

The Subprime Mortgage Meltdown: New Role for the FHA

By Raymond Natter¹

The United States faces one of the most severe financial challenges since the Great Depression. As a result of a spectacular bubble in housing prices, fed by easy credit and lax underwriting standards, Americans today are facing the prospect of millions of home foreclosures. Concerned that these foreclosures could have a serious negative impact on our financial institutions and our economy in general, the Administration and both Houses of Congress have come forward with plans to enhance the ability of the Federal Housing Administration (FHA) to assist home owners by permitting many of them to refinance out of higher cost, often variable rate loans, and into FHA insured mortgages.

While the concept behind all of these plans is very similar, the details vary enough that the legislation has been stalled in Congress for many months. This situation changed dramatically when the Secretary of the Treasury and the Chairman of the Federal Reserve Board urged Congress to grant the Treasury authority to lend to and if necessary, invest in the equity securities of Fannie Mae and Freddie Mac. As a result of this unusual request, it now appears that Congress will probably enact comprehensive mortgage and housing related legislation before the August recess.

At this time, no one know which version of the FHA refinancing bill will become law, or whether some compromise between the two bills will be adopted. However, the following comparison shows the issues in which the House and Senate agree and disagree, along with the provisions the Administration suggested could be accomplished without legislation. This comparison should provide a useful guide to understanding what is before the Congress and the nature of what is likely to result later this summer.

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Comparison of FHA Refinancing Proposals of Subprime Mortgages

Subject	House Passed	Senate Passed	Administration's Proposal Expansion of FHA Secure ²
Short Title	FHA Housing Stabilization and Homeownership Retention Act of 2008	HOPE for Homeowners Act of 2008	FHA Secure
New FHA Program	FHA <u>shall</u> insure mortgages on 1-4 family residences that are made to refinance "eligible" mortgages.	FHA is <u>authorized</u> to insure loans that refinance "eligible" mortgages.	FHA Secure is discretionary.
Oversight	"Oversight Board" (OB) composed of Secretaries of HUD and Treasury and Chair of the <i>Federal Reserve</i> . OB is to establish details of the program requirements and standards.	Board of the HOPE for Homeowners Program: Secretaries of HUD and Treasury and Chairs of the <i>FDIC and the Federal Reserve</i> . Board is to establish requirements and standards and prescribe necessary regulations.	Secretary of HUD.
Insurance Fund	The bill creates a Special Risk Insurance Fund.	The bill establishes the HOPE Fund.	No new insurance fund.
New Disclosures Required 3 Days Before Closing	Three days <i>before</i> closing on the refinancing loan, the lender must provide detailed disclosures to the borrower, e.g., total amount of loan, LTV, maturity date, amount of the exit premium, borrower's income.	New disclosures required at least 7 days before closing. If disclosures have to be modified, corrected information must be provided at least 3 days before closing.	No new disclosures.

² As described by the Department of HUD.

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Reduction in Principal and Other Terms	<p>The new loan must “substantially reduce” the amount of indebtedness owed on existing mortgages; and</p> <p>Must meaningfully reduce the amount of the debt service, through reduction of principal, APR, or changes in the term of the loan (or any combination).</p> <p>The new loan to value ratio (LTV) may not exceed 90% of the appraised value of the property. The 90% limit must also include: (i) the initial 3% FHA premium; and (ii) closing costs up to 2% of the amount of the loan.</p>	<p>The principal obligation cannot exceed the reasonable ability of the borrower to repay under standards developed by the Board; and</p> <p>In no case may the refinanced loan have an LTV that exceeds 90% of the appraised value of the property (<i>after including the initial FHA premium as part of the debt but not closing costs</i>).</p>	<p>Write down of current loan to 97% of current appraised value for borrowers with no more than 2 delinquencies in the past year.</p> <p>Write down of current loan to 90% of appraised value for borrower with 3 delinquencies in the past year.</p>
Existing Loan	Adjustable or Fixed	Adjustable or Fixed	Adjustable Rate Loan Only
FHA premiums and other fees in connection with New Loan	All initial fees, appraisal fees, inspections, and closing costs up to 2% of loan, and an initial 3% FHA premium are paid through the proceeds of the refinanced loan. Annual FHA premium thereafter is 1.5% of remaining insured balance. HUD is to establish reasonable limitations on origination fees, and ensure that the APR will be commensurate with market rates.	The initial 3% FHA premium is paid from the proceeds of the loan. Annual FHA premium thereafter is 1.5% of remaining insured balance. The Board is to establish reasonable limitations on origination fees, and ensure that the APR will be commensurate with market rates.	Borrowers will have to pay upfront and annual premiums. FHA will be updating its pricing policies for these premiums. New premiums will be determined upon the individual borrower's credit risk profile.
Loan Amount	The refinanced loan may be up to \$729,000 for the life of the program.	The refinanced loan may be up to \$550,440.	Loan limit is \$729,000 until December 31, 2008, unless further extended by law.
Documentation	The lender must document and verify income through income tax returns for prior two tax years and other methods as prescribed by the OB.	Same.	Documentation required under current FHA standards.

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Fixed Rate, 30 Year Term	The new loan must have a fixed APR.	New loan must have a fixed APR and a maturity of <u>at least</u> 30 years from start of loan amortization.	Other options are available.
Underwriting Criteria	<p>The OB to establish flexible underwriting criteria designed to ensure that the borrower would have a “reasonable expectation” of paying the loan. Criteria may not result in denying insurance to a borrower <i>solely</i> on the basis of: (i) current FICO scores; (ii) delinquency or default under the prior loan; or (iii) bankruptcy filing. Criteria must permit a total debt to income (DTI) ratio of 43%. The OB may permit a DTI ratio of 50% if the borrower can make payments on existing mortgage in the amount that would be due under the new FHA insured loan, for a six month period. The existing mortgage holder is directed to exercise forbearance during this “trial” period. In addition, the OB may alter the DTI ratio for a class of borrowers, as the Board considers appropriate.</p> <p>If borrower is in bankruptcy, DTI includes the amount of monthly payments due under a confirmed bankruptcy plan, but is not recurring debts that have been discharged.</p>	The Board is authorized to establish underwriting standards.	<p>Lenders will be required to use underwriting standards that ensure borrowers have the capacity to repay their mortgages. Borrowers must have a “reasonable credit history; employment history; and fully document and verify their incomes.”</p> <p>Under this program, DTI ratio limit is 43%, but could be higher with compensating factors.</p>
Lack of Capacity to Pay	As of March 1, 2008, the borrower must have had a total mortgage DTI ratio of more than 35%.	As of March 31, 2008, the borrower must have had a total mortgage DTI ratio of more than 31%, or higher ratio as the Board may require.	Only borrowers who are delinquent on subprime ARM loans. Borrowers with more than 3 delinquencies may not participate.

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Intentional Default	The borrower must certify that he or she did not intentionally default.	The borrower must certify that he or she did not intentionally default on the mortgage, or any other debt. Certification must also contain a statement that a false statement may result in a fine or imprisonment, or both.	No similar provision.
Owner-Occupied	The home must be owner-occupied and must be the principal residence of the borrower. Borrower may not have an ownership interest in another residence, unless OB creates an exception for a "partial ownership" interest.	The borrower must provide documentation to the FHA to prove that the loan is primary residence, occupied by the borrower, and is the only residence in which the borrower has any present ownership interest.	Owner-occupied principal residence.
Fraud Conviction	The borrower must not have had a conviction for mortgage fraud in the prior 7 years. Borrower must certify that he or she did not provide materially false information in obtaining the loan.	The borrower must not have a conviction for fraud under any Federal or State law. No time restricted.	No similar provision.
No Fraud in Obtaining Existing Loan	Borrower must certify that he or she did not knowingly, or willfully and with actual knowledge, furnish material information that was false in obtaining existing loan.	No similar provision.	No similar provision.
Fraud in Obtaining FHA Loan	Borrower must certify that he or she will repay the FHA loan for any benefit received if he or she made misrepresentations.	Same.	No similar provision.
Origination Date of Existing Loan	Existing mortgage originated prior to January 1, 2008.	Existing mortgage originated before January 2, 2008.	Existing mortgage originated before December 31, 2008.
FHA Premiums	Initial premium of up to 3%. Annual premium of up to 1.5% of remaining insured balance.	Same.	Initial premium of 2.5%. Annual premium of .55%.

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Prepayment Penalties	Mortgage creditors must agree to waive all prepayment penalties and default/delinquency fees.	Same.	No similar requirement.
Loan Proceeds as Payment in Full	Existing mortgage holders must agree to accept the proceeds of the new loan as payment in full.	Same.	Existing mortgage holders can recapture write down through subordinate loans.
Treatment of Second Lien Holders	OB is to facilitate agreement among lien holders. The OB is to establish either a formula for a fixed payment to second lien holders or a formula to provide second lien holders a portion of net equity realized when the house is sold or refinanced. In no case can the formula provide a second lien holder more than 1 percent of the current appraised value if the value of the property is less than the amount of the first mortgage. The program is voluntary.	The Secretary of HUD may take actions to facilitate agreement among mortgage holders, subject to standards established by the Board to allow junior lien holders to share in future appreciation. This is a voluntary program.	Existing mortgage holders can recapture write down through subordinate loans.
Source of Funds to Pay Second Lien Holder	Any amount paid to the second lien holder in connection with this program must come from the holder of the existing mortgage or from participation in the realization of net equity	No similar provision.	No similar provision.

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	upon sale or refinancing of the insured loan.		
Imposition of an Exit Fee	<p>Proceeds from the sale, refinancing or other disposition of the property remaining after satisfaction of the FHA insured loan (“net proceeds”) are subject to an “exit premium.” The premium will be at least 3% of the principal amount of the FHA insured loan, and could be higher, based on a formula that relates the share going to the FHA with the period in which the insured loan has been in existence. During the first year, 100%. During the second year, 80%. During the third year, 60%. After the third year and thereafter, 50%.</p> <p>The exit fees are to be reduced by the amount of insurance fees paid prior to the sale, refinancing or other disposition.</p>	<p>Any “equity” created from the sale, disposition or refinancing of the property is subject to sharing with the FHA.³ This “equity” is divided between the FHA and the borrower pursuant to a schedule: During the first year, 100% to the FHA. During the second year, 90%. During the third year, 80%. During the fourth year, 70%. During the fifth year, 60%. After 5 years, 50%.</p> <p>In addition, upon the sale or disposition of the property, the FHA and borrower are each entitled to “50 percent of any appreciation in value of the appraised value of such property that has occurred since the date that such mortgage was insured.”⁴</p>	None.
Prohibition on New Second Loans	During the first 5 years after the refinancing, the OB shall prohibit second liens, except if necessary to ensure appropriate maintenance.	During the first 5 years, the borrower may not obtain a new second mortgage. <u>No exceptions authorized.</u>	Second mortgages are permitted.
Appraiser Independence	Appraisers must meet the competency requirements of the Uniform Standards of Professional Appraisal Practice, and the appraisal must be conducted in accordance with the appraisal requirements for federally related mortgage transactions. No lender or other interested party may improperly influence the appraisal. Exception permits	Same, except does not include provisions specifically allowing the lender to provide additional data, ask for better explanation, or correct errors. In addition, the appraiser must be licensed or certified under State law or nationally recognized professional appraisal organization, and have demonstrated verifiable education in the	No similar provision.

³ It is not clear how to compute “equity.”

⁴ This may be a drafting error.

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	lender to ask appraiser to consider additional data, provide further details or explanations, and correct errors.	appraisal requirements established by the FHA. Parties interested in the loan may not improperly influence the appraisal.	
Standards to Protect Against Adverse Selection	The Oversight Board shall establish standards and policies to require the underwriter to provide reps and warranties on compliance with all underwriting and appraisal standards.	Same, and in addition, the FHA may not pay insurance benefits to a lender who violates reps and warranties, or in any case in which the borrower fails to make the first payment on the mortgage. The Board may establish other standards to protect against adverse selection, and may require "higher risk" borrowers to demonstrate payment performance for a reasonable time prior to being insured.	FHA may require similar reps and warranties.
Auction and Bulk Refi Mechanism	The Fed, in consultation with the OB, to study the need for, and efficiency of, an auction or bulk refinancing mechanism. Report is due 60 days after the enactment.	The Board shall study the need and efficacy of an auction or bulk refinancing mechanism. A report is due within 60 days.	No similar provision.
Aggregate Cap	Insurance for up to \$300 billion of new refi loans.	Same.	Program assumes using existing \$185 billion insurance authority.
Experts and Consultants	FHA may contract with private parties to develop underwriting criteria, pricing standards, quality review and other duties.	Same, and also provides that the Board may contract for services of experts and consultants as the Board considers appropriate.	Government agencies generally have authority to contract for experts and consultants.
Monitoring and Reports	HUD will monitor independent quality reviews to determine compliance with all requirements and status of insured loans, including rates of delinquencies. Various reports must be made to Congress.	Independent quality reviews not mandated, but the Board is required to make monthly reports on status of the program.	FHA provides annual credit report to Congress. HUD I.G. conducts annual audit.
I.G.	The I.G. must conduct an annual audit and report.	No similar provision.	
GNMA	The Secretary to ensure that GNMA will guarantee securities backed by insured refinanced mortgages.	Same.	

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Sunset	This authority terminates 2 years after enactment, except Secretary may authorize up to 4 six-month extensions.	FHA may not insure mortgages under this program before October 1, 2008 or after September 30, 2011.	
Duty of Servicers	Absent contractual provisions to the contrary, a servicer owes a duty to maximize return to the securitization vehicle for the benefit of all investors and not to any individual party or group. A servicer shall be deemed to be acting in the best interests of the securitization vehicle and in the best interests of investors if the servicer modifies the loan, enters into a workout plan, or engages in other types of loss mitigation efforts, such as a short sale. Absent contractual provisions to the contrary, a servicer is not liable to any party for entering into a qualified loan workout plan.	Similar, but: (i) Adds this to the Truth-in-Lending Act; (ii) provides that the servicer owes a duty to investors, not to the securitization vehicle; (iii) does not override provisions of an "investment" contract; (iv) limits safe harbor to modifications involving owner occupied properties; (v) limits safe harbor to modifications in which the anticipated recovery under the modification exceeds, on a net present value basis, the anticipated recovery through foreclosure; and (vi) <i>does not provide any specific immunity from liability.</i>	
Funding	Appropriations.	Establishes HOPE Bonds and HOPE Trust Fund. The Treasury is to issue bonds (HOPE bonds) to provide necessary subsidy to the FHA for loans guaranteed under the program and other costs to the Government. The GSEs are to pay for the costs of borrowing by diverting contributions from the Affordable Housing Fund to a Housing Trust Fund, on a declining basis. Amounts collected in excess of the funds needed for the HOPE program will be used to reduce the national debt.	

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Authorizations	Appropriations authorized of \$230 million for counseling services and \$150 million for contracting and additional FHA personnel. Of the \$230 million, at least \$34.5 million is for counseling organizations providing loss mitigation information in low- and moderate-income neighborhoods; \$35 million for the Neighborhood Reinvestment Corporation to make grants to counseling organizations; at least \$21 million to hire lawyers to assist homeowners; and at least \$20 million to assist veterans returning from active duty. At least \$4.6 million must be used to identify and notify homeowners who are eligible to participate in the program.	Appropriates \$180 million for counseling and related services.	
Grants Authorized	Authorizes \$45 million per year for three years to provide grants to States and non-profit organizations providing homeownership and rental counseling.	Appropriates \$3.92 billion to assist States and local governments in the redevelopment of abandoned and foreclosed upon homes.	
FBI Authorization	Appropriations of \$31.25 million are authorized per year for three years to hire additional FBI agents and prosecutors for mortgage fraud, and \$.75 million for an interagency task force.	No similar provision.	

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Office of Housing Counseling, Public Outreach	An Office of Housing Counseling is established in the Department of HUD. The Office is to conduct research, grant administration, public outreach, and policy development related to housing counseling. An advisory committee is also established to assist the Department. The Office will establish materials, certify software, and conduct nationwide media campaigns. Appropriations are authorized of \$3 million per year for three years.	No similar provision, but bill requires the Secretary of HUD to conduct a public outreach to ensure homeowners and lenders are aware of the FHA refi program. As noted, appropriates funds for homeownership counseling services.	
Fair Value Accounting	The SEC, in consultation with the Fed, to conduct a study of fair value accounting applicable to financial institutions. A report is required 90 days after enactment.	No similar provision.	
Study of Root Causes of Defaults	The Secretary of HUD to study the root causes of default and foreclosure using as much empirical data as possible. The study will look at the role of escrow accounts to avoid foreclosures.	No similar provision.	
GAO Study	The GAO to study the effects of a tightening credit market on first time homebuyers. The study is to include an analysis of financial literacy outreach efforts.	No similar provision.	
HUD Certified Counselors	An organization may not receive assistance for counseling unless it is HUD certified or uses HUD certified counselors.	No similar provision.	
Mortgage Booklet	The Secretary of HUD is to prepare a real estate settlement booklet at least once every 5 years.	No similar provision.	

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