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Why Raising the FHA Mortgage Insurance Limit Would Be Bad Policy

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As Congress moves to consider the House and Senate appropriations bills for the Departments of Housing and Urban Development (HUD) and Veterans Affairs (VA), lawmakers will have to consider provisions to raise the maximum mortgage amount that can be backed by the Federal Housing Administration (FHA) insurance fund. If ultimately enacted into law, these provisions would expand the federal government's role even deeper into the residential mortgage market, provide windfall profits to a select group of mortgage financiers, undermine the viability of private mortgage insurers, and expose the U.S. taxpayers to a costly bailout for the already faltering FHA insurance fund.

Since early this year, the FHA has been confronting much-higher-than-expected loan defaults and insurance claims. According to budget data provided to Congress by HUD, the FHA's 1997 property acquisitions through foreclosure were up 117 percent, or a staggering $2.3 billion, from initial projections. The FHA further announced that it anticipated this higher rate of foreclosure to continue, and that it was revising 1998 foreclosed property acquisition estimates upward from an initial $1.9 billion to almost $4 billion. The FHA's declining confidence in the quality of its mortgage insurance portfolio has been justified by events. In the first quarter of 1998, despite the booming economy and rising employment throughout the United States, the FHA's delinquency rate reached an all-time high of 8.35 percent, meaning that nearly one in ten FHA borrowers were behind in their payments. This compares with a default rate of just 2.91 percent on conventional mortgages, the market on which the FHA seeks congressional approval to encroach.

Apparently having learned little from the devastating collapse of the savings and loan industry in the 1980s and the subsequent scandals that revealed shoddy underwriting standards in billions of dollars of mortgages, some Members of Congress are proposing that the FHA be allowed to insure a greater share of the market by moving into riskier, higher-valued mortgages. They also are recommending that the FHA's minimum down-payment requirement be reduced from its already inadequate levels. Minimal down-payment requirements under current law allow the FHA to insure 99.6 percent of a $100,000 loan, leaving little or no equity cushion to protect FHA reserves in the event of loan default and/or foreclosure.

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HUD Secretary Andrew Cuomo has proposed that the FHA maximum loan limit be increased to

$227,150 throughout the country, and that FHA's already generous down-payment requirements be made even more generous. House and Senate appropriators have agreed to propose much of what Cuomo is asking for: upping the regional cap on the minimum loan from $86,000 to $109,000, raising the maximum cap from $170,000 to $197,000, and allowing borrowers to make an even smaller down payment.

If enacted into law, these changes would worsen an already deteriorating situation within the FHA's insured portfolio by exposing it to disproportionately greater risks. With FHA out-of-pocket losses typically running at a rate equivalent to 30 percent of the value of the loan on the foreclosed property, the unanticipated foreclosed property acquisitions in 1997 and 1998 could lead to additional losses of $1.26 billion against the FHA's reserves.

Rather than placing the taxpayer at far greater risk of having to pick up the tab on foreclosed FHA-backed mortgages, a better alternative for Congress to consider is an amendment to the Senate bill that will be offered by a bipartisan coalition composed of Senators Don Nickles (R–OK), Herbert Kohl (D–WI), Connie Mack (R–FL), Wayne Allard (R–CO), and Russell Feingold (D–WI). Their amendment would raise the floor on the maximum-size mortgage the FHA can insure from the current $86,000 to $109,000 to target first-time and moderate-income home buyers more accurately while also eliminating much of the windfall corporate welfare benefits FHA mortgages bestow on some mortgage financiers. Whereas conventional mortgages allow mortgage originators to keep just 20 to 25 basis points in servicing fees, the FHA currently allows them 44 basis points, which largely explains the real estate industry's enthusiasm for the further federalization of the market. Under the bipartisan coalition's plan, these excessive servicing fees would be cut back to 38 basis points, with the 6-basis-point difference applied to the Government National Mortgage Association, a part of HUD that repackages and reinsures FHA and VA mortgages for final sale to investors.

Although the bipartisan coalition's amendment is a step in the right direction, an even better alternative would be for Congress to reject any expansion of the FHA's scope and instead hold oversight hearings to determine the reason the FHA and the mortgage originators that use the program have done such a consistently poor job of maintaining the financial integrity of a program that could be of considerable value to first-time home buyers. By failing to achieve underwriting standards common in the conventional mortgage market, the existing management of the FHA has exposed the U.S. taxpayer to the risk of a costly bailout and made it likely that many more FHA home buyers will face the humiliation and financial loss of foreclosure.

—Ronald D. Utt, Ph.D. is Grover M. Hermann Fellow in Federal Budgetary Affairs at The Heritage Foundation. For additional information, see the author's "HUD Wants Federal Housing Administration to Offer More Corporate Welfare," Heritage Foundation Executive Memorandum *No. 512, March 9, 1998.*