No. 512 March 9, 1998

HUD Wants Federal Housing Administration to Offer More Corporate Welfare

Ronald D. Utt, Ph.D.

Housing and Urban Development (HUD) Secretary Andrew Cuomo is asking Congress to expand the agency's meddling in the private mortgage market by increasing the Federal Housing Administration's insurance coverage to $227,150 on mortgages throughout the country. The new proposed maximum is more than twice the average FHA loan made today under loan limits that range from $86,300 for low-cost areas to $170,362 in high-cost communities. Cuomo's proposed increase would expand the role of the taxpayer-funded FHA from helping modest-income, first-time home buyers to underwriting insurance for riskier mortgages in upper-income neighborhoods. Congress should reject the Secretary's request and encourage him to focus his attention on the swift resolution of the many serious management problems that diminish HUD's ability to help those in greater need.

FHA's current limits are sufficient to finance, at low down payments, half the existing houses sold in America. They also accommodate the needs of first-time buyers and repeat buyers of moderate incomes. Although HUD claims that private insurers are interested only in "cherry picking" less risky mortgages, private mortgage insurance offers FHA serious competition for the home buyer's business even at the low end of the market. According to data from the Home Mortgage Disclosure Act, the private insurance industry insured 40 percent of the low down payment mortgages under $85,000, the current average size of FHA loans. FHA covered 49 percent of such loans while the Department of Veterans Affairs (VA) and others covered the rest. Significantly, 73 percent of all mortgages made for $85,000 or less were provided by the private sector because the borrower made a down payment large enough to obviate the need for any mortgage insurance.

Produced by
The Domestic Policy
Studies Department

Published by
The Heritage Foundation
214 Massachusetts Ave., N.E.
Washington, D.C.
20002-4999
(202) 546-4400
http://www.heritage.org

By raising the current caps to Cuomo's proposed limits, FHA would expand into a market of well-to-do buyers who do not need government assistance. If FHA were allowed to operate up to Cuomo's $227,150 cap, it would be assisting households with incomes above $80,000, the minimum needed for a loan this large. Only 14 percent of U.S. households have an income this high, and 87 percent of those that do already own a house.

As troubling as this misplaced generosity seems, HUD's expansion into higher cost houses also exposes FHA to losses greater than those already charged against its reserves. Under current law, a family buying a $100,000 house could get FHA to

insure the loan for $99,592, or nearly 99.6 percent of the collateral, because FHA allows buyers to finance the settlement costs and the up-front FHA insurance premium. These extras eat into the 4.6 percent down payment that FHA would require on a $100,000 house. With FHA insuring a loan that is nearly equal to the value of the collateral, there is no equity cushion to protect the insurer, and the first dollar lost is a loss passed onto FHA.

Such losses are more likely to occur in periods of price decline or stability like the present. Because selling and settlement costs equal about 10 percent of a property's value, a home bought with 100 percent financing must rise more than 10 percent in value for the net sales proceeds to cover the outstanding mortgage. During periods of low inflation, when home prices are flat, subsequent sales of homes carrying FHA mortgages could yield a loss to the seller, who might chose simply to walk away from the house and leave the problem to FHA.

Problems caused by inadequate equity are exacerbated by higher loan limits because larger loans go into default more frequently than smaller ones. Data from the Mortgage Insurance Companies of America show that default rates for low down payment loans of more than $200,000 are three times higher than those for loans in the $50,000 to $74,000 range. Because the FHA, even when confined to loans of more modest amounts, experiences delinquency rates much higher than conventional loans—8.13 percent compared to 2.78 percent—the combination is a recipe for disaster.

Such a disaster would worsen the rising losses now occurring in FHA. According to budget data provided by HUD to Congress, FHA's 1997 property acquisitions through foreclosure were up 117 percent, or $2.3 billion, from initial projections. FHA anticipates that higher foreclosures will continue, and 1998 acquisition estimates have been revised from the initial $1.9 billion to almost $4 billion. FHA expects this trend to continue through 1999. With FHA's out-of-pocket losses typically running at a rate equal to about 30 percent of the value of the loan on the foreclosed property, the unanticipated property acquisitions in 1997 and 1998 could lead to additional losses of a staggering $1.26 billion against FHA's reserves.

Given the potential risks FHA would assume for no other purpose than to extend its reach to upper-income buyers, it is hard to imagine why HUD would propose such a change. One explanation could be the financial windfall that would accrue to companies that benefit from an increase in FHA activity. Under current practice, most mortgages, once made, are later sold to investors in the secondary market at a price to yield an interest rate 50 basis points (half a percentage point) less than the interest rate paid by the borrower. For private insured mortgages sold to secondary investors, this 50 basis point difference is split evenly between the mortgage originator and the investor, with the 25 basis points received by the originator as compensation for the cost of servicing the mortgage (collecting monthly payments and managing escrow accounts).

But for FHA mortgages, which are packaged into federally guaranteed pass-through securities and sold to secondary investors, federal law mandates that the originator receive 44 of the 50 basis points as compensation for servicing the loan—an amount nearly twice what would be received for servicing a privately insured mortgage. Thus, for every additional $1 million in mortgages that an originator can shift from private to FHA insurance, the originator's annual revenues will rise by an additional $2,100. Because no additional servicing costs would be incurred by the shift to FHA mortgages, the additional revenues would be pure profit.

Congress should reject Secretary Cuomo's scheme to extend corporate welfare to a privileged few financiers at the expense of private mortgage insurers and the FHA's own dwindling reserves.

—Ronald D. Utt, Ph.D., is a Visiting Fellow in Economic Policy Studies at The Heritage Foundation.

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