HUD Agency May Insure Riskier Loans (Wall Street Journal)

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When Phillip Germany set out to refinance his University Heights, Ohio, home in 2002, his weak credit history prompted his mortgage broker to steer him to Ameriquest Mortgage Co., a "subprime" lender based in Orange, Calif. The 8.9% interest rate seemed high, but Mr. Germany took it anyway. "I assumed that the [broker] had tried all options," says the 56-year-old semiretired auto worker.

In January, his interest rate rose to 9.75%. Now, Mr. Germany thinks he could have found a better deal.

The government agrees. The Department of Housing and Urban Development plans to revitalize the Federal Housing Agency, a mortgage-insurance program that puts relatively low-interest loans within reach of low- and middle-income homebuyers who have little or poor credit -- and provides an alternative to the commercial subprime lenders, which take on risky borrowers but charge them interest well above the prime rate.

Although FHA is the nation's oldest housing-related agency -- founded in 1934 during the New Deal, it predates Fannie Mae, Freddie Mac and HUD -- the agency has lost so much market visibility that many home buyers don't even know it exists. Among the forces prompting its comeback plans are community activists, who say too many consumers are getting a raw deal from subprime lenders, and some members of Congress, who worry about the agency's declining market share.

The FHA is losing share to hordes of aggressive subprime mortgage lenders, which offer a range of flexible products, including no-money-down mortgages and interest-only payments. They also have high rates and hefty closing costs. But because the subprime lenders offer fast approvals, instant home appraisals, less paperwork and fewer hassles, they are attracting many consumers who could easily qualify for a lower-cost FHA mortgage.

Mortgage-industry analysts say the explosion in subprime lending, and the FHA's decline, is a reminder of how market forces sometimes overtake the public sector, even when the government is offering a better deal. "The subprime lenders are more aggressive and they are pushing FHA to the margins," says Geoff Smith, project director for the Woodstock Institute, a nonprofit community development organization in Chicago. "They often solicit door-to-door or over the phone to sell a mortgage."

Heavy marketing has helped drive the subprime boom. In 2004, subprime mortgage originations, or the dollar volume of such new loans nationwide, totaled $530 billion, more than triple the 1999 volume of $160 billion, according to Inside Mortgage Finance Publications, of Bethesda, Md. FHA-backed loan volume over the same period fell to $94 billion from $122 billion.

Mortgage loan volume at Ameriquest, the nation's largest subprime lender, nearly doubled last year alone to $82.7 billion. Parent company ACC Capital Holdings Corp. last month said it has set aside $325 million to settle claims stemming from regulator investigations into its sales and appraisal practices in 30 states.

A bill would make FHA-insured, no-money-down mortgages available to first-time homebuyers is under consideration by the House Financial Services Committee after a subcommittee hearing in June. A similar bill last year made it through the committee but never went to a full vote, after criticism of the $500 million price tag and the potential risks. The new bill, which has the FHA's support and was introduced by Ohio Republican Rep. Patrick Tiberi and Georgia Democratic Rep. David Scott, aims to limit the cost and risk by capping the number of loans at 50,000 over a five-year period. Experts say the current bill has a better shot at passing.

FHA-backed mortgages, which can go as high as $312,895, depending on geographic region, are available to just about anyone. But they are designed for and used mainly by buyers who lack the standard 20% down payment or whose credit history is weak. The FHA doesn't lend money directly. Instead, it works through thousands of certified banks and thrifts, which take the loan application and submit it to FHA. If FHA endorses and guarantees the loan, the bank can offer a mortgage at a rate lower than what the borrower would otherwise qualify for.

For example, an FHA borrower with a credit score of 600 (out of a perfect 900) seeking a $250,000 mortgage could expect to receive a rate of about 6.5% on a conventional 30-year fixed loan. A borrower with the same credit profile might pay 8.5% on a typical subprime loan, according to Raymond Carroll, a consultant with A.S.U. Mortgages, a Brooklyn, N.Y., broker.

As a result, the FHA client would pay $1,582 a month in principal and interest, compared with $1,922 for the subprime client. Although the FHA customer also has to pay an average of $150 in monthly mortgage-insurance fees, his total monthly cost still would be almost $200 less than the subprime borrower's. The FHA often waives the insurance fee after five years.

Under the pending bill, FHA lenders could waive the down payment and in exchange charge slightly higher mortgage-insurance premiums. Tim Doyle, director in government affairs for the Mortgage Bankers Association, says for those loans the upfront insurance premium, paid at closing, would increase from to 2.25% from 1.5%. The annual insurance payment would rise to 0.75% from 0.5%.

Mr. Doyle says a no-money-down program is necessary if FHA is to regain some of the business it has lost to subprime lenders. "We think that FHA being allowed to enter the no-down-payment arena will help its originations," he says.

Several other FHA products are aimed at making the agency more competitive with subprime lenders. The most ambitious is Streamline(K), announced in April, which gives certain FHA borrowers grants of as much as $15,000 for certain home repairs. The money has to go toward specific procedures, such as roof or electrical repairs, and only pre-approved contractors may do the job.

Considering that many first-time homeowners are purchasing fixer-uppers, FHA's Streamline program may fill a badly needed niche. "Lifestyle demands have changed, and older houses need some work. In that regard, there are few products on the market that are specifically earmarked [for renovations]" says Jim Wheaton, associate director of Chicago's Neighborhood Housing Services.

FHA also offers counseling and payment-assistance services to borrowers in trouble, making it more likely that FHA homeowners will stay in their homes and out of foreclosure. According to the Mortgage Bankers Association, foreclosure rates for the first quarter were 3.5% for subprime loans compared with 2.6% for FHA loans.

Still, it won't be easy to claw business away from subprime lenders. Their rates are higher, but they offer faster approvals and a wider variety of products. They also are willing to serve clients with poorer credit. Says Stephanie Christie, senior vice president at Wells Fargo Mortgage, a unit of **Wells Fargo** & Co., "While FHA has played a huge role in expanding homeownership, there are now more options for consumers."

Tom Detelich, president of North American consumer lending at **HSBC** Corp., says another source of fuel for subprime lending is the rise of computerized risk-pricing, so that factors beyond debt and income, such as type of employment and number of years at a job, are used to assess the likelihood that a borrower will repay a loan. "We are seeing better pricing for the same level of risk," he says. "Customers that may have been on the sidelines can now buy a home. That is absolutely a good thing."