’s largest mortgage

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[15] *See* Center for Responsible Lending, “Subprime Lending: A Net Drain on Homeownership” (Mar. 27, 2007), at 3, available at http://www.responsiblelending.org/mortgage-lending/policylegislation/congress/Net-Drain-in-Home-Ownership.pdf

[16] *Id.*

[17] For a much longer discussion of the roots of today’s crisis, see Testimony of Eric Stein, Center for Responsible Lending, before the Senate Committee on Banking (Oct. 16, 2008), *available at* http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/senate-testimony-10-16-08-hearing-stein-final.pdf

[18] *See, e.g.*, Chad Terhune and Robert Berner, “FHA-Backed Loans: The New Subprime” (November 19, 2008) *Available at* http://www.businessweek.com/magazine/content/08_48/b4110036448352.htm

[19] HUD Mortgagee Letter, 2010-20, June 11, 2010

[20] *See* http://portal.hud.gov/portal/page/portal/HUD/press/testimonies/2010/2010-05-13

[21] *See* http://portal.hud.gov/portal/page/portal/HUD/press/press_releases_media_advisories/2010/HUDNo.10-162

lenders and servicers, originating approximately 7.5% of FHA's endorsements in FY 2008 and the first ten months of 2009, was seized in August of 2009 by the Federal Bureau of Investigation and other federal and state regulators. Over 28% of this lenders portfolio was found to be in default and 28 types of loan origination deficiencies were found by FHA's Quality Assurance Division. Identifying fraudulent originators who fail to abide by FHA policies and procedures should do more to help bolster the MMIF fund than any incremental change to FICO or downpayment requirements. [22]

(4) Improve avoidance of claim costs through enhanced loss mitigation.

CRL estimates that by 2012, the foreclosure crisis will strip homeowners of $1.9 trillion as nearby foreclosures drain value from neighboring homes.[23] As a result of the depression of home values, nearly one in four borrowers are "underwater," owing more than their home is worth.[24] It is now clear that current prevention efforts alone will allow the current crisis to continue and fester, even under a best-case scenario.

Some new approaches along with changes in the way the FHA loss mitigation program is implemented could significantly strengthen foreclosure prevention and reduce associated losses. While every solution does not have to fit all borrowers, an effective response must include the following: (1) consideration of monthly affordability of the loan payments and long-term sustainability of the loan modification, including any changes in interest rate as well as the homeowner's equity position; (2) appropriately aligned incentives for servicers, loan owners, and all other actors in the system; (3) adequate oversight and safeguards to ensure fairness and accountability, including ensuring that the borrower has a clear understanding of the rationale underlying any decision; and (4) the cultivation of trust among lenders, servicers, and borrowers.

The existence of the FHA mandatory loss mitigation program is a model for the entire mortgage market. Broader Federal loan modification programs and incentives have been hampered by their voluntary nature and corresponding lack of accountability for servicers. However, to live up to its promise, the FHA loss mitigation program requires increasing oversight and enforcement. Ideally, any agency enforcement efforts would be supplemented by giving homeowners the ability to stop any foreclosure action where the loss mitigation guidelines were not followed.

In addition to enhancing loss mitigation procedures, change also needs to occur prior to homeowner default. Proper servicing of loans is a cost-effective way to keep loans from progressing to the stage where loss mitigation is necessary. The FHA portfolio can and will be stronger if increased scrutiny is placed upon servicer performance, servicer practices and FHA servicer guidelines. Good servicing can mitigate against some of the

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[22] *See* http://www.hud.gov/offices/hsg/fhafy09annualmanagementreport.pdf
[23] Center for Responsible Lending, Soaring Spillover: Accelerating Foreclosures to Cost Neighbors $502 Billion in 2009 Alone; 69.5 Million Homes Lose $7,200 on Average (2009).
[24] First American Core Logic Negative Equity Report Q12010, *available at* http://www.loanperformance.com/infocenter/library/Q1_2010_Negative_Equity_Final.pdf

causes of poor loan performance. FHA should put new guidelines in place that push servicers to avoid practices that cause or compound bad results. If the servicing and loss mitigation programs can identify loans with higher levels of risk for default, then solutions can be forged *while options still exist and before significant levels of default occur.*

Similarly, the new FHA short refinancing program should be very carefully monitored to ensure that it's working. Making data about the program public as early as possible will ensure that many different viewpoints can be brought to bear to solve any problems or to expand the program if it proves successful.

Conclusion

One result of the recent rapid expansion of the FHA market is a decline in performance from the most recent vintages of loans. FHA has responded with policy changes designed to replenish the MMIF capital reserve account including increasing mortgage insurance premiums, tightening underwriting guidelines, strengthening enforcement measures to reduce claims, and enhancing loss mitigation.[25]

Increased mortgage insurance premiums coupled with the elimination of the seller-funded downpayment assistance programs and other improvements to underwriting are expected to significantly bolster the MMIF fund. Also, recent enforcement actions suggest that much of the increased risk can be traced to specific actors and practices.[26] Additional sustainable income streams will be generated as lenders follow appropriate underwriting practices and more sustainable loans enter the pipeline.

However, if the FICO-based changes to applicant eligibility and minimum downpayments were expanded to apply to a broader class of consumers it would be devastating to communities of color, and have a perverse impact on the market as a whole. Borrower FICO scores alone do not tell the story.

Adherence to sound underwriting principles and continued vigorous FHA oversight will transition the FHA portfolio to one with sustainable, productive loans and reduce the number of loans made by lenders who failed to follow sound underwriting and responsible lending practices. This combination of efforts should be given a chance to produce results.

[25] FHA July 2010 Proposal at 41218.
[26] S*ee, e.g.*, http://portal.hud.gov/portal/page/portal/HUD/press/press_releases_media_advisories/2010/HUDNo.10-162