



Prepared Testimony

of

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on

**“The Future of the Federal Housing Administration’s Capital Reserves:
Assumptions, Predictions and Implications for Homebuyers”**

Before the

**Committee on Financial Services,
Subcommittee on Housing & Community Opportunity**

United States House of Representatives

October 8, 2009

Good afternoon Chairwoman Waters, Ranking Member Capito, and members of the Committee. I am John Councilman, chairman of the Federal Housing Administration (“FHA”) Committee of the National Association of Mortgage Brokers (“NAMB”). I am a Certified Mortgage Consultant (“CMC”) and Certified Residential Mortgage Specialist (“CRMS”), with over 26 years of experience as a mortgage professional in the state of Maryland. Thank you for inviting me to testify today on “The Future of the Federal Housing Administration’s Capital Reserves: Assumptions, Predictions and Implications for Homebuyers.”

I. Introduction

NAMB is the only national trade association representing the mortgage broker industry. NAMB advocates on behalf of more than 70,000 mortgage professionals nationwide. NAMB also represents the interests of homebuyers, and advocates for public policies that serve mortgage consumers by promoting competition, facilitating homeownership and ensuring quality service.

NAMB is committed to enhancing consumer protection and promoting the highest degree of professionalism and ethical standards for its members. NAMB requires its members to adhere to a professional code of ethics and best lending practices that fosters integrity, professionalism and confidentiality when working with consumers. NAMB provides its members with access to professional education opportunities and offers rigorous certification programs, including the CMC and CRMS, to recognize members with the highest levels of professional knowledge and education. NAMB also serves the public directly by sponsoring consumer education programs for current and aspiring homebuyers seeking mortgage loans.

NAMB members are typically small business owners, employing between three and fifty employees. They serve both urban and rural communities of every size, and operate in all 50 states and the District of Columbia. NAMB members work with consumers as they make their way through the complex mortgage origination process, and add value to that process for both consumers and lenders by serving many areas that are typically underserved by banks and other financial institutions. Because many NAMB members establish and operate their businesses exclusively within the communities they serve, these individuals also add value to the origination process by providing goods, facilities, and services with quantifiable value, including a loyal customer base and goodwill.

NAMB members, together with the rest of the mortgage broker industry, bring greater competition to the market for origination services and typically provide consumers with a local alternative to using a large national bank or lender.

II. The Role of Mortgage Brokers

A mortgage broker is a real estate financing professional or entity that works with borrowers and lenders, while representing neither, to obtain a mortgage loan. A mortgage broker's value lays in the broker's ability to provide goods, services, and facilities with quantifiable value, including a customer base and goodwill.

Because a mortgage broker works with consumers throughout the entire mortgage origination process, a broker's role may include: taking an application; performing a financial and credit evaluation; producing documents; working with Realtors; ordering title searches, appraisals, and pay-off letters; assisting in remedying faulty credit reports or title problems; and facilitating loan closings. The assistance a mortgage broker provides often varies widely, depending on the nature of the transaction, the requirements of the customer, lender, or loan purchaser, and other factors.

A mortgage broker may have a working relationship with one or more banks or other lenders and may provide the consumer with access to a wide range of options for financing a home. This allows mortgage brokers to provide consumers a highly efficient and cost-effective means of obtaining a mortgage that satisfies the consumer's financial goals and circumstances.

Mortgage brokers also facilitate competition in the marketplace and help drive down origination costs for borrowers. A 2005 independent study conducted by economists at three major universities concluded that "broker-originated mortgages are less costly to the borrower than lender-originated mortgages after holding other loan terms and borrower characteristics constant."¹ Similarly, a study by Richard Todd of the Federal Reserve Bank of Minneapolis and Professor Morris Kleiner of the University of Minnesota

¹ Amany El Anshasy (George Washington University), Gregory Ellihausen (Georgetown University) & Yoshiaki Shimazaki (Oklahoma State University), *The Pricing of Subprime Mortgages by Mortgage Brokers and Lenders*, July 2005 ("Mortgage Pricing Study"), at 12.

found that “[b]rokers have helped to shorten the loan process and made it cheaper.”² This study also showed when certain state regulatory burdens were imposed on brokers, impeding brokers’ entry into mortgage markets, the number of brokers declined, and those states experienced “higher foreclosure rates, and a greater percentage of high-interest-rate mortgages.”³

III. Mortgage Broker Participation in FHA

Before we discuss the process by which mortgage brokers may become approved by FHA, it is important to identify the specific role a mortgage broker plays in originating an FHA loan.

A mortgage broker is responsible for taking a consumer’s loan application, obtaining merged credit reports and importing loan application data to the FHA system. The mortgage broker then enters his or her FHA correspondent ID and the sponsoring wholesaler FHA lender ID. The next step involves sending the borrower’s information through Freddie Mac’s Loan Prospector or Fannie Mae’s Desktop Underwriter system, both of which are programmed with FHA Total Scorecard underwriting parameters. At this point, the mortgage broker receives a full “FHA Total Scorecard Feedback Certificate.” Next, the mortgage broker processes the information he or she has collected from the borrower and sends the full file to the sponsoring FHA lender. Finally, the sponsoring lender reviews the “FHA Total Scorecard Feedback Certificate,” underwrites the loan per FHA requirements, and makes the final lending decision.

In a FHA mortgage transaction, both the lender and the mortgage broker must be approved by FHA. FHA approves mortgage originators based on the function(s) they will perform during a transaction, as well as by the type of entity or organization they are.

There are four basic types of FHA-approved originators. They are “supervised mortgagees,” who are members of the Federal Reserve and whose accounts are insured by either the Federal Deposit Insurance Corporation (FDIC), or the National Credit Union Administration (NCUA); “non-supervised mortgagees” (*i.e.*, mortgage lenders), who are not depository institutions; and “supervised and non-supervised loan correspondents.” Non-supervised loan correspondents are typically mortgage brokers, having as their principal activity the origination of FHA-insured mortgages for sale or transfer to one or more sponsoring lenders who are responsible for underwriting the mortgages.

All loan correspondents must be sponsored by a fully approved supervised or non-supervised direct endorsement (“DE”) lender, who agrees to underwrite and fund the loan originated by the FHA correspondent. The loan correspondent retains the option to either close the loan in its own name or in the name of the sponsoring DE lender. Traditionally, mortgage brokers will close the loan in the name of their underwriting sponsor. Loan correspondents never underwrite any FHA loans.

Most NAMB members participating in the FHA program are non-supervised loan correspondents. As loan correspondents, these originators are required to have at least one sponsoring DE lender who is a FHA-approved mortgagee. That sponsor must agree to underwrite and fund the loans originated by the correspondent that satisfy the requirements of FHA and the sponsor’s lending criteria. Both the loan correspondent and the sponsoring DE lender are responsible for adhering to all FHA regulations and guidelines.

² Morris Kleiner & Richard Todd, *Mortgage Broker Regulations that Matter: Analyzing Earnings, Employment, and Outcomes for Consumers*, National Bureau of Economic Research Working Paper 13684 (December 2007) (“Broker Regulations Analysis”) at 7.

³ Broker Regulations Analysis at 1.

The process through which a mortgage broker becomes a FHA-approved loan correspondent takes considerable effort. There are currently many structural requirements, investigations, net worth requirements, audited financial statements, staffing requirements and additional information required for approval. Additionally, these requirements are continuing in nature and must be recertified to FHA each year.⁴

Every FHA-approved mortgagee and loan correspondent is required to renew its approval status annually. HUD then reviews statistics and other information regarding each approved mortgagee and loan correspondent to determine if continued approval is appropriate. All mortgagees are required to submit an annual verification report, and most pay an annual renewal fee. Non-supervised mortgagees and non-supervised loan correspondents are also required to submit audited financial statements and supplementary reports each year.

IV. Preventing Fraud in the Mortgage Industry

NAMB was the first, and for many years the only industry representative in Washington, D.C. calling for heightened professional standards for all mortgage originators. Since 2002, NAMB consistently advocated for a licensing and registration regime for all mortgage originators, which would include criminal background investigations, proficiency testing, and continuing education.

NAMB's vision was realized when the S.A.F.E Mortgage Licensing Act ("SAFE Act") was signed into law in July 2008 as part of the Housing and Economic Recovery Act. The SAFE Act established a nationwide licensing and registration system for mortgage originators. Under the system, all mortgage originators, regardless of whether they are state or federally-regulated, are required to submit fingerprints to the FBI, and any other governmental agency or entity authorized to receive such information for a state and national criminal background check, and must obtain a unique identifier through the Nationwide Mortgage Licensing System and Registry administered by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators ("CSBS/AARMR"). Additionally, all state-licensed loan originators are required to meet minimum education and testing standards.

The SAFE Act represents a critical step toward achieving the higher level of uniformity and professionalism in the mortgage lending industry that NAMB has advocated for so many years. Mandating education and testing for every mortgage originator helps ensure that consumers will receive accurate and consistent product information, which will allow them to make an informed decision about different loan financing options available in the market. Additionally, mandatory continuing education and professional ethics training helps ensure that mortgage originators remain knowledgeable and competent to address consumer concerns. Finally, state and federal criminal background checks are the most effective means of preventing unqualified individuals from entering, remaining, or moving within the mortgage industry.

In addition to the tremendous effort expended in support of implementing a nationwide licensing and registration system for mortgage originators, NAMB has diligently monitored trends in the mortgage origination industry that might pose a threat to consumers, to FHA, or to the industry in general. One such threat that NAMB has been able to identify and encourage FHA to explore further involves "non-approved counselors." These counselors are essentially individuals who have found a way to operate outside of the standards set forth by FHA. Non-approved counselors originate FHA loans and receive a fee for providing this service to consumers. However, these counselors are not required to adhere to any of the FHA origination requirements and are not employees of or affiliated with any approved mortgagee, effectively circumventing the approval process that exists today. Such counselors are not required to be

⁴ Appendix A: John Councilman, *What it Takes to be FHA Approved*, Mortgage Press (November 2008).

licensed, as they are only being paid for “counseling services” and cannot take a loan application, verify data or give disclosures; yet they often collect one to two percent of the loan’s value, which often amounts to thousands of dollars. Additionally, the fees charged by these counselors are not typically paid by the FHA-approved mortgagee, but rather by the consumer from his or her own available funds. This loophole, which essentially allows unlicensed individuals with no credentials or checks to advertise that they can provide FHA loans, was identified by NAMB and brought to the immediate attention of the U.S. Department of Housing and Urban Development (“HUD”).

Finally, NAMB has adopted and continually works to strengthen a professional Code of Ethics and Best Lending Practices that all NAMB members are required to adhere to. NAMB also provides its members with state-approved education courses covering critical topics such as ethics and professionalism, as well as specialized topics including participation in FHA and other loan programs. Finally, NAMB offers professional certification opportunities for its members that require candidates to educate themselves beyond most state licensing requirements and meet rigorous testing requirements that carry a high rate of failure.

V. FHA is Not the New Subprime

With the collapse of the subprime market, many are concerned that the problems leading to that collapse will begin to creep into the FHA market and expose the FHA insurance fund to greater risk. However, NAMB strongly believes that the FHA rules and policies currently in place, together with the larger reforms across the entire mortgage industry, will be sufficient to prevent this from happening.

First, and most importantly, the SAFE Act has significantly increased professional standards and accountability for all mortgage originators. Today, as opposed to during the peak of the subprime lending boom, it is extremely difficult for bad actors to enter, remain, or move within the mortgage industry to prey on consumers. Additionally, FHA imposes its own requirements for mortgagees and loan correspondents, which further vets the individuals and entities that may be approved to participate in the program.

Finally, much like originators, borrowers using FHA must adhere to higher standards than the ones which existed in the subprime market. Some of these higher standards include income verification, mandatory downpayment requirements and strict loan-to-value ratios. Additionally, FHA does not permit many of the loan product features, such as prepayment penalties, huge payment spikes and negative amortization, which exposed borrowers and lenders to greater risk and were prevalent in so many loans made in the subprime market. FHA also requires borrowers to occupy the home they are purchasing as their primary residence, which was never a requirement in the subprime market.

There has almost certainly been some migration of mortgage originators from the subprime market over to FHA, since a significant majority of the mortgage industry was involved in some way with subprime lending. However, with the safeguards that are now in place at FHA and throughout the mortgage industry, this migration should not be viewed as a threat to the FHA program, but rather as a tremendous opportunity for growth. Now, perhaps more than ever, highly qualified and well-established mortgage originators are again looking to FHA as a means of offering an affordable loan product to their customers. This renewed interest in the FHA program, coupled with heightened standards for every mortgage originator who wishes to remain in the industry, should position FHA to recapture much of the market share that was lost to the subprime market over the past decade.

VI. FHA Policy Changes being Pursued by Mortgage Letter, Effective January 1st

FHA Commissioner David Stevens has proposed a number of sweeping policy changes to the FHA loan program. These new policies proposed by Commissioner Stevens will have a profound effect on the FHA program and will greatly impact mortgage brokers.

NAMB applauds Commissioner Stevens for his work in putting these new policies into place, and we are largely supportive of his efforts to improve the FHA loan program. However, NAMB does believe there are areas in the new system that will need to be addressed, and those areas must be worked out to ensure that the system continues to run efficiently and effectively into the future.

1. Appraiser Independence

FHA is proposing new guidelines on ordering appraisals for FHA insured mortgages that it believes will enhance appraiser independence and geographic competence. The new guidelines prohibit mortgage brokers and commission-based lender loan officers from ordering appraisals, much like the Home Valuation Code of Conduct (“HVCC”), which was implemented by Fannie Mae and Freddie Mac (together, “the GSEs”) in May 2009. FHA believes its existing policies regarding appraiser independence are consistent with the HVCC, and FHA says it will adopt language from the HVCC to ensure full alignment of FHA and GSE standards.

The HVCC is a highly controversial shift in appraisal policy that is the result of a joint agreement reached between the GSEs, the Federal Housing Finance Agency (“FHFA”), and New York Attorney General, Andrew Cuomo. The HVCC purports to enhance the independence and accuracy of the appraisal process. However, what the HVCC truly accomplishes is an increase in consumer costs, a decline in appraisal quality, the extension of closing deadlines, and the virtual extinction of independent appraisers.

Although FHA has varied the provisions of the HVCC slightly in Mortgagee Letter 2009-28, these variations are unlikely to allow FHA to escape any of the serious issues currently facing consumers and originators in the conventional mortgage market as a result of the HVCC.

NAMB believes it is important to strengthen the integrity and independence of the home appraisal process, as appraiser independence is essential to protecting consumers and the FHA insurance fund from fraud and unnecessary risk. However, NAMB does not believe the HVCC, or the new FHA appraisal guidelines, will effectively achieve these goals.

The impetus behind these new appraisal policies – the HVCC and the new FHA guidelines – is the perception that appraisers were being pressured or improperly influenced by mortgage originators. However, the HVCC is failing to provide any greater protection for appraisers. Appraisers are still subjected to significant pressure and undue influence, but instead of coming from mortgage originators it is now coming from the Appraisal Management Companies (“AMCs”) that were granted a virtual monopoly over the appraisal process by the HVCC.

In fact, a growing number of appraisers are reporting that the pressure and attempts to improperly influence their professional judgment is far worse under the AMC dominated regime prescribed by the HVCC than it ever was when appraisers were permitted to work directly with originators. Specifically, appraisers are reporting that AMCs are requiring them to prepare appraisals in violation of the Uniform Standards of Professional Appraisal Practice (“USPAP”) and generally accepted appraisal guidelines.

Today, unlike when an appraiser had multiple mortgage broker and/or loan officer clients, the HVCC has restricted their work to be on behalf of only one or possibly two AMCs. Under this construct, if an appraiser fails to comply with any AMC “request,” they will no longer receive appraisal assignments from possibly their only client. With many knowledgeable and skilled appraisers unwilling to work under

such conditions and consequently leaving the profession, the appraisers that remain willing to work for the AMCs are generally far less qualified and experienced. This has resulted in a rapid decline in appraisal quality since the implementation of the HVCC, which directly contradicts the widely purported view of HVCC proponents that turning over virtually exclusive authority for appraisal ordering to third-party AMCs would produce more accurate appraisals.

Although it can be fairly said that conducting appraisals is both a science and an art form, there is evidence showing that multiple appraisals ordered on the same property under the HVCC can vary by more than 20%. While it is unrealistic to expect multiple appraisals to come in with values that fall within a tight tolerance window, the extremely large variances we are seeing on multiple appraisals under the HVCC are cause for great concern.

Moreover, with the virtual elimination of all competition in the market for home appraisals, AMCs have reduced appraisers' fees by as much as 50%, while at the same time increasing consumer costs for appraisals by more than 50%. HUD believes it has solved this problem by making the AMCs pay rates that are "customary and reasonable" for the area where a property is located. However, with AMCs dominating the market and most AMCs underpaying appraisers for their work, it will likely prove to be extremely difficult to establish what "customary and reasonable" really means.

NAMB strongly opposes FHA's decision to follow in the footsteps of the HVCC, given its glaring weaknesses and failures in the short time since it has taken effect. Moreover, NAMB believes FHA already has a more effective mechanism in place for assuring appraiser independence, as every FHA appraisal is reviewed by the sponsoring DE lender's underwriter prior to loan approval. This system of checks has served FHA well for years and we believe would continue to do so in the absence of the proposed new appraisal guidelines. Finally, NAMB believes that adequate additional safeguards were put in place by the amendments to Regulation Z of the Truth-in-Lending Act, which took effect October 1, 2009.⁵

Prior to HUD's announcement of these proposed new appraisal guidelines, FHA was the only remaining segment of the market where independent appraisers could receive a fair wage and operate without unreasonable pressure, scrutiny or restraints. NAMB strongly encourages HUD to consider withdrawing Mortgagee Letter 2009-28 and engage representatives from both the mortgage and appraisal industries in meaningful discussions of alternative approaches prior to implementing the proposed guidelines or any other significant changes to the appraisal ordering process for FHA.

2. *Appraisal Portability*

Mortgagee Letter 2009-29 specifically addresses the issue of appraisal portability, which is another tremendous problem created by the HVCC. FHA proposes new guidelines that would allow a second appraisal to be ordered under a limited set of circumstances when a borrower switches from one lender to another and restates the requirement that the first lender must transfer the appraisal to the second lender at the request of the borrower. These new guidelines are designed to prevent delays in closing that often occur when a loan is transferred from one lender to another.

NAMB strongly supports FHA's effort to increase appraisal portability. However, we are concerned that this new FHA policy, as written, will fail to achieve its intended goal. As long as mortgage brokers are prohibited from ordering appraisals for their customers, they cannot be identified as the "client," and the appraisal will not truly be portable.

⁵ Truth in Lending, 73 Fed. Reg. 44522 (July 30, 2008) (to be codified at 12 C.F.R. 226.36(b)).

Appraisals are addressed to the “client” who orders the appraisal. USPAP prohibits the “readdressing” of appraisals. When mortgage brokers order an appraisal, the broker is the “client” and that appraisal may be freely transferred to any FHA approved sponsoring lender with whom the broker maintains a relationship. However, if lenders are required to order the appraisal and are identified as the “client,” not even HUD’s mandate that an appraisal must be transferred from one lender to another upon a borrower’s request will permit readdressing the appraisal to the second lender. Moreover, even if a transfer of the appraisal was lawful, the time that would almost certainly be lost in that process would prove to be severely damaging to the borrower.

3. Modified Procedures for Streamlined Refinance Transactions

FHA proposes modifying certain procedures for streamline refinance transactions to: establish new requirements for seasoning, payment history, income verification, and demonstration of net tangible benefit to the borrower; provide for collection of credit score information when available; and cap the maximum loan-to-value ratio at 125%. An appraisal would be required in all cases where a borrower wants to add closing costs to the transaction. These revisions will bring documentation standards for streamline refinance transactions in line with other FHA loan origination guidelines, ensure a borrower’s capacity to repay the new mortgage, and prohibit the dangerous practice of loan churning, where borrowers raise cash through successive cash-out refinancings that put them further in debt.

NAMB is concerned that many borrowers will not be able to refinance to a lower rate, which could possibly increase the default rate rather than provide an equity cushion had the borrower not refinanced.

VII. FHA Policy Changes being Pursued by Rulemaking

1. Modified Mortgagee Approval and Participation in FHA Loan Origination

Lenders seeking approval to originate, underwrite or service an FHA loan would be required meet the eligibility criteria for a supervised or non-supervised mortgagee. Approved mortgagees would be required to assume liability for all the loans they originate and/or underwrite. Loan correspondents would be eliminated, but third-party originators would continue to be permitted to originate FHA insured loans through their relationships with approved mortgagees. Third-party originators would no longer receive independent FHA approval or maintain any status with FHA.

These proposed policy changes would require FHA approved mortgagees to assume responsibility and liability for every FHA insured loan underwritten and closed by the mortgagee. HUD believes these changes align FHA with the GSEs and could potentially increase the number of third-party originators who are eligible to originate FHA insured loans. HUD also believes these changes will provide for more effective oversight of third-party originators through the supervision of FHA approved mortgagees.

NAMB has long advocated for changes to the FHA approval process that would help a greater number of third-party originators become eligible to originate FHA loans. Therefore NAMB is very supportive of Commissioner Stevens’ efforts to increase opportunities for third-party originators to participate in the FHA program. NAMB also shares Commissioner Stevens’ belief that maintaining annual audit and net worth requirements for third-party originators does not protect HUD as well as other available methods of supervision.

Nevertheless, NAMB is concerned that the total elimination of loan correspondents from the FHA program may fail to adequately represent the widely varied participants in today’s mortgage market and will almost certainly not serve the best interests of consumers.

It is a common misperception that the term loan correspondent is synonymous with mortgage broker. In reality, FHA loan correspondents take various forms, including small banks that lack the staff to perform all FHA functions, independent mortgage bankers who do not desire to service FHA loans and mortgage brokers who possess the requisite expertise but need a funding partner. This is why NAMB believes it is important for these entities that occupy the space in between FHA approved mortgagees and true third-party originators to have an opportunity to receive independent FHA approval, maintain some status with HUD and the FHA, and retain access to the FHA system.

If qualified loan correspondents are not properly accounted for under a new system for determining participation in the FHA program, borrowers choosing to work with these entities will be forced to apply blindly for FHA loans because their chosen originator will not have the necessary access to Total Scorecard or the FHA Connection. As such, it will be impossible for these originators to make any initial determination of whether the borrower is qualified, the borrower has been excluded from participating in a government loan program, or the property is unacceptable.

FHA loan correspondents have always played an important role in originating FHA loans, and we believe they can continue to play a critical role moving forward into a new era for FHA. NAMB largely supports the changes proposed by Commissioner Stevens, but believes that additional consumer protections should be put into place along with the proposed changes.

2. Increased Net Worth Requirements for Mortgagees

FHA proposes to increase the net worth requirement for approved mortgagees to meet industry standards. The current requirement is \$250,000, and has not increased since 1993. The proposed initial increase would establish a new net worth requirement of \$1,000,000. FHA believes these changes will help to ensure that their approved mortgagees are sufficiently capitalized to meet potential needs, thereby mitigating any losses that may result and decreasing risks to the FHA insurance fund.

FHA cites the recent rise in net worth requirements by Fannie Mae and Freddie Mac as reason to raise the net worth requirements for approved mortgagees. Although FHA proposes to delay instituting the net worth requirement for underwriting and servicing mortgagees for one year, it would likely still be very difficult for smaller lenders to move from a \$250,000 net worth to \$1,000,000 within the span of one year. Some have proposed an incremental increase to \$500,000 in the first year, with subsequent increases to \$1,000,000 over next several years. Another alternative would be to tier net worth requirements based on volume.

Concern over an increased net worth requirement is two-fold. First, it would tend to concentrate power and control in the hands of only the largest lenders. Under such a scenario, when a large entity fails, the resulting losses could severely destabilize the FHA insurance fund. Also, there is a real risk that providing the largest lenders with a virtual monopoly will result in higher costs and other adverse consequences for consumers. Second, net worth has been shown to evaporate in mere days, meaning the satisfaction of a net worth requirement, no matter how large, can create a false sense of security. To date, there has been no link made between loan quality or performance and net worth. Eliminating high-quality mortgagees simply on the basis of net worth could have an inverse effect and actually harm the quality of FHA loan production.

Instead of a mandate for a higher net worth requirement, NAMB suggests implementation of a recovery fund whereby every FHA approved mortgagee must contribute to such fund in order to originate, fund or service an FHA loan. Similar requirements are currently standard for any person that wants to become licensed in a state pursuant to the SAFE Act.

VIII. Additional Changes to FHA that NAMB Would Propose

1. Update the Neighborhood Watch Early Warning System

In order to monitor compliance, FHA instituted the Neighborhood Watch Early Warning System to identify mortgagees who have an unacceptable default rate. The Neighborhood Watch Early Warning System is triggered when a mortgagee's default rate exceeds mortgages originated within the preceding 24 months, exceeds 200 percent of the default and claim rate within the geographic area served by a HUD field office, and also exceeds the national default and claim rate. The name implies prompt recognition of high default rates. However, 24 months must elapse to achieve a true average. The mortgagee must be notified and has appeal rights. This process is often very slow, and the affected individuals move on to another mortgagee leaving the issue unsolved and the mortgagees unnamed. NAMB recommends that FHA update the Neighborhood Watch Early Warning System and expedite the recognition of high default rates.

2. Mortgagee Review Board

Default is only one indicator of mortgagee problems. Fraud, failure to comply with FHA guidelines and poor practices can create undetected problems as well. FHA is too often slow in identifying problems and the Mortgagee Review Board is slow to respond to them. Finally, the courts make it difficult for HUD to recover any losses and it can take years to complete the process. NAMB suggests that HUD put more resources toward improving the Mortgagee Review Board process and insuring its actions and judgments come to fruition.

3. FHA Resources

In order to increase efficiency and productivity, funding for HUD and the FHA program must increase. The FHA has too few employees reviewing new applicants. It can take up to 6 months to receive an answer back from the FHA as to the status of an application for approval as a mortgagee or loan correspondent. With the increase in volume of FHA loans, there is a clear need to increase funding for all areas relating to FHA, particularly including computerization, lender assessment, approval and enforcement. In addition, there is a need for better coordination between HUD and law enforcement, as well as increased enforcement of the Truth-in-Lending Act and the Real Estate Settlement Procedures Act.

4. FHA Loan Limits

FHA volume has increased in part due to the increase in FHA loan limits. As intended, the temporary increase in loan limits for FHA (and the GSEs) is having a significant impact in high cost areas, particularly in the California housing market.

It is critical that we keep affordable mortgage finance available at a time when the housing markets struggle to climb out of their greatest hole in more than 70 years. NAMB strongly supports permanently establishing FHA loan limits in high-cost areas at their current levels.

IX. Conclusion

NAMB and the mortgage professionals we represent are very interested in maintaining a strong, healthy and relevant FHA loan program. FHA has been an innovator as well as an engine driving the housing market in this country. Not since the Great Depression has FHA's role been so vital.

NAMB strongly believes that the efficiency and expertise of the mortgage broker industry remains critically important to the health and future prosperity of the FHA loan program. Mortgage brokers are the most efficient mortgage distribution channel and therefore should remain an integral part of any plans to reform the FHA program. Moreover, we have seen the damage done by the HVCC to the quality and costs of appraisals in the conventional mortgage market simply by excluding mortgage brokers from the process. We strongly believe that any further exclusion of mortgage brokers, as proposed in the new FHA guidelines, will very likely have an adverse effect on the viability of the program and ultimately raise costs for consumers.

Thank you for inviting NAMB to testify today and offer our perspective on “The Future of the Federal Housing Administration’s Capital Reserves: Assumptions, Predictions and Implications for Homebuyers.” We are grateful for the many opportunities we have had to work with HUD and this Committee, and we look forward to continuing to build and strengthen these relationships as we tackle many of the issues discussed today.

What It Takes to be FHA Approved

By John Councilman, CMC, CRMS

There are a number of items to consider before applying to be an FHA approved Correspondent. (All brokers are called Correspondent Mortgagees in FHA language.) FHA mortgagee status is more than just being able to offer FHA loans. It is a structural change to the way most brokers operate their business. There is also a considerable financial commitment that will be there every year, not just for approval. The structural change makes the broker behave more like a larger business. This can be a good transition for many brokers, especially if they are considering mortgage banking.

The first thing a broker should do is find a wholesale lender who is willing to fund at least \$1 million dollars or all of your production. Even your existing wholesalers will want you to sign an FHA addendum to your agreement and provide other documents. You will need to get an Application for Approval (Form 11701) from HUD's website. (www.hudclips.org/sub_nonhud/cgi/pdf/forms/11701.pdf) This was form 92001 so don't be confused if you see an old list. There are a few basic requirements that you won't see on the form that must be dealt with. At least 50% of the company's revenue must come from mortgage services. If you plan to use the same company for real estate sales or title services, you may be faced with setting up a separate affiliated company. You cannot be a sole proprietorship. Certain LLCs and partnerships do not qualify and some S-Corporations have improper structure. FHA is looking for "...a permanent organization having succession." In other words, if you are a one person operation and you die, the business would stop. The best bet is to be a C-Corp. Your company name may not include "national," "Federal," or another restricted word unless you are a bank.

Be careful about becoming a "net branch." Theoretically, HUD does not prohibit branches where the manager is paid on a "net" basis. They do frown on branches that are not true branches under the full control of the mortgagee. Control and supervision of employees must include, at a minimum, regular and ongoing reviews of employee performance and of work performed. A mortgagee must pay all its own operating expenses. This includes expenses of its main and branch offices involved in originating or servicing any FHA insured mortgages. Operating expenses include, but are not limited to, equipment, furniture, office rent, overhead, employee compensation, and similar expenses.

At least one person in management must be a 40-hour per week, full-time employee and have 3 years experience in mortgage origination and supervision. Experience in real estate sales or brokerage does *not* qualify. HUD will look closely at resumes when a mortgagee applies for approval to see if management personnel have experience in the areas in which they will be performing duties. The main office must have at least 2 full-time employees and each branch must have one employee. No employee who originates or works on FHA loans may have other employment in mortgage lending, in real estate or another finance-related field. Direct endorsement underwriters are included in this provision. An underwriter may not work on a part-time basis for any other mortgagee, even underwriting conventional mortgage loans. An employee may not perform duties for any other business while working at their job with the mortgagee. Loan officers and

managers may be paid on a commission or “net” basis but still must receive a W-2. HUD has clarified that an employee who is not involved in FHA loans is not required to meet any of these restrictions. Some clerical functions may be outsourced but the costs of the outsourcing may not be passed on to the borrower. The applicant must certify that neither it nor any of its officers, directors, or principals, has been denied an operating license or otherwise sanctioned by any licensing or regulatory body. If the company or any of the primary people in the company have had problems with a state or federal regulator, it must be documented and explained. If you have any problems with your state or federal regulators, don’t expect to be approved by FHA. HUD will want proof of proper licensure in the states where you will do business.

An applicant applying for approval as a non-supervised mortgagee or a non-supervised loan correspondent must provide sufficient evidence that its facilities meet FHA requirements. The applicant must submit photographs of its facilities, including its entrance, with evidence of permanent identification to the public. The applicant must submit a floor plan, which may be hand-drawn. The applicant must also submit a certification, signed by a senior officer, that the facilities comply with FHA requirements. If your office is in your house, you must be zoned for it, have a sign, a separate entrance and be completely lockable from the residence. Even commercial offices must be segregated from other businesses in an office building. You must have private space for interviews and be certain you have your Fair Housing poster up. You must have toll-free telephone service to any area you serve outside your local calling area. These submissions are in lieu of an on-site visit by FHA to the mortgagee’s office facilities; however, FHA may still conduct an on-site visit. Evidence of acceptable facilities is not required for branch offices.

A Correspondent applicant must order and pay for credit reports and submit the complete originals, with the application, directly to the Lender Approval and Recertification Division, HUD Headquarters. A tri-merged report must be provided for all 25% or greater owners. A commercial credit report or a Dun & Bradstreet report must be included on the applicant and any parent company. This is required even if the applicant is a start-up company. A written explanation must be submitted by the applicant for all negative items disclosed by any credit report.

One of the biggest problems for mortgage brokers is meeting the net worth requirements. The business entity (not the owner) must have a net worth of at least \$63,000. HUD is very finicky about what they allow you to count in the net worth. You may not include notes from officers, goodwill, borrowed funds or items used for personal purposes. If you have branches, each branch adds \$25,000 more to the net worth requirement up to \$250,000. Of that net worth, 20% must be kept liquid, essentially, in your checking account. Lines of credit or even marketable mortgages are not considered liquid assets. You must maintain that net worth and liquidity all year long.

Each broker should consider the costs before applying. The application requires a \$1,000 fee plus \$300 more for each branch. Every year thereafter, the renewal fee is \$500 and \$200 additional for each branch. That is the small part of the overall costs. The major cost for most brokers is the audit. You can’t just hire any CPA for your audit. Your CPA will have to have special courses in government auditing, continuing education in it and be peer reviewed. That eliminates about 90% of the CPAs in the phone book. A

long distance audit, that is where the auditor doesn't physically come to your shop, may cost less than \$5,000. A thorough onsite audit starts around \$6,000 and often costs \$12,000 to \$15,000. It may seem like a no-brainer to use an offsite audit but you get what you pay for. You will spend a lot more time gathering materials and shipping them to the CPA. Full service accounting firms generally will only do onsite audits. I found that going from onsite audits for a number of years, then to an offsite audit for a year and then back to an onsite audit revealed the weaknesses of the offsite audit. I spent thousands of dollars documenting what the offsite auditor had done to get back to a tight audit. Small accounting firms aren't necessarily a bargain either. The larger onsite auditor usually packages consulting and an excellent tax preparation staff with the audit. I gained the few thousand in fees back with a dedicated expert tax department doing our corporate taxes. It was a good feeling when the IRS called for an onsite tax audit to have an expert there to work them. It also felt really great to get a "no change" IRS audit. The rigors of the FHA audit made the IRS audit really easy.

FHA audits are prepared according to Federal auditing standards. These standards are quite rigorous. You will not only need a check or credit card statement to prove you paid for something, you will need a specific receipt. Even if you keep every receipt, the auditor will ask at random for specific receipts that you will have to wade through that mountain of receipts to find. You learn to be better organized right away. They will pull your files and ask for the settlement sheets, copies of incoming checks, deposit logs, receipts for payments from the proceeds and review ECOA and Fair Housing information. If you are the kind of owner who never balances the checkbook, perhaps FHA is not for you.

Most brokers are used to keeping their books on a "cash basis." That means you write in your books when you get the money and when you pay for something. Cash accounting is not acceptable for Federal audits. You will need to practice "accrual basis accounting." That means money is considered for the books when the money is earned not when you receive it and debts are considered for the period covered, not when you pay them. That will send you scurrying for things like your insurance policies to see how much of the policy covers the current year and how much covers the next year or the previous year.

Government auditing requires a concept called "internal controls." In broker language, that means that various people in your organization check each other to make certain there is no hanky-panky. Ideally, one person should log in all incoming checks, the bookkeeper should itemize all checks deposited, label them on deposit slips and enter them in the correct category in your accounting software. Finally, the owner or manager will check the bookkeeper to make certain all monies are accurate and linked to the items in the file. Starting next year, the AICPA has new standards for government audits. The auditor, according to SAS 112, is not supposed to be the person who keeps your books but audits them. The auditor will be required to perform "risk analysis." This will undoubtedly raise the price of the audit and your blood pressure as well. Your auditor will need to note areas where there is a lack of controls which could result in misstated financial statements. They will have to perform a pre-engagement risk analysis with initial planning. Then they will have to do specific risk analysis and detailed planning. Finally, they will have to develop steps that respond to the risk assessment. If that

sounds like a lot of words that don't mean anything, you can be certain that it means a lot more work for your accountant that you will pay for.

Then there is payroll. FHA requires that all loan officers and staff be paid on a W-2 basis. If you have been paying on a 1099 basis, you may want to seriously consider getting a payroll company. For about \$100 to \$200 a month, life will become much easier. Don't expect your CPA to do a great job with this. I've tried it several times. Get the payroll company. You will sleep far better and your audit will be much easier not to mention you will save enough in state and federal penalties to pay for the payroll company. The state has no compunction about slapping you with a lien without ever going to court or padlocking your office if payroll is not to their liking.

FHA may choose to come to your business unannounced. They have the right to look at any FHA files which should be readily available. Usually, they will set a time for their audit. Nearly every mortgagee I have spoken to that has undergone an audit gets some negative finding. Most are merely corrective but FHA can impose sanctions and fines or even revoke your FHA approval. Brokers especially fear indemnification. At times, FHA has required mortgagees to sign indemnification agreements that require the mortgagee to reimburse HUD if they take a loss on a mortgage where some material violation of FHA guidelines has occurred. FHA freely admits that they are much more likely to audit mortgagees that have a higher default rate than mortgagees who have a low default rate. If your default rate exceeds 150 percent of the Field Office average for a year, you may lose your FHA approval.

To be FHA approved, you will need to develop a quality control plan. It may surprise you that sometimes companies are approved as a mortgagee when their quality control plan does not meet FHA requirements. This won't come to light until FHA comes to you to do an audit and you are cited for having an inadequate quality control program. You are supposed to maintain a QC program that meets FHA requirements. This requires periodic updates. Even if you have an adequate quality control plan, it is very difficult to follow it on every loan. FHA expects a quality control review to be performed on approximately 10% of your loan production within 90 days of closing. It can be performed internally. However, I strongly recommend it be done by a good outside company. They will also help you to maintain a compliant quality control plan.

Becoming an FHA mortgagee does not give a company the right to use a government seal. Mortgagees are also prohibited from implying that an advertisement is from or endorsed by FHA or HUD. I have seen a mailer stating "This is an official notice..." HUD prohibits anything that simulates official notice from HUD. They can impose hefty fines or refer the case for criminal prosecution.

FHA is like a sleeping giant. Once you are approved, you may not hear from FHA for years if your audit is clean and your default rate is low. But, when FHA awakes, you do not want to be on the receiving end. As anyone knows, the government has endless lawyers and money. They can drive a small company into submission or into the ground in short order. If you make the commitment to become FHA approved, it will be an investment in accounting and in staff for many smaller companies. You must understand that your company is no longer just you. It has a life of its own. Many small companies

find the rigidity and costs imposed on them unacceptable. At the moment, FHA is allowing non-approved individuals to be paid a “counseling” fee. The non-approved individual may not process the loan or be paid by the lender. They are not even allowed to take the loan application. HUD envisions them receiving a small fee. One should be careful in trying to earn the same fees or act in similar fashion to an FHA-approved loan correspondent.

Weigh the options carefully. If, after reading this article, FHA is for you, it can be quite profitable. But, be forewarned, it requires a new structure for most mortgage brokers.

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