

ISSUE BRIEF

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Will FHA Require the Next Round of Housing Bailouts from the Taxpayer?

John L. Ligon

The conventional mortgage market has tightened lending standards in the past few years and, consequently, witnessed a decline in delinquency rates with fairly clear lines in credit quality of borrowers and reasonable requirements on borrower collateral (generally a 20 percent down payment to avoid private mortgage insurance) for loan approval.

The Federal Housing Administration (FHA), however, has maintained a weaker book of loans containing a high proportion of borrowers with poor credit quality and low down payment, resulting in higher delinquency rates. The deteriorating financial health of the FHA has loomed behind the scenes until recently.

The FHA has deviated from its mission of providing support to low- and moderate income and first-time homebuyers with sound underwriting standards. The FHA should eliminate its current practice of supporting homeownership among high-income individuals and setting lending standards that undermine sustainable homeownership for creditworthy low- and moderate-income and first-time homebuyers.

Taxpayers and Homeowners at Risk. The FHA's core mission of targeted homeownership

support encourages individuals to save and create opportunity for responsible working-class homeownership. The FHA does not make the loans itself, but sets lending guidelines and provides 100 percent insurance coverage on mortgage loans made by approved lenders.¹

While delinquency rates have recently decreased in most of the conventional mortgage market, the delinquency rate in the FHA portfolio remains high. More than 16 percent of FHA loans have been 30 days or more delinquent over the past two years; over 11 percent are 60 days or more delinquent.²

The high rate of delinquency and default on loans seriously impacts the financial solvency of the FHA book of loans.³ The FHA backs a total loan portfolio over \$1 trillion—even though it has a little more than \$1 billion (or 0.1 percent) in capital, leaving it with a forward capital shortfall—portfolio insolvency—in the range of \$20 billion per year.⁴

The losses in the FHA insurance fund are likely to continue and could ultimately necessitate a substantial taxpayer bailout.

FHA Homeownership Support Beyond Creditworthy Working-Class Homebuyers. The FHA has a core mission of providing targeted support to creditworthy low- and moderate-income, minority, and first-time homebuyers. The FHA cannot responsibly achieve these intended objectives when it is expanding its market share and competing with the conventional market for high-cost mortgage loans.

The conforming loan limit in FHA's book of loans is 16 percent higher than the conforming limit in the conventional mortgage market. The Housing and Economic Recovery Act of 2008 (HERA) increased

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The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

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the maximum conforming loan limit for mortgages in the FHA and other government-sponsored enterprises (GSEs) to \$729,750 for loans held in their respective books of business. The conforming loan limit for GSEs has since decreased to \$625,500, while the FHA loan limit has remained the same.⁵

The changes in the FHA's conforming loan limit are important for a number of reasons. First, Congress passed HERA when the housing market was very weak, with home prices about 30 percent lower than current levels. As home prices have increased and the FHA conforming limit remains \$100,000 above the conventional market, the FHA's share of the mortgage market has grown from 5 percent to nearly 30 percent in the past two years.⁶

Second, the FHA continues to set lending guidelines that effectively combine low borrower down payments and low borrower credit profiles. The concentration of loans with low down payments (less than 5 percent) has increased from about 60 percent of total loans in 2007 to over 70 percent in 2012.⁷ Moreover, the percentage of FHA loans with low credit quality remains a large share of its overall book of loans.

Third, the FHA's insurance fund faces an estimated capital shortfall of up to \$35 billion⁸ yet

continues to provide 100 percent coverage to lenders on all loans in its insurance fund.

How to Avoid a Bailout. Small yet prudent actions are necessary and urgent to decrease the credit risk in the FHA book of loans, reduce its share of the mortgage market by lowering its maximum loan limits, and establish proper incentives with lenders.

■ **Reduce market share by decreasing the FHA conforming loan limit.** The FHA should not need to insure high-cost mortgage loans and support a higher market share with an already insolvent book of loans. By the end of 2013, the FHA should lower its conforming limit to \$625,000—the same as the conventional market (including the maximum loan limit to special exclusion cases such as Alaska, Hawaii, Guam, and the Virgin Islands). Over the next four years (2014–2017), the FHA should schedule reductions in the conforming loan limit to \$350,000.

■ **Establish responsible credit requirements for borrowers.** The FHA should promote opportunity for responsible and stable homeownership while encouraging individuals to save and, overall, achieve purposeful home equity. The FHA

1. The Veterans Administration insures between 25 and 30 percent of losses, depending on the size of the loans. Private insurance companies provide similar risk sharing with lenders, generally covering between 20 and 30 percent on loan losses. See Mark Calabria, "Fixing Mortgage Finance: What to Do with the Federal Housing Administration?," Cato Institute, February 6, 2012, p. 11, <http://www.cato.org/sites/cato.org/files/pubs/pdf/bp123.pdf> (accessed May 14, 2013).
2. Edward J. Pinto, *FHA Watch*, Vol. 2, No. 5 (May 2013), American Enterprise Institute, Appendix Table A2, http://www.aei.org/files/2013/05/22/-fha-watch-vol-2-no-5-may-2013_142246828385.pdf#page=3 (accessed June 3, 2013).
3. AEI scholar Joseph Gyourko notes that unemployment is a strong predictor of default and that the FHA's default estimation model fails to account for this risk. Consequently, the FHA remains unable to accurately forecast aggregate losses on its insurance fund. See Joseph Gyourko, "Unfounded Optimism: The Danger of FHA's Mispriced Unemployment Risk," American Enterprise Institute, April 2013, http://www.aei.org/files/2013/04/24/-unfounded-optimism-the-danger-of-fhas-mispriced-unemployment-risk_122326666163.pdf (accessed May 15, 2013).
4. Matthew J. Scire, U.S. Government Accountability Office, letter to the Honorable Jeb Hensarling (R-TX) and Randy Neugebauer (R-TX), March 7, 2013, pp. 7-10, <http://www.gao.gov/assets/660/652829.pdf> (accessed May 15, 2013).
5. The maximum FHA loan limit on houses is as high as \$729,050 in most high-cost areas (\$1,094,625 is the limit in "exception" areas) in the U.S. for one-unit properties. It is about 16 percent above the conforming loan limit in the conventional market. U.S. Department of Housing and Urban Development, "Federal Housing Administration Maximum Loan Limits, Effective Period: January 1, 2013, through December 31, 2013," December 6, 2012, <http://portal.hud.gov/hudportal/documents/huddoc?id=12-26ml.pdf> (accessed May 14, 2013).
6. Scire, pp. 5-6.
7. Integrated Financial Engineering, Inc., "Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year 2012," prepared for the U.S. Department of Housing and Urban Development, November 5, 2012, pp. 46-48, http://portal.hud.gov/hudportal/documents/huddoc?id=ar2012_forward_loans.pdf (accessed May 16, 2013).
8. Peter J. Wallison and Edward J. Pinto, "Bet the House: Why the FHA Is Going (for) Broke," American Enterprise Institute, December 2011/January 2012, http://www.aei.org/files/2012/01/24/-bet-the-house-why-the-fha-is-going-for-broke_144915374900.pdf (accessed May 23, 2013).

should establish a maximum debt-to-income ratio and set a higher minimum credit score and down payment for all borrowers, effective in 2014.

- First, the FHA should establish a maximum debt-to-income ratio for all borrowers at 45 percent—for borrowers with credit (FICO) scores below 680, this limit should be set to a maximum of 40 percent.
- Second, it should set a minimum down payment for all borrowers at 5 percent of the loan—no FHA lender should be allowed to make a loan with higher than a 95 percent loan-to-value ratio.
- Third, it should establish a minimum credit (FICO) score for borrower eligibility at 620. Borrowers with scores below 680 should meet a 10 percent minimum down payment requirement and should not be eligible for mortgage term length above 20 years.

- **Increase risk sharing from FHA lenders.** FHA-approved lenders should share in the risk that accompanies the loans they originate. First, the FHA should decrease the loss insurance on all loans made by lenders from the current 100 percent coverage level to a maximum of 50 percent over the next three years (2014–2016). Second, the FHA should establish a take-back requirement for all lenders on any loans that default within six months of loan origination beginning in 2014.

The FHA's Proper Role. Addressing these reforms to FHA policy over an appropriate time frame would ensure that its practices do not undermine federal taxpayers and the low- to middle-income homeowners it intends to support. The FHA needs to properly align incentives for borrowers and lenders and return to a smaller, more targeted role in the mortgage market.

—*John L. Ligon is a Senior Policy Analyst in the Center for Data Analysis at The Heritage Foundation.*