Reform, not rescue

by the St. Louis Post-Dispatch

As homeowners by the millions fall behind on their subprime mortgages, cries for a government bailout are starting to echo through Washington. That would be a very bad idea. It would reward irresponsible lenders and leave the taxpayers holding the bag. Rescuing the irresponsible only leads to more reckless lending.

But there are things that government should do to ease the crisis and prevent a repeat of the current mess. For starters, Congress and the White House could light a fire under the moribund Federal Housing Administration.

Subprime loans are made to people who can't qualify for prime-rate mortgages. Generally these are people with poor credit, little savings or not enough income to safely support their home loan.

Long before the subprime lending industry sprang up, such loans were the province of the Federal Housing Administration. The FHA insures mortgage loans made by private lenders. That allows borrowers to borrow at rates 3 percentage points below comparable subprime loan rates. But the FHA bureaucracy long ago became sluggish and unresponsive. Until last year, it required lenders to send bulky loan applications in by mail, while subprime lenders often approved loans quickly and electronically. The FHA also was extremely picky about home inspections, insisting, for example, that missing doorknobs be fixed before it would approve a loan.

As a result, FHA loans fell into disfavor with real estate agents, lenders and borrowers alike. Meanwhile, subprime lenders were out ballyhooing their wares on television and radio. As a result, the FHA's market share dropped.

"People who could have come to the FHA for loans were steered toward these predatory subprimers instead," said John Taylor, president of the National Community Reinvestment Coalition.

The FHA never let its underwriting standards fall as far as many subprime lenders' - a good thing for taxpayers whose dollars guarantee the loans. For instance, the FHA still wants a 3 percent down payment.

But the FHA certainly could help some homeowners out of their current subprime jam. By some estimates, a quarter of the people with subprime loans would have qualified for prime loans if they had gone to a bank or savings and loan rather than to a subprime lender's office.

Taylor, whose group advocates lending reform for the poor, wants the FHA to launch a full-fledged campaign to rescue homeowners faced with default on subprime loans. Under his plan, the FHA would guarantee loans at interest rates that low-income homeowners could afford, letting them avoid foreclosure.

It's hard to see how this could work without shifting losses from subprime lenders to the government or without saddling taxpayers with shaky loans. The idea is worth exploring on a limited basis, but it shouldn't turn into a full-blown bailout.

In the long run, the FHA should streamline its procedures and speed up its loan approval process, something the agency claims is under way now. Then, it will need a rebranding effort to repair its image among borrowers and lenders.

The FHA also wants permission to make no-down-payment loans and charge higher fees to riskier borrowers; that would let it compete more directly with subprime lenders. But Congress should be wary here lest the FHA wind up in the same sinking financial boat as subprime lenders. The FHA's foreclosure rate is 2.19 percent, compared to 4.53 percent - and rising - for subprime loans.

Over time, the subprime crisis should be largely self-correcting. Lenders and their investors are taking a financial whipping they won't soon forget. As a result, underwriting standards are rising sharply, and fewer shaky loans will be made in the future.

Government generally should take a light hand in regulating lending, lest it unintentionally cut off credit on which the American economy runs. But government could and should rein in some of the sleazier practices in the subprime industry, including predatory loans laden with useless fees and exorbitant interest rates that push borrowers inexorably toward foreclosure.

Prepayment penalties should be outlawed; they trap borrowers in high-priced loans when they could qualify for cheaper ones. There should be limits on outrageous fees added to loan amounts. The law should provide penalties for lenders and brokers who put people into mortgages they can't possibly support on their income. Disclosure statements should be stronger and spell out for borrowers how their payments may rise when "teaser" rates expire.

Congress and state legislators would do borrowers and the lending industry a favor by booting the predatory lenders out of the market.

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