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FHA-Backed Loans: The New Subprime

The same people whose reckless practices triggered the global financial crisis are onto a similar scheme that could cost taxpayers tons more

By Chad Terhune and Robert Berner

As if they haven't done enough damage. Thousands of subprime mortgage lenders and brokers—many of them the very sorts of firms that helped create the current financial crisis—are going strong. Their new strategy: taking advantage of a long-standing federal program designed to encourage homeownership by insuring mortgages for buyers of modest means.

You read that correctly. Some of the same people who propelled us toward the housing market calamity are now seeking to profit by exploiting billions in federally insured mortgages. Washington, meanwhile, has vastly expanded the availability of such taxpayer-backed loans as part of the emergency campaign to rescue the country's swooning economy.

For generations, these loans, backed by the Federal Housing Administration, have offered working-class families a legitimate means to purchase their own homes. But now there's a severe danger that aggressive lenders and brokers schooled in the rash ways of the subprime industry will overwhelm the FHA with loans for people unlikely to make their payments. Exacerbating matters, FHA officials seem oblivious to what's happening—or incapable of stopping it. They're giving mortgage firms licenses to dole out 100%-insured loans despite lender records blotted by state sanctions, bankruptcy filings, civil lawsuits, and even criminal convictions.

MORE BAD DEBT

As a result, the nation could soon suffer a fresh wave of defaults and foreclosures, with Washington obliged to respond with yet another gargantuan bailout. Inside Mortgage Finance, a research and newsletter firm in Bethesda, Md., estimates that over the next five years fresh loans backed by the FHA that go sour will cost taxpayers $100 billion or more. That's on top of the $700 billion financial-system rescue Congress has already approved. Gary E. Lacefield, a former federal mortgage investigator who now runs Risk Mitigation Group, a consultancy in Arlington, Tex., predicts: "Within the next 12 to 18 months, there is going to be FHA-insurance Armageddon."

The resilient entrepreneurs who populate this dubious field are often obscure, but not puny. Jerry Cugno started Premier Mortgage Funding in Clearwater, on the Gulf Coast of Florida, in 2002. Over the next four years, it became one of the country's largest subprime lenders, with 750 branches and 5,000 brokers across the U.S. Cugno, now 59, took home millions of dollars and rewarded top salesmen with Caribbean cruises and shiny Hummers, according to court records and interviews with former employees. But along the way, Premier accumulated a dismal regulatory record. Five states—Florida, Georgia, North Carolina, Ohio, and Wisconsin—revoked its license for various abuses; four others disciplined the company for using unlicensed brokers or similar violations. The crash of the subprime market and a barrage of lawsuits prompted Premier to file for U.S. bankruptcy court protection in Tampa in July 2007. Then, in March, a Premier unit in Cleveland and its manager pleaded guilty to felony charges related to fraudulent mortgage schemes.

But Premier didn't just close down. Since it declared bankruptcy, federal records show, it has issued more than 2,000 taxpayer-insured mortgages—worth a total of $250 million. According to the FHA, Premier failed to notify the agency of its Chapter 11 filing, as required by law. In late October, an FHA spokesman admitted it was unaware of Premier's situation and welcomed any information *BusinessWeek* could provide.

You'd think the government would have had Premier on a watch list. According to data compiled by the FHA's parent, the U.S. Housing & Urban Development Dept. (HUD), the firm's borrowers have a 9.2% default rate, the second highest among large-volume FHA lenders nationally.

Now, members of the Cugno family have started a brand new company called Paramount Mortgage Funding. It operates a floor below Premier's headquarters in a three-story black-glass office building Jerry Cugno owns in Clearwater. In August 2007, only weeks after Premier sought bankruptcy court protection, the FHA granted Paramount a license to issue government-backed mortgages. "I am the only person in the country who really understands FHA," Cugno says with characteristic bravado.

One day recently, Nicole Cugno, his 27-year-old daughter and a Paramount vice-president, was on the phone at her desk, giving advice to new branch managers. Despite past troubles with Premier, the family says Paramount dutifully serves borrowers. The Cugnos stress that the two companies are legally separate organizations.

Similarly worrisome stories are playing out around the country. In Tucson, First Magnus Financial specialized in risky "Alt-A" mortgages, which didn't require borrowers to verify their income. State and federal regulators cited the company for misleading borrowers, using unlicensed brokers, and other infractions. It shut down last summer and laid off its 5,500 employees. But in May, the FHA issued a group of former First Magnus executives a new license to make taxpayer-insured home loans. They have opened a company called StoneWater Mortgage in the same office building that First Magnus had occupied.

G. Todd Jackson, an attorney for StoneWater, said in a written statement that the new company "is not First Magnus." StoneWater employs "a new business model, with different loan products, in a different market," he added. First Magnus had "a long record of compliance," he said. "Isolated incidents and personnel problems occurred, but none were remotely systemic, and all were promptly addressed and corrected by management when discovered."

BACK TO LIFE

Nationstar Mortgage, based in suburban Dallas, closed its 75 retail branches in September 2007 after the subprime market crashed. But in August, Chief Information Officer Peter Schwartz told the trade paper *American Banker* that Nationstar now plans to emphasize FHA-backed loans, which he called a "high-growth channel." The lender received federal approval in March to offer government-guaranteed loans. Just a year earlier, it agreed to pay the Kentucky Financial Institutions Dept. a $105,000 settlement—one of the largest of its kind in that state—to resolve allegations that Nationstar employed unlicensed loan officers and falsified borrowers' credit scores. Nationstar didn't admit wrongdoing in the case.

"All loans we originate conform to industry best practices, as well as all applicable federal and state laws," says Executive Vice-President Steven Hess. The settlement in Kentucky, he adds, isn't "relevant to our FHA status."

Lend America in Melville, N.Y., uses cable television infomercials and a toll-free number (1-800-FHA-FIXED) to encourage borrowers in trouble with adjustable-rate mortgages to refinance with fixed-rate loans guaranteed by the FHA. Anticipating the real estate crash, the Long Island firm switched its strategy in 2005 from subprime to FHA-backed mortgages, says Michael Ashley, Lend America's chief business strategist. This year, the company will make 7,500 FHA loans, worth $1.5 billion, he says. "FHA is a big part of the future," Ashley adds. "It's the major vehicle for the government to bail out the housing industry."

But why the federal government would want to do business with Lend America is perplexing. Ashley has a long history of legal scrapes. One of them led to his pleading guilty in 1996 in federal court in Uniondale, N.Y., to two counts of wire fraud related to a mortgage scam at another company his family ran called Liberty Mortgage. He was sentenced to five years' probation and ordered to pay a $30,000 fine. His father, Kenneth Ashley, was sentenced to nearly four years in prison. "I was just a pawn in a chess game between my father and the government," says the younger Ashley, who is 43. "It doesn't affect my ability to do lending." The default rate on Lend America's current FHA loans is 5.7%, or 53% above the national average, according to government records.

Asked about FHA oversight of former subprime firms, agency spokesman Lemar Wooley says: "FHA has taken appropriate actions, where necessary, with these lenders with respect to their participation in FHA programs." First Magnus, Nationstar, and Lend America met all applicable federal rules, Wooley says. But on two occasions since 2000 one office of Lend America in New York temporarily lost its authority to originate FHA-backed loans because of an excessive default rate, he says. Wooley says the FHA wasn't aware that Lend America's Ashley had been convicted. The firm didn't list Ashley as a principal, Wooley says. FHA lenders are required to disclose past regulatory sanctions and are forbidden to employ people with criminal records.

Founded during the New Deal, the FHA is supposed to promote first-time home purchases. Open to all applicants, it allows small down payments—as little as 3%—and lenient standards on borrower income, as long as mortgage and related expenses don't exceed 31% of household earnings. In exchange for taxpayer-backed insurance on attractively priced fixed-rate loans, buyers pay a modest fee. Lenders and brokers can get a license to participate in FHA programs if they demonstrate industry experience and knowledge of agency rules.

During the subprime boom, the FHA atrophied as borrowers migrated to the too-good-to-be-true deals that featured terms such as extremely low introductory interest rates that later jumped skyward. But since the subprime market vaporized in 2007, FHA-backed loans have become all that's available for many borrowers. By fall 2008, FHA loans accounted for 26% of all new mortgages being issued nationwide, up from only 4% a year earlier. As of Sept. 30, the most recent date for which data are publicly available, the FHA had 4.4 million single-family mortgages under guarantee, worth a total of $475 billion.

A SWELLING "TSUNAMI"

Congress and the Bush Administration are strongly encouraging lenders to apply for FHA approval and tap into the government's loan-guarantee reservoir. In September, the agency guaranteed 140,000 new loans, up from 60,000 in January. In October, as Congress and the White House scrambled to respond to the spreading financial disaster, the FHA began to extend $300 billion in additional loan guarantees under the banner of a new program called HOPE for Homeowners. The limit on the amount buyers may borrow will rise in January to $625,000 from $362,790 in 2007.

Some current and former federal housing officials say the agency isn't anywhere close to being equipped to deal with the onslaught of lenders seeking to cash in. Thirty-six thousand lenders now have FHA licenses, up from 16,000 in mid-2007. FHA "faces a tsunami" in the form of ex-subprime lenders who favor aggressive sales tactics and sometimes engage in outright fraud, says Kenneth M. Donohue Sr., the inspector general for HUD. "I am very concerned that the same players who brought us problems in the subprime area are now reconstituting themselves and bringing loans into the FHA portfolio," he adds.

FHA staffing has remained roughly level over the past five years, at just under 1,000 employees, even as that tsunami has been building, Donohue points out. The FHA unit that approves new lenders, recertifies existing ones, and oversees quality assurance has only five slots; two of those were vacant this fall, according to HUD's Web site. Former housing officials say lender evaluations sometimes amount to little more than a brief phone call, which helps explain why questionable ex-subprime operations can reinvent themselves and gain approval. "They are absolutely understaffed," says Donohue, "and they need a much better IT system in place. That is one of their great vulnerabilities."

Joseph McCloskey, a former director of FHA's single-family asset management branch, says workers reviewing lender applications have had difficulty for years tracking whether executives of previously disciplined mortgage firms were applying for new FHA licenses. "Technologically, they are challenged," McCloskey, now a consultant to FHA lenders, says of his overmatched former colleagues.

The FHA's Wooley disputes these criticisms. The agency can cross-check names and thoroughly examine lender applications, he says.

LIKE FLIES TO HONEY

There are numerous law-abiding FHA lenders and brokers, just as there are subprime mortgage firms that behaved honestly and cautiously in recent years. But the current economic crisis has turned the FHA into a profit magnet for all kinds of financial players. Major Wall Street investment firms are finding their own angles, which are entirely legal.

In April 2007, Goldman Sachs (GS) purchased a controlling stake in Senderra Funding, a former subprime lender in Fort Mill, S.C. Goldman, which has received $10 billion in direct federal rescue money, converted Senderra into an FHA lender and refinance organization. The strategy appears likely to produce hefty margins. In September, Goldman paid 63¢ on the dollar in a $760 million deal with Equity One (EQY), a unit of Banco Popular (BPOP), for a batch of subprime mortgage and auto loans. Through Senderra, Goldman plans to refinance at least some of the mortgages into FHA-backed loans. Because of the government guarantee, it can then sell those loans to other financial firms for as much as 90¢ on the dollar, according to people familiar with the mortgage market. That's a profit margin of more than 40%.

Goldman's dealings suggest another reason FHA-insured lending is booming: The federal guarantee creates an incentive for banks to buy FHA loans and bundle them as securities to be sold to investors. This is happening as the securitization of subprime and conventional mortgages has largely ceased.

Operating far from Wall Street, the Cugno clan of Clearwater exemplifies a certain indefatigable American spirit in the face of economic setbacks. Whether that enterprising drive is always something to celebrate is less clear.

The Cugnos concede that their older mortgage firm, Premier, had its flaws. "My dad's company got too big," says Nicole Cugno. "It was too hard to control." At its peak in 2006, Premier originated $1 billion in loans each month and had annual revenue of more than $200 million. It sold what amounted to franchises to brokers around the country who frequently operated with little supervision from the 200-employee home office. "Everybody had a few bad apples, and I had a few of them," Nicole's father, Jerry, says. "If they got in trouble, we fired them."

Mark Pearce, deputy commissioner of banks in North Carolina, one of the five states that banned Premier, counters that the company seems to have invited abuses. North Carolina investigators concluded that Premier's branch in Charlotte allowed, among other deceptive practices, unlicensed brokers from around the country to "park" loans there for a fee. The aim was to make it appear that the mortgages were associated with a licensed broker trained and supervised by a substantial firm. "This is a company that should not be doing business in North Carolina," Pearce says.

But the Cugnos are very much staying in business. While Premier's bankruptcy proceedings continue in Tampa, members of the family are employing essentially the same model with their new company, Paramount. Only this time they are stressing federally guaranteed FHA loans. Paramount charges branches $1,625 a month to use its name, FHA license, and software. On its Web site, it tells brokers that FHA loans are "the new subprime."

"We're taking some of the things Premier did and tweaking [them]," says Barry McNab, a former Premier executive who now heads FHA lending for Paramount. About 9 out of 10 Paramount loans have FHA backing, he explains. It's difficult to evaluate most of those guaranteed loans, since they are so new. But a look at the experiences of some past Premier borrowers isn't encouraging.

U.S. District Judge Richard Alan Enslen in Kalamazoo, Mich., began a June 2007 written opinion about Premier's practices with this observation: "The crooks in prison-wear (orange jump suits) are easy to spot. Those in business-wear are not, though they do no less harm to their unsuspecting victims."

The case before Judge Enslen concerned Marcia Clifford, 53. She won a civil verdict that Premier had violated federal mortgage law when it replaced the fixed-rate loan it had promised her with one bearing an adjustable rate. Enslen also found that Premier had misrepresented Clifford on her application as employed when she was out of work and living on $700 a month in disability payments. Despite his ire, the judge decided to award Clifford, who did sign the deceptive documents, only $3,720 in damages, an amount based on unauthorized fees Premier had pocketed.

Clifford's name now appears along with a lengthy list of Premier's other creditors in the bankruptcy court in Tampa. Unable to make her $600 monthly mortgage payment, she received an eviction notice in June and says she is likely to lose her three-bedroom house in Belding, Mich. "It was a bait and switch," Clifford says, sobbing. "The folks at Premier are coldhearted."

Janice Dixon is also owed money by Premier. In March 2006 an Alabama jury awarded her $127,000 in damages related to a fraudulent refinancing in which, she alleged, the company didn't disclose the full costs of her borrowing. "Who will fix this?" Dixon, 49, asks. "They will continue to do these same things over and over."

Wooley, the FHA spokesman, says the agency noticed Premier's default rate rising earlier this year. But he adds that both Premier and Paramount met FHA requirements.

LOW INCOME? NO PROBLEM

Like the Cugnos, Hector J. Hernandez lately has shifted his mortgage business away from subprime and toward FHA loans. The Coral Gables (Fla.) lender has a different twist on the business: He uses FHA-backed loans to help hard-pressed borrowers buy condominiums in buildings he owns.

Sascha Pierson was an unlikely borrower. She had no employment income when she bought a three-bedroom condo in Palmetto Towers, a Hernandez property in Miami, in July 2007 for $318,000. She borrowed almost the entire purchase price from Great Country Mortgage Bankers, Hernandez's loan company. Pierson, 29, says she is pursuing a psychology degree online from Kaplan University. She lives on a $42,000 annual educational grant from the government of the Cayman Islands, where she is a citizen. But the grant ends this year, and even with two roommates, she doesn't know how she's going to pay the $2,600 monthly bill for her mortgage and condo fee. "I am seriously worried about defaulting on my loan," she says.

Less extreme versions of Pierson's situation seem common at Palmetto Towers, a pair of eight-story stucco buildings Hernandez acquired in 1996. *BusinessWeek* interviewed eight condo owners at the complex, all of whom had obtained FHA-backed loans from Great Country. All eight, including Pierson, say they agreed to terms that required them to make mortgage and condo-fee payments that total considerably more than the FHA's guideline of 31% of their monthly income. Four of the eight owners say they received cash payments at closing of $10,000 or more as incentives to buy. The payments, which the FHA says are prohibited, were included in the loans. Pierson says she received $19,500. "They called it a 'cash-back opportunity,'" she explains.

Her neighbor, Lorena Merlo, 27, received a Great Country check for $14,640 at the closing in April on her $316,375 three-bedroom unit. Merlo, a part-time legal assistant, and her husband, Renny Rivas, a drywall laborer, earn a total of $52,000 a year and have two young sons. Their monthly home payments amount to 58% of their gross income, way over the FHA limit. "We are four months behind on our mortgage," says a mournful Merlo.

DEFAULTS AND DENIALS

Of the 158 units in Palmetto Towers, 66 are in foreclosure, records show. An additional 33 are unsold. Great Country has originated 1,855 FHA mortgages since November 2006; 923 of those were in default proceedings as of Oct. 31. The firm's 50% default rate is the highest in the entire FHA program.

Hernandez blames the high failure rate on the disastrous South Florida real estate market, not Great Country's practices, which he says are all legitimate. Asked in a phone interview whether he encourages buyers to purchase condos they can't afford, paying them questionable cash incentives, he says flatly, "That is not true." He adds: "[The buyers] are lying. They are disappointed by falling prices."

In October, however, the FHA decided it had seen enough. It ended Great Country's guaranteed-lending privileges in the Miami and Orlando markets where it had been active. Borrowers on nearly half of the company's defaulted loans made payments for only three months or less; 105 borrowers never made any payments at all. Brian Sullivan, another FHA spokesman, says the agency has referred the case to its inspector general's office. In response to *BusinessWeek*'s questions, the Florida Financial Services Dept. has started a separate investigation, a person close to the state agency says.

But don't assume that Hernandez is through with FHA-guaranteed loans. At the Palmetto Towers sales office, Alexis Curbelo, a loan officer for Great Country, explains in an interview that buyers can now obtain FHA loans through Ikon Mortgage Lenders in Fort Lauderdale. Public records show Ikon closed a Palmetto Towers FHA loan in September for $222,957. Edgard Detrinidad, Ikon's president and a former business associate of Hernandez, denies he is financing any other loans for Hernandez's buyers.

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A Warning to Homeowners

A personal finance column in *The Washington Post* in October noted that while the Federal Housing Administration's expanded $300 billion mortgage insurance program may help some struggling families keep their homes, the assistance could come at a steep price. For example, the government gets to keep half of any appreciation in the value of the house once it is sold, even after the mortgage is paid off, the Post pointed out.

For more of the Post's analysis, go to http://bx.businessweek.com/housing-market/reference.

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