TESTIMONY

H.R. 3755
The Zero Downpayment Act of 2004

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It is an honor to appear today before this Subcommittee to discuss H.R. 3755, the Zero Downpayment Act of 2004. I am managing partner of Federal Financial Analytics, a consulting firm that advises on U.S. legislative, regulatory and policy issues affecting financial institution strategic planning. In this capacity, we advise a variety of companies on the implications of legislation and regulation in the mortgage and housing markets. Clients in this practice include trade associations, mortgage insurers, and mortgage lenders.

There are a few key points I would like to make regarding the real benefits and risks associated with a new FHA zero downpayment mortgage program:

- I strongly support the Administration's goal of increased homeownership, with a focus especially on low-income and minority individuals. Because of the vital role of homeownership in personal and community well-being, it is critical that new programs focus not only on giving borrowers a mortgage in the short term but also on helping them keep their homes for the long term, especially during periods of economic stress.
- Zero downpayment loans are viewed by the private sector as higher risk, resulting in reliance on careful underwriting. Thus, FHA entry into zero downpayment loans must be carefully structured to prevent risk to borrowers, communities, and the rest of the FHA Mutual Mortgage Insurance (MMI) Fund. The MMI Fund has proven itself as a vital spur to homeownership in key underserved markets, and it is thus critical that a new program not endanger it.

- To protect borrowers, communities and the MMI Fund, HUD should consider limits beyond those currently proposed for zero downpayment loans. These could include targeting the program to low- and moderate-income borrowers, reliance only on proven FHA lenders, and increased sampling.

<u>Key Factors in the Zero Downpayment Loan Program</u>

First, the borrower's initial downpayment is a major factor in limiting first-time homeownership for low- and moderate- income buyers. Thus, the Administration's proposal strikes at the heart of a key issue that limits homeownership and, of course, community development. However, initial downpayment is also a proven major risk factor for mortgage insurers, lenders and investors, especially during periods of economic stress. For the past five to six years, lenders working with private mortgage insurance companies, community groups and government-sponsored enterprises have tailored zero downpayment programs to balance the risks and the rewards to homeowners. To the extent the FHA successfully insures zero downpayment mortgages while minimizing the potential risk to the borrower, the FHA MMI Fund and inner city neighborhoods, it will clearly help more low- and moderate- income borrowers first to become and then to remain homeowners.

Second, as private mortgage participants have learned, careful underwriting by all the parties at risk -- lenders, insurers, investors and community groups -- is necessary to ensure that only the right borrower takes on a zero downpayment mortgage. Failure to tailor underwriting criteria to the unique nature of the zero downpayment mortgage could well harm borrowers, communities and the FHA Fund.

Borrowers using zero downpayment mortgages have the most to lose if home prices stop increasing in their neighborhood. Once closing costs, fees and the FHA's own up-front financable insurance premium are added to the loan amount, the borrower starts homeownership owing 103%, 105% or even more of the property's initial value. In a geographic area with very low – or no –home price appreciation, a borrower owing significantly more than the property's initial value has to wait a long time before assurance that, if the home is sold, they will be able fully to pay off the remaining mortgage using only the proceeds of the sale of the house after paying real estate fees. If home prices fall in the neighborhood, then the borrower will be underwater in the mortgage for at least several years. In my opinion, the FHA must make every effort to avoid placing first-time homebuyers – especially low- and moderate-income ones -- in a position where their hopes of moving to accept a new job or live close to family are dashed solely because of a zero downpayment mortgage taken out years before. Careful underwriting is critical along with providing the borrower with an explanation of the risks inherent in the zero downpayment mortgage.

Third, the FHA MMI Fund is a vital part of the nation's housing system. The FHA zero downpayment program is projected to generate revenues of $184 million in its first year. However, I do not believe this budgetary calculation robustly reflects the true risks of a zero downpayment program during periods of stagnant or falling regional home prices. Any new FHA program should be tested to ensure that poor loan performance resulting from the program will not put the MMI Fund in jeopardy, assuming reasonable economic scenarios. This is particularly true for a zero downpayment program, where not only the cumulative claim rate,[1] but also the loss severity rate on foreclosed properties[2] likely will be higher during periods of stress than rates experienced to date in other FHA programs. Certainly, higher claim rates and loss rates are the experience of the private mortgage insurance and mortgage investing community when dealing with very low downpayment mortgages.[3] The same appears to be true for FHA.

The latest Deloitte Touche Actuarial Review of the FHA MMI Fund shows that FHA 30-year fixed rate loans with initial loan to value ratios (LTVs) above 96% experience significantly higher cumulative claim rates than similar loans with lower initial LTVs.[4] I believe that FHA loans with initial LTVs of 103% or more will follow the higher claim path found by Deloitte Touche for high LTV loans. Because of the negative borrower equity in a zero downpayment mortgage, the loss severity associated with any of these loans that go to foreclosure will be higher than that for other FHA loans, holding other factors constant.

In my view, it is critical to the health of the FHA Fund that the zero downpayment program be designed to bring new borrowers into the FHA rather than serve as a means

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[1] Cumulative claim rate is the percentage of a book of loans originated in a given year that go to claim over the life of that book.

[2] The Deloitte Touche report defines claim severity or loss severity as "the ratio of the profit/(loss) on a property to the amount of principal unpaid on the loan. The profit/(loss) on a claim is defined as the acquisition cost plus selling expense less selling price… The acquisition cost is composed of the unpaid loan balance, interest lost by the lender as a result of default and legal/administrative costs associated with foreclosure. Holding costs are the net costs to FHA for repairing, maintaining, paying taxes, and collecting rents (if possible) on the property while it is held in inventory." Actuarial Review of MMI Fund as of FY 2003, page C-1.

[3] See Fannie Mae 2003 10-K, March 15, 2004, p.98: "The likelihood of default and the gross severity of a loss in the event of default are typically lower as the LTV decreases, all other factors held equal."
See also Calem and Follain, Federal Reserve Board Staff Paper, *The Asset Correlation Parameter in Basel II for Mortgages on Single Family Residences*, p.23 for results of joint FRB and MICA study of default and loss rates on 90% and 95% LTV mortgages.

for those borrowers who have the wherewithal to make a 3% downpayment simply to avoid doing so. Some lenders and real estate brokers may look to the zero downpayment program as a way to move an FHA borrower into a larger mortgage rather than bringing low- and moderate-income potential borrowers who otherwise would not qualify for an FHA-insured loan into a starter home. The Deloitte Touche report shows that, for 30-year fixed rate single-family mortgages insured by FHA in 2003, loans with initial LTVs of 97% or higher comprised 43% of these loans on a loan count basis and 78% of these loans on a dollar amount basis.[5] Clearly, FHA is already exposed to the risk associated with very high LTV loans. The addition of a zero downpayment program will increase this exposure. Thus, an FHA fund with a relatively large share of zero downpayment borrowers would significantly increase the MMI Fund's risk exposure during periods of regional house price declines or economic contraction.

Finally, neighborhoods are also at risk from a poorly planned zero downpayment program. One of the major concerns with FHA for community groups has been the concentration of foreclosed FHA properties in inner city areas resulting from fraud, predatory lending or other problems associated with giving low-and moderate-income borrowers mortgages they could not afford for homes with over-appraised values. The zero downpayment program augments the risks associated with a bad appraisal. Correct property appraisals are critical in accurate mortgage underwriting. Since the zero downpayment borrower starts homeownership owing more on a mortgage than the house is worth, an inflated appraisal puts that borrower further behind the goal of building

[4] Actuarial Review of MMI Fund as of FY 2003, page IV-4. Table IV-3 shows cumulative claim rate for "high LTV" loans—loans with initial LTVs greater than 96% -- originated in 2000 are projected to be 7.94% versus 5.34% for loans with "medium" LTVs and 2.55% for those with "low" initial LTVs.

[5] Actuarial Review of MMI Fund as of FY 2003 Table III-2B, page III-4 and Table III-7, page III-9.

equity. The combination of a bad appraisal, economic problems for the zero-downpayment borrower and stagnant home values can result in a high level of foreclosures in those inner city and moderate income areas where these FHA mortgages will be concentrated. The result of concentrated foreclosures is further downward pressure on home prices that escalate the downward spiral for that neighborhood.

Recommended Improvements

The above noted points are what I see to be the risks associated with a poorly planned FHA zero downpayment program. However, a properly structured program will, in my opinion, advance the administration's goal of increased homeownership in vulnerable communities, helping low- and moderate-income borrowers – especially minorities and immigrants – to invest in their neighborhoods and help them flourish.

So far, the details of the zero downpayment program proposed by HUD in my opinion do not offer all of the necessary protection to the borrower, the neighborhoods the new program will affect or the FHA MMI Fund. To assure the success of a zero downpayment program, I urge that HUD consider applying the following criteria:

1. To better target the beneficiaries of the zero downpayment program to low- and moderate- income borrowers, HUD should consider targeting the program to borrowers with incomes below area median income, focusing on borrowers seeking properties in low and moderate-income census tracts and/or setting the area maximum loan amounts for this program below the current applicable FHA limits.

2. It will not serve the goal of expanded homeownership if borrowers using the new program are those who have the wherewithal to make a 3% downpayment but choose the zero downpayment program either to buy a larger home or go still more deeply into debt. To prevent inappropriate use of this new program, the FHA lender should be required to attest that the borrower did not have sufficient cash to qualify for another FHA loan.
3. During the early years of the program, HUD should limit it to those lenders proven to be careful underwriters of FHA loans. These lenders are most likely to carefully review the quality of the appraisal being given for the property. They can also objectively assess the impact of seller contributions, which sometimes result in particularly over-inflated appraisals. Without such lender care, vulnerable borrowers are at particular risk.
4. Finally, it is critical that the program be carefully managed. As part of its quality control process, FHA currently reviews 10% of the post endorsement loans in its single-family program. Given the significantly higher risk associated with zero downpayment loans, the sampling of FHA loans within this program should be higher. This higher rate of sampling would be appropriate for at least the first several years.