The Heritage Foundation Backgrounder UPDATE

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LIMITING THE DAMAGE FROM THE FEDERAL HOUSING ADMINISTRATION COLLAPSE

(Updating *Issue Bulletin* No. 148, "S.565: Pushing the Federal Housing Administration Toward Bankruptcy," June 12, 1989, and *Backgrounder* No. 528, "How Congress Can Defuse the Federal Housing Administration Time Bomb," July 29, 1986.)

The General Accounting Office (GAO) audit of the Federal Housing Administration released late last month shocked even the most pessimistic observers of FHA's deeply troubled operations. The audit shows that FHA lost a staggering $4.2 billion last year, and the government's equity in FHA, essentially the reserves to back $303 billion of insurance in force, fell to a minus $2.9 billion.

The GAO report shows clearly that the FHA has been suffering from some of the worst management in government, and that its basic programs are fundamentally flawed. Urgent action is needed and Housing and Urban Development Secretary Jack Kemp last week outlined the first steps that should be taken. But his proposals are only first steps: more sweeping reform is required.

Continuing Losses Likely. The GAO report makes clear that FHA's problems have fallen squarely into the lap of the taxpayer, who will be called upon yet again to bail out another badly managed federal credit program. The FHA is the fourth major federal credit program since 1987 to lose more than $4 billion; the Farm Credit Administration, the Federal Savings and Loan Administration, and the Federal Deposit Insurance Corporation all have done as badly or worse. FHA losses likely will worsen, notes the GAO audit, and even if Congress and HUD institute fundamental reform at FHA, the taxpayer still will have to pick up the tab for much of the financial collapse that already has occurred. Noting that the amount of insurance written by FHA has soared in the past few years, and that these insured mortgages have reached the point where losses normally are the greatest, the GAO audit contends that mortgage "...defaults are likely to continue at a relatively high level, at least in the near term." And, according to the audit, uncertainties regarding the ultimate outcome of investigations into fraud, embezzlement, and other illegal acts suggest that "...the losses may be greater than those reported in the financial statements."

Warnings Ignored. Most lawmakers, faced with another federal financial fiasco, express shock at the GAO report. But they have had plenty of warning. Over the past several years, numerous GAO audits and Inspector General reports pointed to persistent financial problems at FHA, and a 1986 Heritage Foundation study warned of the impending collapse.[1] All warnings were ignored by Capitol Hill and the housing industry alike. Indeed, the National Association of Realtors, a real estate trade association, charged that the Heritage study "grossly exceeds the bounds of thoughtful analysis."[2]

The Senate, meanwhile, is considering a bill by Alan Cranston, the California Democrat, and Alfonse D'Amato, the New York Republican (S.565) that would make the FHA situation even worse and increase the agency's losses.[3] Despite the fact that low downpayments are the single greatest contributor to high FHA default rates and losses – almost 40 percent of the 1982 FHA mortgages with downpayments of less than 3 percent have gone into default – the Cranston-D'Amato bill would allow even lower downpayments. Since FHA already permits the equivalent of loans in excess of 100 percent of the value of the property, by allowing borrowers to finance both the mortgage insurance premium and some settlement costs, a reduced downpayment would cause FHA losses to skyrocket. When home prices increase only modestly or not at all, FHA borrowers already find it in their financial interest simply to walk away from their property, as they have been doing by the tens of thousands, and leave FHA with the costs of disposition. Reducing the downpayment would make owners even more likely to default.

Variable Rationale. Some lawmakers also want to increase the size of the mortgage that FHA can insure, from the current $101,250 to a variable cap that could be in excess of $200,000 in some communities. Their rationale for this proposal changes from day to day, but none of their reasons make much sense. The purpose of raising the limit at first was said to be to enhance housing affordability in some of the high cost areas of the country. When asked if that meant the rich should be subsidized to afford expensive housing, supporters shifted the rationale to one of enhancing FHA solvency, arguing that the increase in business would bring in more premiums. But the problem with this is that it would also mean more losses in the future – losses that likely would exceed the volume of new premium income and so worsen FHA's plight. An independent consultant to FHA explains that the higher loan values could lead to greater losses because much of the new business probably would be in the form of risky low downpayment mortgages. Given FHA's staggering losses, this seems hardly the time to take a chance of adding greater risk to the agency's portfolio.

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1 Stephen Moore, "How Congress Can Defuse the Federal Housing Administration Time Bomb," Heritage Foundation *Backgrounder* No. 528, July 29, 1986.

2 "Realtors Counterblast Criticism of FHA by Heritage Foundation," *Daily Commerce*, Los Angeles, CA, September 30, 1986.

3 Ronald Utt, "S.565: Pushing the Federal Housing Administration Toward Bankruptcy," Heritage Foundation *Issue Bulletin*, No. 148, June 12, 1989.

With the FHA in bad and deteriorating shape, Congress and the Bush Administration must work together to enact reforms to restore solvency. The recommendations of the President's Commission on Privatization,[4] which examined FHA in 1988, along with Heritage Foundation and GAO suggestions, are a basis for a genuine reform effort. Among these recommendations:

1) **Overhaul FHA's system of management**, accounting, and financial controls so that those responsible for the program can identify problems take prompt action.

2) **Refocus FHA insurance** on the first-time homebuyer of modest income so that FHA can devote its limited resources where it is needed the most instead of spreading itself thinly across several markets, often in competition with the private sector.

3) **Terminate immediately** the FHA insurance programs for vacation homes, investor properties, and refinancings. These programs have led to substantial losses while drawing funds away from FHA's primary mission.

4) **Require a downpayment** of no less than 5 percent of the cost of the property. Loans with downpayments of 5 percent or more have much lower default rates than those with 3 percent or less and also entail lower losses to FHA because of the larger equity cushion.

5) **Make a sustained commitment** to rebuild the FHA reserves to 4 percent of the agency's insurance in force, through a combination of higher premiums and better underwriting.

Early this month, HUD Secretary Kemp recommended a package of bold reforms, including a substantial overhaul of FHA's accounting and financial control systems, termination of some of the most abusive practices and programs, and a series of proposals to end FHA insurance on mortgages used to acquire vacation homes and investor properties. This is a good start and deserves congressional support. But as the GAO report makes clear, much more needs to be done.

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4 *Privatization: Toward More Effective Government,* Report of the President's Commission on Privatization, University of Illinois Press, 1988.