



Federal Financial Analytics, Inc.

PETROU CAUTIOUS ON FHA REFORM

“FHA reform should follow, not precede, long-overdue reforms to the mortgage-origination process.”

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WASHINGTON, D. C. – Testifying today before the Senate Banking Committee, Basil N. Petrou, managing partner of Federal Financial Analytics, outlined key considerations for Congress as it evaluates the Bush Administration proposed reforms for the Federal Housing Administration (FHA). Petrou noted that the FHA is proposing to get into higher-risk products at precisely the time when the overall mortgage market is in distress and borrowers are experiencing record foreclosures. He urged the FHA to focus its resources under current law to assist troubled borrowers now and to offer any new services in pilot programs to ensure that the FHA’s internal controls – long a serious problem – are in place in advance to ensure borrowers are not put at still more risk.

Specifically, Petrou argued that:

- FHA reform should follow, not precede, long-overdue reforms to the mortgage-origination process. This Committee has rightly called on the federal banking agencies to take stern and strong action, and new standards are, as a result, emerging. Recent action by the Office of Federal Housing Enterprise Oversight (OFHEO) – the regulator of Fannie Mae and Freddie Mac -- will help to ensure that all lenders – not just federally-regulated ones – comply with these enhanced origination standards. However, there is much more to do with regard to improved origination, as legislation before this Congress makes clear. If FHA reforms are enacted ahead of these reforms, originators will have still greater incentives than before – a new federal guarantee atop fees that encourage poor practice – to put borrowers in unsuitable mortgages at risk to them and their communities.

- Further, program reforms must be conducted not only in tandem with broad market reform, but also after changes within the FHA. This Committee is all too familiar with presentations that suggest control problems are being addressed, only to discover a year or so down the road that this in fact was not the case. Promises aren't enough; performance is all that counts to prevent long-term taxpayer risk. In this regard, the HUD Inspector General has noted that the FHA modernization legislative package proposed by the Administration could bring higher default and foreclosure risks and will require FHA system modifications and impose new administrative and cost burdens on originating and servicing lenders. The FHA must and should satisfy its Inspector-General and the General Accountability Office (GAO) before being allowed into new ventures with untold risk.

- That there is risk is clear from current market turmoil. Simple dependence on underwriting factors like a credit score or third-party rating is no protection from significant credit risk. If FHA offers high-risk mortgage products – those with no downpayment, for example – it must do so with state-of-the-art internal controls built in advance, tested beforehand and validated by expert third parties like GAO.

- Finally, in crafting its reform, FHA should focus on truly underserved borrowers who, if helped through the government’s programs, can buy a home and stay in it. Looking solely at “market-share” – as FHA did when it first proposed these changes – is not only the wrong approach for the federal government, but also one that could put the FHA alongside some other market players who favor their own self-interest ahead of borrowers. Backed by a full-faith-and-credit guarantee from the U.S. Government, the FHA and investors in its mortgages operate without effective market discipline, so Congress should ensure that the program is effectively controlled by defined policy objectives in a rigorous governance process.

Petrou’s testimony is attached.

Federal Financial Analytics, Inc. has for the past twenty years counseled large financial institutions and even their regulators on major legislative, regulatory and policy issues that pose strategic risk. It does not lobby on behalf of clients, but advises them on appropriate responses in light of identified challenges, working on an array of GSE, Basel II, and acquisition-value issues. The firm publishes numerous information and analytical services, including Financial Services Management and GSE Activity Report.

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