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S. 565: PUSHING THE FEDERAL HOUSING ADMINISTRATION TOWARD INSOLVENCY

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INTRODUCTION

The Federal Housing Administration (FHA) was created in 1934 to revive the badly depressed residential real estate market and create greater opportunities for homeownership. For years, the FHA did this well, contributing to improvements in housing standards and expanded homeownership for Americans of modest means. In recent years, however, the FHA's balance sheet has been badly battered by rising loan defaults, foreclosures, and insurance claims. This poses a threat to home buyers, who may have to pay higher fees to receive federal insurance, and to taxpayers, who have the ultimate obligation to rescue the finances of FHA.

The FHA's condition will be further jeopardized if proposals before Congress become law. In particular, the National Affordable Housing Act (S. 565), introduced by Senators Alan Cranston, the California Democrat, and Alphonse D'Amato, the New York Republican, would modify the FHA program by permitting lower downpayments on all FHA-insured loans, allowing extra downpayment concessions for first-time buyers, and by raising the maximum size of federally insured loans from the current $101,250 to an amount equal to 95 percent of the median house sales price for each region of the country. This last change would double the maximum size of FHA loans in high cost areas. George Bush gave a general endorsement to such proposals during last year's election campaign, and his administration is now considering its formal position on the FHA plan and the other features of Cranston-D'Amato.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

Numerous studies demonstrate that low downpayment loans lead to greater risk exposure for the FHA fund because these loans experience much higher default and foreclosure rates and incur proportionately larger losses per loan when a foreclosure takes place. Currently, FHA insured loans with downpayments of 3 percent or less experience insurance claims at about twice the rate as FHA loans with downpayments of 5 percent or more. And while lower downpayments may help those few buyers who have not yet saved enough for the downpayment, in general this does not help lower-income buyers because the reduced downpayment comes at the expense of higher monthly mortgage payments. Moreover, raising the maximum loan amount would expand the FHA into the market already served by private mortgage insurance companies (PMIs) and allow richer Americans to use a government-supported program to purchase expensive homes. Between 1985 and 1986, the FHA expanded its market share from 36 percent to 57 percent of the insured mortgage market, while that for the PMIs fell from almost two-thirds to less than half over the same period.

Losing $40 Million a Month. Not only would the proposed changes for FHA do little or nothing to make houses more affordable for average Americans or open up greater homebuying opportunities to those with lower incomes, the changes would undermine further the already shaky FHA mortgage insurance fund. Poor underwriting standards, low downpayments, and excessive risk-taking have combined with weak regional real estate markets to raise the default rate and substantially increase claims against the insurance fund. At present, FHA is losing $40 million a month. Lowering the downpayment for FHA insurance would increase this default rate. Two recent reports by the General Accounting Office(GAO)[1] warn that a worsening of these underlying conditions could require a Treasury bailout of the FHA.

To avoid the danger of FHA becoming a carbon copy of the savings and loan disaster, the President and Secretary of Housing and Urban Development should reject the changes for FHA contained in S. 565. They should urge lawmakers to adopt reforms to protect the taxpayer and better serve potential homebuyers by strengthening the financial position of the FHA program.

Among the necessary steps:

♦ ♦ FHA should focus on the first time buyer and those with modest incomes.

♦ ♦ FHA should stop insuring mortgages on vacation homes, investor properties, and refinancings.

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1 *Federal Housing Administration's Accounting Methods and Section 203(b) Program* and *Federal Housing Administration Fund's 1987 Statement of Financial Position,* United States General Accounting Office, May 1989.

♦ ♦ The minimum downpayment should be no lower than 5 percent of the cost of the property.

♦ ♦ FHA should begin to build reserves equal to 4 percent of FHA's contingent liabilities.

Without these and other necessary reforms, rising claims and losses at FHA ultimately might have to be covered by the taxpayer.

THE DETERIORATING FINANCIAL CONDITION OF FHA

For many of the same reasons that large numbers of savings and loan associations have slipped into terminal insolvency, the FHA mortgage insurance programs have been struggling with mounting financial problems. The result: FHA losses are increasing the unified federal budget deficit and eroding FHA's reserves. Rapid increases in claims filed by lenders against the FHA fund, which have jumped from $2.9 billion in 1986 to $4.4 billion in 1988, and are estimated to hit $6.6 billion in 1989, are the chief source of the problem.[2] And because revenues from premiums are expected to decline, FHA losses will rise at an accelerating rate. This year's losses, moreover, could be even worse than estimated, since the unanticipated housing downturn will cut deeply into premium revenues while generating additional delinquencies and defaults. Mortgages delinquent more than 60 days accounted for 5.5 percent of FHA mortgages at the end of 1988, compared with 5 percent in the third quarter and just 2 percent in 1979.[3]

Despite the threat of insolvency, with its potential for a huge taxpayer bailout of yet another federal finance agency, some in Congress and the Bush Administration support FHA changes that would lead to greater losses. Two major changes are proposed: 1) a reduction in the required downpayment, to as low as one percent in some instances; and 2) an increase in the maximum loan size that FHA can insure. Lawmakers claim these changes are necessary to make homeownership easier for Americans.

HOW LOW DOWNPAYMENTS LEAD TO HIGHER LOSSES

Efforts to expand homeownership opportunities by lowering the downpayment (which raises the loan-to-value ratio) would jeopardize the fund in two ways. First, the higher loan-to-value ratio would reduce the borrower's equity and, hence, the financial cushion between the estimated value of the property and the loan insured by FHA. Unless there is a rapid appreciation in the property's value, foreclosures on high loan-to-value

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2 *Special Analyses, Budget of the United States Government, Fiscal Year 1990* (Washington, D.C.: U.S. Government Printing Office, January 1989), p. F-18.

3 *Ibid.*, p. F-45.

mortgages lead to substantial losses for an insurer because the foreclosure and disposition costs, and other expenses, exceed the borrower's equity.

Reduced Financial Stake. Second, low downpayment mortgages have a much higher probability of going into default and foreclosure than mortgages with higher borrower equity contributions. Notes a recent General Accounting Office report, "Claim rates are higher for higher loan-to-value ratios (i.e., when the loan represents a greater portion of the mortgage's property) and vice versa."[4] The reason for this is that without a significant financial stake in the property, overstretched borrowers are less inclined to meet their borrowing obligations because there is little or no cost associated with simply walking away from the property when payments become difficult to afford. When the value of the property falls below the value of the loan – a common situation when downpayments are very low – default is even more likely.

An example illustrates why low downpayment mortgages are more likely to go into default and foreclosure and cost the FHA much more if they do. Under current law, an individual buying a house costing $100,000 would be required to make a minimum downpayment of $4,500 to be eligible for an FHA-insured mortgage to finance the remaining $95,500 of the purchase price. The buyer also would be permitted to finance the 3.8 percent FHA insurance premium as well as the likely one percent (or one "point") origination fee that the lender would charge at settlement. These charges add $4,584 to the loan, bringing the total amount financed with FHA insurance to $100,084.

Walking Away from Homes. The buyer thus has incurred $100,084 in debt to acquire a property worth $100,000, resulting in a loan-to-value ratio in excess of 100 percent. This could be a problem later if the owner in this example has to sell the house. Suppose the owner lives in one of those communities experiencing only limited appreciation in house prices. It is likely therefore that the house can now be sold for just $102,000. If the house is sold for this amount, say, two years later, with likely settlement costs of approximately $7,650, the net proceeds would be $94,350. This is $4,564 short of the partially amortized loan that the owner must pay off. The choice thus confronting this homeowner is whether to try to raise money to pay the deficiency or simply to walk away from the property and leave it to FHA. Great numbers of such homeowners obviously are walking away from their homes. This is why the FHA probably will have to pay out $6.6 billion in claims this year.

FHA's claims experience shows that loans with loan-to-value ratios above 97 percent experience losses at rates about twice as high as those with ratios of 95 percent or less. For example, the claim rate for FHA low downpayment

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4 *Federal Housing Administration's Accounting Methods and Section 203(b) Program, op. cit.*, p. 40.

97 percent loans made in 1981 and 1982 amounted to approximately a third of the dollar volume of such loans insured.[5] Some of the proposals before Congress that would substantially reduce the downpayment also would require the borrower first to submit to counseling. But the potential financial disincentives confronting the borrower likely would overwhelm this charmingly naive effort to instill good behavior.

HOW HIGHER LOAN LIMITS WOULD HELP RICH AMERICANS BUY EXPENSIVE HOUSES

The other proposed change in FHA rules would raise the mortgage limit above the current $101,250 cap. This would not make housing more affordable for first time buyers or for buyers with moderate incomes. If households cannot afford the lower-priced homes now eligible for FHA insurance, they certainly cannot afford even more expensive houses. Concludes a recent Congressional Research Service report: "Many areas have an affordability problem - incomes have not kept pace with rising home prices. Raising the FHA limit, however, does not address the problem. If the family cannot afford the home, the level of the FHA limit does not matter."[6]

Borrowers qualifying for larger mortgages already are served adequately by the private mortgage insurance industry — at no risk to the taxpayer. Moreover, raising the FHA limit could contribute to greater FHA losses in the future because the increase in the size and number of risky high loan-to-value ratio mortgages would subject the FHA insurance fund to a greater number of larger potential loan losses. Although this change could create the appearance of short-term benefits as the larger loan limits expand FHA market share and generate more premium revenues to offset the rising number of claims now being submitted, this gain will be at the expense of higher future losses because such losses tend to be at their highest during the second through the fourth year of the mortgage.

THE FEDERAL TAKEOVER OF THE MORTGAGE MARKET

There are other concerns with proposals that would expand the use of FHA mortgages. In particular, by expanding FHA's market share, these proposals would lead to a further federalization, or nationalization, of the residential mortgage insurance market. This would unfairly crowd out existing private sector insurers who must pay taxes on their profits and who require no subsidies or protection from the Treasury to remain in business. Through

5 *Ibid.*
6 "Federal Housing Administration: Raising the Mortgage Limit," Congressional Research Service, April 19, 1989, p. i.

1985, private mortgage insurance (PMI) had a larger market share than the FHA. But that situation reversed dramatically the following year. By 1987, the FHA was insuring twice as many mortgage dollars as were the PMIs.[7] Raising the FHA cap would cause a further decline in the market share held by the PMIs and a corresponding increase in the share backed by the taxpayers' checkbook.

Crowding Out Private Providers. The federal crowding out of the PMIs is not an isolated situation. It has been matched by the other forms of federal and federally sponsored mortgage credit support during the 1980s. Whereas such federal support covered just 17 percent of outstanding mortgage debt in 1980, the federal share rose to 29 percent last year, as the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), FHA, and the Government National Mortgage Association (GNMA) expanded their activities and displaced private providers of mortgage credit and insurance. By 1987 more than a third of the increase in the outstanding mortgage debt was accounted for by federal and related agencies.[8]

Such growth in liabilities exposes the government and thus the taxpayer to increasingly large levels of risk. According to last month's GAO report on FHA, at the end of 1987 the FHA had a meager $1.2 billion in equity to support a staggering $277 billion of insurance-in-force.[9] Because losses have risen significantly since then, FHA's equity could be lower today. Moreover, the FHA's ratio of equity and reserves to insurance is well below the level that states require PMIs to maintain to do business with their citizens.

FNMA is not in much better shape. A 1989 report on FNMA by the U.S. Department of Housing and Urban Development concludes that in 1987 it had only $1.8 billion in accounting net worth to support its $97 billion portfolio of mortgage loans and its $140 billion in mortgage-backed security guarantees. Because interest rates have risen since this estimate was made, FNMA's equity, measured on a "mark-to-market basis" which values assets at their market value rather than book value, could be smaller today.[10]

7 *Privatization: Toward More Effective Government*, Report of the President's Commission on Privatization, University of Illinois Press, 1988, p. 30, and the Mortgage Insurance Companies of America.
8 *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, 1989), p. 395.
9 *Federal Housing Administration Fund's 1987 Statementof Financial Position*, *op. cit.*, p. 3.
10"1987 Report to Congress on the Federal National Mortgage Association", Office of Policy Development and Research, U.S. Department of Housing and Urban Development, Chapter One, p. 6.

THE NEED TO REBUILD FHA'S FINANCIAL SOLVENCY

Given taxpayer concern over their enormous exposure to housing credit risks, and the rising losses at the FHA, lawmakers should be taking prompt action to return the FHA to sound financial footing, not adding risk to its portfolio. This can be done while maintaining FHA's historic commitment to assist families of modest incomes to buy homes. As a start, FHA activities should be refocused on these moderate-income buyers. This means dropping lines of business that expose the agency to potential losses while doing nothing to assist the first time buyer or the buyer of modest means.

Basis for Reform. The 1988 recommendations of the President's Commission on Privatization[11] and those developed by The Heritage Foundation in 1986[12] could serve as the basis for a substantive reform effort. In its final report, the Privatization Commission recommended that FHA concentrate on those potential buyers who might otherwise not be adequately served by the private sector. To achieve this, the Commission recommended that FHA limit or restrict coverage for borrowers with high incomes, buyers of vacation homes, borrowers who seek large mortgages, those wanting to refinance their homes, and investors who intend to rent out the premises being financed.

FHA's experience with the insurance of mortgages used to acquire property for investment illustrates why the FHA should return to its traditional functions. Although such loans amount to only 12 percent of the insured portfolio, they account for 30 percent of the defaults.[13] Insurance for mortgages used to acquire vacation homes also should be ended, since FHA's depleted reserves should not be exposed to the financial risks generated by second homes. Similarly, high valued mortgages should be discouraged: they expose FHA to additional risk while doing little or nothing to assist the families that FHA was intended to help.

In addition to the reforms proposed by the Privatization Commission, recommendations have been offered by Heritage Foundation Grover M. Hermann Fellow Stephen Moore. These include:

1) Requiring the FHA to build sufficient reserves.

These should equal 4 percent of FHA contingent liability; this is the same level required of private insurers. With these reserves, the FHA would have sufficient funds to cover unexpectedly high losses.

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11 *Ibid.*, Chapter 3.

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

13 "Curbs on Government-Backed Mortgages are Instituted by Reagan to Battle Fraud," *The Wall Street Journal*, April 4, 1986, p. 3.

2) Requiring a minimum downpayment of 5 percent of the purchase price from homebuyers obtaining FHA insurance.

Low downpayments are one of the greatest contributing factors to high default rates and insurance claims. Decreasing these losses by raising the required downpayment just a few percentage points will improve FHA's financial position.

3) Imposing a 5 percent coinsurance requirement on the lender on direct endorsement loans.

A coinsurance requirement means that the lender shares a portion of the risk of default. In this case, 5 percent of the losses on a defaulted FHA loan would be borne by the lender. By requiring the lender to underwrite a portion of the insurance on the loans it originates, the FHA would have greater protection against fraudulent claims.

4) Phasing in an income cap on participation in the FHA mortgage insurance program.

An income cap on FHA insurance eligibility would return FHA to its proper role of helping moderate-income homebuyers. After a phase-in over several years, a permanent cap should be set at 140 percent of the area's median family income, thus assuring access to the housing credit market to low- and middle-income families. By phasing in the income limit slowly, Congress would minimize any possible short-term disruptions to the housing market that might be caused by FHA's contraction.

CONCLUSION

The recommendations of the President's Commission on Privatization, together with those proposed by The Heritage Foundation, would help refocus the FHA toward those home buyers of modest means who need help in qualifying for their first home loan. At the same time, these recommendations would begin the process of making the FHA's insurance fund more solvent and thus limiting the potential liability confronting the taxpayer.

Pattern of Bailouts. The 1980s have seen the unraveling of the federal government's vast collection of questionable credit programs in support of politically influential constituencies. The 1987 bailout for the federally sponsored Farm Credit Administration was the first major credit disaster of the decade and cost the taxpayers more than $4 billion. That, however, was a mere *hors d'oeuvre* to the $285 billion that the General Accounting Office estimates the American taxpayer will have to pay to resolve the savings and loan fiasco.[14]

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14 "GAO Puts Cost of S&L Rescue at $285 Billion," *The Wall Street Journal*, May 22, 1989, p. A4.

Risk of Collapse. Will FHA be next? It already is edging precariously close. In its recent audit of FHA for the GAO, the international accounting firm of Price Waterhouse notes that the fund was sound at the end of 1987, but adds that a study by an independent contractor concludes that it would barely survive a severe regional downturn without U.S. Treasury support.[15]

Such an possibility cannot be ruled out. With the housing market weakening in response to high interest rates and with the economy of the Southwest yet to recover, lawmakers should be taking urgent action to repair the financial foundations of the FHA, not further undermining the fund with ill-considered proposals that increase the risk of FHA's collapse.

15 *Federal Housing Administration's Accouting Methods and Section 203(b) Program*, *op. cit.*, p. 12.

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