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The Federal Housing Administration: What Record of Success?

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Abstract

Over its more than 80 years of existence, the Federal Housing Administration (FHA) has contributed to the long-run expansion in federal guaranteed mortgage debt in the U.S. financial system, increasing financial risk to both homeowners and taxpayers. Despite various reform initiatives since the 1930s, the FHA has consistently had trouble meeting safety and soundness guidelines, undermined the stability of the housing market, and in recent years required several billion dollars to cover losses. In return, the FHA's mortgage insurance programs have had minimal impact on homeownership rates, suggesting that additional FHA reforms will, at best, provide merely temporary financial improvements to the agency, without appreciable benefits to the housing market. Therefore, we argue that the FHA has outlived its usefulness to taxpayers and homeowners. Congress should eliminate the FHA and get the government out of the home financing business.

More than 80 years ago, Congress passed a series of laws that significantly expanded the federal government's presence in the housing finance system. These federal programs have grown and contributed to an explosion of mortgage debt over the past few decades. Homeownership rates, however, have barely changed since the late 1960s.

The long-term increase in mortgage debt spurred by these federal programs exposes homeowners and taxpayers to significant financial risks. The government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, which still reside in federal conservatorship, received significant attention after a $200 billion bailout in 2008. Less known is that the Federal Housing Administration

Key Points

- The Federal Housing Administration (FHA) has had minimal long-term impact on increasing homeownership in the United States.
- At best, the FHA's single-family mortgage insurance program accelerates homeownership for individuals who would otherwise obtain home loans in the conventional market a few years later.
- Research suggests that all federal housing finance programs combined explain at most 13 percent of the growth in homeownership between 1940 and 1960, with the VA accounting for around 7 percent.
- After accounting for market risk, the FHA is more likely to cost the federal taxpayer billions of dollars annually than generate "savings."
- No conceivable economic externality justifies federal taxpayer support of high-cost home loans, yet the FHA insures such mortgages.

This paper, in its entirety, can be found at **http://report.heritage.org/bg3006**

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(FHA) needed an infusion of $2 billion in taxpayer money in 2013.

Created in 1934, the FHA is a federal agency responsible for several mortgage insurance programs. The FHA charges fees to provide lenders with full loan-loss coverage on mortgages. This coverage allows lenders to recover the full amount of the loan from the FHA when a borrower defaults on a loan. The FHA charges borrowers fees to cover the cost of this loan insurance, but the FHA has a history of not charging high enough fees to cover all of its losses. Taxpayers are liable for the difference, and private firms are crowded out of the market because they cannot easily compete with underpriced government insurance. Despite various reform initiatives since the 1930s, the FHA has consistently had trouble meeting safety and soundness guidelines, has undermined the stability of the housing market, and in recent years has needed several billion dollars to cover its losses.

In return for the substantial costs to taxpayers, the FHA's mortgage insurance programs have had minimal impact on homeownership rates. This suggests that additional FHA reforms will, at best, provide merely temporary financial improvements to the agency without adding appreciable benefits to the housing market. Congress should take the steps necessary to get the federal government out of the home financing business.

Origins of FHA and Federal Home Financing Policy

Before the 1930s, many homeowners had various types of interest-only, short-term mortgages with balloon payments that often required refinancing. State laws before the Great Depression dictated a variety of specific provisions in loan contracts, such as the length of the contract (the term) and the loan-to-value (LTV) ratio. With no particular pattern, some states prohibited banks from loaning more than 50 percent, 67 percent, or 80 percent of the value of a home for terms typically between five years and 15 years. For example, in Pennsylvania from 1913 to 1937, banks could not legally lend more than two-thirds of the property's value (i.e., an LTV of 66.7 percent), and loans could not exceed a term of 15 years.[1]

A great deal of private innovation led to a general lengthening of loan terms and products that allowed people to finance a larger portion of a home's purchase price, but the practice of frequent refinancing persisted throughout the 1920s.[2] This refinancing feature, along with massive job losses and a collapse in home prices, contributed to the failure of many banks and private mortgage insurance companies during the 1930s. Naturally, many of the more activist polices of the 1930s addressed this very aspect of home financing because it became such a problem during the Depression, with many banks becoming insolvent when homeowners defaulted on home mortgages that exceeded the value of the underlying homes.

One of the principal federal agencies created to deal with this issue in 1934 was the Federal Housing Administration. The FHA provided lenders with mortgage insurance on "approved" loans, the very first of which was a 20-year fixed-rate mortgage with a 20 percent down payment (for no more than $16,000). This maximum loan amount was approximately three times the median home price in 1934, a fact that underscores that a main goal of the FHA was to stimulate construction jobs, not to assist low-income individuals.[3] Legal scholar Richard Bartke notes:

> The primary purpose of the Act [that created the FHA] was to stimulate building and thereby increase employment. The increase in the amount and quality of housing in the country was merely a secondary consideration.[4]

1. As late as 1913, nationally chartered banks were prohibited from lending more than 50 percent of the value of a home. See John L. Ligon and Norbert J. Michel, "GSE Reform: The Economic Effects of Eliminating a Government Guarantee in Housing Finance," Heritage Foundation *Backgrounder* No. 2877, February 7, 2014, http://www.heritage.org/research/reports/2014/02/gse-reform-the-economic-effects-of-eliminating-a-government-guarantee-in-housing-finance.
2. See John L. Ligon and Norbert J. Michel, "Why Is Federal Housing Policy Fixated on 30-Year Fixed-Rate Mortgages?" Heritage Foundation *Backgrounder* No. 2917, June 18, 2014, http://www.heritage.org/research/reports/2014/06/why-is-federal-housing-policy-fixated-on-30-year-fixed-rate-mortgages.
3. See Kerry D. Vandell, "FHA Restructuring Proposals: Alternatives and Implications," *Housing Policy Debate*, Vol. 6, No. 2 (1995), pp. 301–302, http://www.knowledgeplex.org/kp/text_document_summary/scholarly_article/relfiles/hpd_0602_vandell.pdf (accessed May 7, 2014).
4. Richard W. Bartke, "Federal Housing Administration: Its History and Operations," *Wayne Law Review*, Vol. 13 (1966–1967), pp. 651–677.

When the federal government created the FHA, it also undertook policies to induce private companies (called associations) to purchase mortgages from banks, thus lowering banks' financial risk while providing funds to build homes. When these private associations largely failed to materialize, the federal government created the Federal National Mortgage Association (Fannie Mae) in 1938.[5] Congress initially authorized Fannie Mae to purchase *only* FHA-insured loans to bring into the secondary market, but it was not supposed to make direct loans. However, Fannie effectively became a lender that competed with savings and loan associations (S&Ls), a main source of mortgage funding after the Depression.[6]

By the late 1930s, the S&Ls served local mortgage markets and small-scale builders, while FHA loans and Fannie Mae primarily funded commercial banks and mortgage companies that financed large-tract builders and multifamily projects. In the aftermath of World War II, Congress authorized the Veterans Administration (VA)[7] to insure low-interest, zero-down-payment home loans to returning U.S. servicemen.[8] Since this period, the FHA and the VA have been the principal federal agencies that provide home mortgage insurance.[9]

FHA's Influence on Homeownership Rates

A major boom in housing corresponded *roughly* with the end of World War II and, therefore, with the operations of the newly created FHA and VA.[10] Thus, federal housing finance policy is often credited with causing an increase in homeownership. However, research suggests that all of the federal housing finance programs combined explain at most 13 percent of the growth in homeownership between 1940 and 1960. One study estimates that the VA programs alone accounted for approximately 7 percent of the overall increase from 1940 to 1960.[11]

In 1938, only four years after the FHA was created, FHA-backed loans accounted for just under 20 percent of new mortgage originations in the U.S.[12] Yet these FHA loans remained a small fraction of the overall market. For example, from 1949 to 1968,[13] *government-backed* mortgages accounted for no more than 6 percent of all mortgages in the market in any given year.[14] In other words, at least 94 percent of the mortgage market for this period received no federal backing of any kind. These federal programs almost certainly drove private lenders to offer loans with longer terms and lower down payments, but the evidence shows that these programs were

5. Fannie Mae was originally established by the Reconstruction Finance Corporation at the request of President Franklin D. Roosevelt. See David C. Wheelock, "The Federal Response to Home Mortgage Distress: Lessons from the Great Depression," Federal Reserve Bank of St. Louis *Review*, Vol. 90, No. 3, Part 1 (May/June 2008), pp. 144–145, https://research.stlouisfed.org/publications/review/08/05/Wheelock.pdf (accessed March 13, 2015). For more on the history of Fannie Mae, see Norbert J. Michel and John L. Ligon, "Fannie and Freddie: What Record of Success?" Heritage Foundation *Backgrounder* No. 2854, November 7, 2013, http://www.heritage.org/research/reports/2013/11/fannie-and-freddie-what-record-of-success.
6. Today, these secondary mortgage market investments are called mortgage-backed securities, but the concept was not yet developed in the 1930s. Efforts to begin some form of secondary mortgage market predate the 1900s, but the market never developed. For a full discussion, see Richard W. Bartke, "Fannie Mae and the Secondary Mortgage Market," *Northwestern University Law Review*, Vol. 66, No. 1 (March–April 1971).
7. The Veterans Administration was elevated to Cabinet status and renamed the Department of Veterans Affairs in 1989.
8. This provision for a loan insurance guaranty was added into the Servicemen's Readjustment Act of 1944 (G.I. Bill of Rights).
9. The Rural Housing Service at the Department of Agriculture manages various single-family housing, multifamily housing, and community facilities programs. See U.S. Department of Agriculture, "Rural Housing Service," http://www.rd.usda.gov/about-rd/agencies/rural-housing-service (accessed March 19, 2015).
10. Between 1940 and 1960, the U.S. homeownership rate increased from 44 percent to 62 percent. Daniel K. Fetter, "The 20th-Century Increase in US Home Ownership: Facts and Hypotheses," National Bureau of Economic Research, July 2, 2013, p. 5.
11. Ibid., pp. 20–22. This research also suggests that it is "likely that there was some commonality between the drivers of the increases in non-farm home ownership in the pre-1930s and the post-1940 periods." Other research suggests that, given the millions of military persons returning to civilian life after World War II, a major expansion would have occurred independent of any housing program. See Vandell, "FHA Restructuring Proposals," p. 307.
12. Wheelock, "The Federal Response to Home Mortgage Distress," pp. 144–145.
13. In 1968, Fannie Mae was first allowed to purchase non-government-insured mortgages.
14. Federal Reserve, Mortgage Debt Outstanding: Historical Data, http://www.federalreserve.gov/econresdata/releases/mortoutstand/frb_mdo_historical.csv (accessed October 31, 2013).

not the main driver of increased homeownership before the 1970s.

From 1949 to 1968, government-backed mortgages accounted for no more than 6 percent of all mortgages in the market in any given year.

Most importantly, the FHA has had a negligible impact on homeownership rates over the past several decades. Specifically, substantial research shows that the FHA's single-family mortgage insurance portfolio has had little effect on increasing total homeownership. At best, the FHA has accelerated the purchase of a home by a few years.[15] In other words, if FHA mortgage holders had waited to borrow, they would have most likely done so in the conventional mortgage market instead of relying on government-insured loans.

Types of FHA Loan Insurance

From its inception, the FHA has managed two primary lines of loan insurance: single-family mortgage insurance and multifamily apartment mortgage insurance. In the 1950s, the FHA's mission began expanding to promote "community development" through insurance on various types of health care facilities in addition to its other multifamily apartment programs.[16] Currently, the flagship FHA program guarantees single-family mortgages via the Mutual Mortgage Insurance Fund (MMIF).[17]

The MMIF principally insures two types of loans: single-family home mortgages (not exceeding four units) and home equity conversion mortgages (HECMs).[18] Both types of loans are available regardless of the borrower's income.[19] The FHA also has a secondary focus on multifamily mortgage projects, which it manages through two separate insurance funds: the General Insurance Fund and the Special Risk Insurance Fund.[20] This paper focuses mainly on the FHA's single-family mortgage insurance and its corresponding MMIF.

15. John L. Goodman Jr. and Joseph B. Nichols, "Does the FHA Increase Home Ownership or Just Accelerate It?" *Journal of Housing Economics*, Vol. 6, No. 2 (June 1997), pp. 184–202. See also John C. Weicher, "Commentary on the Federal Housing Administration," Federal Reserve Bank of St. Louis *Review*, Vol. 88, No. 4 (July/August 2006), p. 314, https://research.stlouisfed.org/publications/review/06/07/JulAug2006Review.pdf (accessed February 12, 2015).
16. There are two principal health care mortgage insurance practices: Section 232 Mortgage Insurance for Residential Care Facilities and Section 242 Mortgage Insurance for Hospitals. See U.S. Department of Housing and Urban Development, "Office of Healthcare Programs," http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities (accessed February 26, 2015). See also U.S. Department of Housing and Urban Development, "Housing: FHA—Mutual Mortgage Insurance Fund, 2015 Summary Statement and Initiatives," p. Z-22, https://portal.hud.gov/hudportal/documents/huddoc?id=FY15CJ_FHAFND.pdf (accessed February 18, 2015).
17. Section 202 of Title II of the National Housing Act of 1934 established the Mutual Mortgage Insurance Fund (MMIF), and Section 203 established the single-family (one to four units) mortgage insurance portfolio. Section 207 of Title II permitted the FHA to provide insurance on multifamily apartment projects up to a maximum loan amount of $10 million per project. Bartke, "Federal Housing Administration," pp. 653–654. See also Thomas N. Herzog, "History of Mortgage Finance with an Emphasis on Mortgage Insurance," Society of Actuaries, 2009, p. 20, http://www.soa.org/library/monographs/finance/housing-wealth/2009/september/mono-2009-mfi09-herzog-history.pdf (accessed February 6, 2015).
18. HECMs are a newer mortgage product included in the FHA book of business and were put in place to give elderly Americans (62 years or older) a mechanism to draw down real estate equity.
19. Unlike the FHA program that uses a debt-to-income ratio to determine a borrower's capacity to service monthly loan payments, the VA home loan program uses this measure in addition to a residual income test to gauge a borrower's ability to pay. The residual income test used by the VA provides a more sufficient view of a borrower's capacity to cover general living expenses in a given area of the U.S. after taking into account all debt service payments, including all mortgage debt. Laurie Goodman, Ellen Seidman, and Jun Zhu, "VA Loans Outperform FHA Loans. Why? And What Can We Learn?" Urban Institute, July 16, 2014, http://www.urban.org/sites/default/files/alfresco/publication-pdfs/413182-VA-Loans-Outperform-FHA-Loans-Why-And-What-Can-We-Learn-.PDF (accessed April 15, 2015).
20. The multifamily insurance programs have remained a small share of the overall FHA insurance portfolio, generally around 15 percent of the overall portfolio. See Weicher, "Commentary on the Federal Housing Administration," p. 313 The FHA also manages a Cooperative Management Housing Insurance (CMHI) Fund that insures mortgages for multifamily cooperatives. See U.S. Department of Housing and Urban Development, "Housing," p. Z-1.

How FHA Loan Insurance Works

Single-family FHA mortgage insurance requires two types of fees, an upfront mortgage insurance premium (UFMIP) and an annual mortgage insurance premium (MIP). The UFMIP is collected when the loan is finalized (i.e., at the closing), whereas the MIP is paid in monthly installments. The UFMIP is currently 1.75 percent of the loan amount, and the MIP varies based on the amount of the loan, the length of the loan, and the down payment.

For instance, on a 15-year loan for up to $625,500 with a down payment of less than 10 percent (LTV of 90.01 percent or more), the MIP is 0.70 percent of the loan amount. For a 30-year loan for more than $625,000 with a down payment of less than 5 percent (LTV of 95.01 percent or more), the MIP is 1.05 percent. A 30-year loan for $200,000 with a down payment of 3 percent (an LTV of 97 percent) would have an MIP of 1.05 percent ($2,100) and a UFMIP of 1.75 percent ($3,500). Under current rules, the annual MIP will "self-cancel" for loans with a LTV ratio of 90 percent or lower after 11 years. For loans originating with a LTV ratio greater than 90 percent, the annual MIP cannot be cancelled.[1]

Borrowers are eligible for FHA loans regardless of their income level, but the FHA will insure only up to a maximum loan amount that is tied to the median home price in a given area. The maximum ranges from a low of $271,400 in Hancock County, Maine, to a high of $721,500 in Honolulu, Hawaii.[2] In all cases, the single-family mortgage insurance program provides full loan-loss coverage to lenders in the event of a loan default. In other words, the FHA insures lenders for the full amount of residential mortgages.

In this structure, homeowners can lose their property due to foreclosure, but the lender has nearly a full buffer against losses via an insurance claim through the MMIF. This level of protection contrasts with the VA single-family insurance program in which lenders *lose* between 50 percent and 75 percent of the loan amount on failed home mortgages. Similarly, private mortgage insurance firms generally protect lenders against no more than roughly 30 percent loan-loss on failed mortgages. In fact, the FHA insurance programs generally have far more relaxed underwriting and loan eligibility standards than private mortgage insurers offer.

1. In 2013, the FHA made a ruling to suspend the policy that allowed some loans to self-cancel the annual MIP at either the end of an 11-year period or when its LTV ratio reached 78 percent. See Carol J. Galante, "Revision of Federal Housing Administration (FHA) Policies Concerning Cancellation of the Annual Mortgage Insurance Premium (MIP) and Increase to the Annual MIP," U.S. Department of Housing and Urban Development, Mortgagee Letter 2013-04, January 31, 2013, http://portal.hud.gov/hudportal/documents/huddoc?id=13-04ml.pdf (accessed March 19, 2015). According to the HUD mortgage letter issued January 26, 2015, the revision to the period assessing Annual MIP set in Mortgage Letter 2013-04 is unchanged. See Biniam Gebre, "Reduction of Federal Housing Administration (FHA) Annual Mortgage Insurance Premium (MIP) Rates and Temporary Case Cancellation Authority," U.S. Department of Housing and Urban Development, Mortgagee Letter 2015-01, January 9, 2015, p. 1, http://portal.hud.gov/hudportal/documents/huddoc?id=15-01ml.pdf (accessed March 19, 2015).
2. These loan limit amounts apply to one-unit properties. The single-family mortgage insurance is applicable to properties with up to four units that range from a low of $521,900 in Hancock County, Maine, to a high of $1,371,150 in Kapaa, Hawaii. (The low-cost loan limits are also designated to the following counties: Winchester, VA-WV and Blacksburg-Christiansburg-Radford, VA.) Additionally, the interest rate charged on FHA loans also varies because not all FHA-approved lenders offer the same interest rate, even on FHA loans that are otherwise identical. U.S. Department of Housing and Urban Development, "ML Attachment II—2015 Loan Limits," [December 2, 2014], http://portal.hud.gov/hudportal/documents/huddoc?id=14-25mlatch2.pdf (accessed March 20, 2015).

Over the 80-year history of the FHA's single-family mortgage insurance practice, the agency has implemented many changes that have altered the underlying credit quality of the loans that it insures (loans-in-force). When the FHA weakens its underwriting standards and therefore the underlying quality of the loans that it insures, it reduces the agency's ability to manage a self-supporting insurance operation. Thus, there is a fundamental trade-off involved in managing an insurance operation that seeks both to maintain the actuarial "safety and soundness" of the reserve fund and to serve an ever-expanding class of potential home buyers. In the face of this trade-off, the FHA has increasingly strived to expand access to mortgage credit to borrowers with weaker credit and income histories and lower levels of initial loan collateral, while trying to manage a self-supporting, actuarially sound insurance practice.

FHA's Attempts to Influence Market Share

There is often confusion about the early mission of the FHA single-family mortgage program in the mistaken belief that the FHA was created to offer access to mortgages to underserved groups of individuals. In fact, the FHA started with relatively strict underwriting standards compared with those required of most loans today. Indeed, the FHA's history exhibits a long-term drift in underwriting standards and the quality of loans insured in the program.

Deterioration in FHA Underwriting Standards. Starting in the mid-1950s, the FHA began to dramatically reduce the level of upfront collateral—the down payment—required to take on a home loan through its single-family mortgage program. By 1961, the maximum loan-to-value ratio allowed on new and existing homes was 97 percent (in other words, a 3 percent down payment).[21] More broadly, annual loan data from 1990 to 2014 shows that fewer than 10 percent of FHA-insured loans during those years would have qualified for eligibility during the first two decades the FHA's existence.[22] The high percentage of low-collateral, highly leveraged FHA-insured loans puts borrowers at a higher risk of default and loan failure, increasing risk to both taxpayers and homeowners.[23]

Dramatic Expansion in Loan Limit Coverage. From 2008 through 2013, the FHA dramatically increased its presence in the mortgage finance system, averaging about 23.3 percent of the purchase (non-refinance) market and 14.2 percent of the overall mortgage market (purchase and refinance). A crucial reason for this change in market share was a 100 percent increase in the coverage limit—that is, the maximum loan amount—for loans in the FHA program. In certain high-cost markets, the coverage change lifted the limit for mortgages over $700,000 on one-unit properties and $1.3 million on four-unit properties.

This increased presence marked a major reversal in the FHA's role in the U.S. housing finance system. Prior to the change the FHA had held a much smaller position within the overall housing finance system for the past few decades. In 1971, three years after the passage of the Housing and Urban Development Act of 1968, the FHA accounted for approximately 15 percent of the purchase market.

Federal Taxpayer Subsidy Costs. Perhaps most importantly, over the years the FHA has garnered numerous credit funding advantages over its private-sector competitors. One of the most important advantages is the guarantee of the federal government during episodes of insolvency in the funds operation. Since the Federal Credit Reform Act (FCRA) of 1990, Congress has treated the FHA single-family mortgage insurance program as an on-budget taxpayer subsidy. U.S. taxpayers are

21. This 97 percent LTV was the maximum limit on values for $10,000 and $15,000. For new and existing homes valued at $20,000 or more, the maximum LTV was 95 percent. See M. Carter McFarland, "FHA Experience with Mortgage Foreclosures and Property Acquisitions," Federal Housing Administration, January 1963, p. 23, http://babel.hathitrust.org/cgi/pt?id=mdp.39015008723499 (accessed March 27, 2015). See also Vandell, "FHA Restructuring Proposals," pp. 303–306.

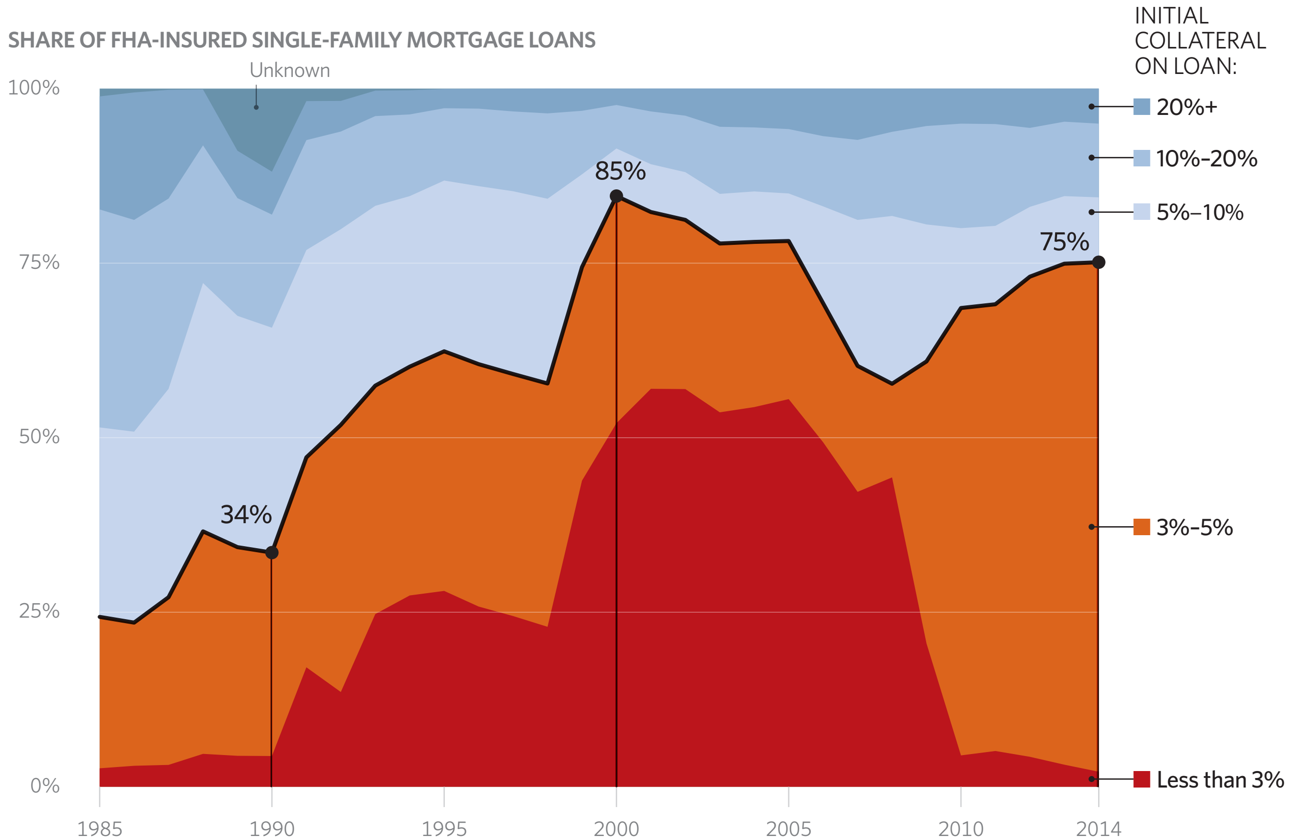
22. This finding is based solely on relaxed loan-to-value ratio (down payment) requirements. See U.S. Department of Housing and Urban Development, *Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year 2014*, p. 42, Exhibit IV-5, http://portal.hud.gov/hudportal/documents/huddoc?id=AR2014MMIFwdRpt.pdf (accessed April 9, 2015).

23. Joseph Gyuorko, "Rethinking the FHA," American Enterprise Institute, June 2013, pp. 1–2, http://www.aei.org/wp-content/uploads/2013/06/-rethinking-the-fha_142030868406.pdf (accessed March 31, 2015). See also Ligon and Michel, "Why Is Federal Housing Policy Fixated on 30-Year Fixed-Rate Mortgages?" pp. 9–10.

CHART 1

Low Down Payments Typical Among FHA Loans

In 1990, the year Congress passed the National Affordable Housing Act, the share of FHA-insured single-family mortgage loans with down payments of 5 percent or less was 34 percent. By 2000 that figure rose to 85 percent. It dipped during the recession, then rose again, and is currently at 75 percent.



Source: U.S. Department of Housing and Urban Development, *Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year 2014*, pp. 41–42, November 17, 2014, http://portal.hud.gov/hudportal/documents/huddoc?id=AR2014MMIFwdRpt.pdf (accessed April 15, 2015).

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obligated to cover any shortfalls in the MMIF with reserves in a capital reserve account.[24] This advantage surely lessens private firms' incentive to enter the mortgage insurance market and, most likely, has prevented (crowded out) some private firms from entering the market.

Reserve Funds Amount to Budget Gimmicks

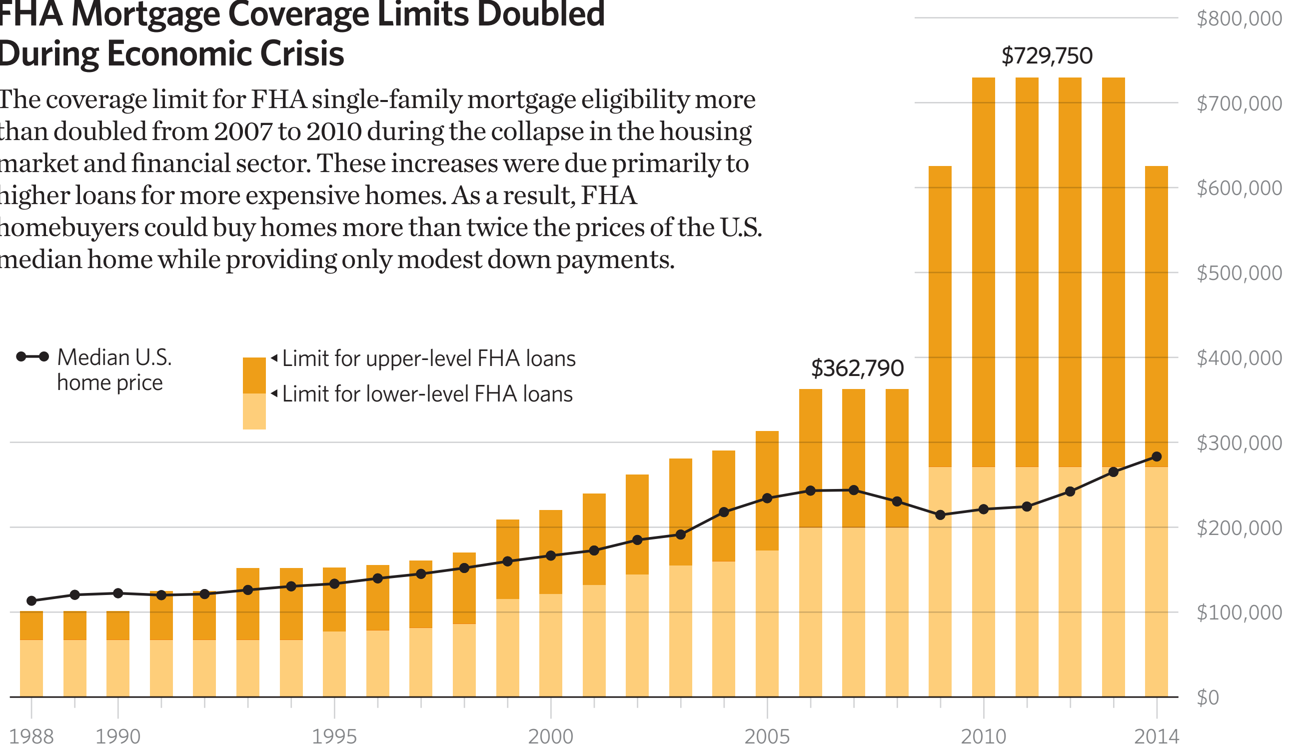
The Federal Credit Reform Act requires the FHA to maintain a 2 percent capital reserve ratio at all times. Private mortgage insurers, on the other hand, are generally required to hold around 4 percent in capital reserves to cover net losses on loans that they

24. There is no statutory requirement that governs a time period the FHA must use when trying to replenish the capital reserve ratio. Mathew J. Scirè, "Mortgage Financing: Financial Condition of FHA's Mutual Mortgage Insurance Fund," testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, September 23, 2010, pp. 10–11. See also Brena Swanson, "HUD's Castro Grilled on FHA Premiums, Capital Strength,'" HousingWire, February 11, 2015, http://www.housingwire.com/articles/32904-huds-castro-grilled-on-fha-premiums-capital-strength (accessed March 16, 2015).

CHART 2

FHA Mortgage Coverage Limits Doubled During Economic Crisis

The coverage limit for FHA single-family mortgage eligibility more than doubled from 2007 to 2010 during the collapse in the housing market and financial sector. These increases were due primarily to higher loans for more expensive homes. As a result, FHA homebuyers could buy homes more than twice the prices of the U.S. median home while providing only modest down payments.



Note: Figures show the aggregate average of each year's monthly median home prices. Each year is demarcated as beginning on January 1.
Sources: U.S. Department of Housing and Urban Development, Federal Housing Administration, "FHA Mortgage Limits," https://entp.hud.gov/idap-p/html/hicostlook.cfm (accessed April 21, 2015), and Federal Reserve Bank of St. Louis, "Median Sales Price for New Houses Sold in the United States," https://research.stlouisfed.org/fred2/series/MSPNHSUS (accessed April 1, 2015).

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insure.[25] Aside from this lower requirement, the FHA's *capital reserve account* is not really a reserve account at all. The FHA's reserve merely represents credited budgetary surpluses (estimated annually).

Put differently, the FHA's capital reserve account has no money, only an accounting of how much money would be in the account. In years that the Mutual Mortgage Insurance Fund program generates positive net income, the surplus (or subsidy "savings") flows to the capital reserve account. In years that the MMIF program generates a net loss, this deficit (or subsidy "cost") is "covered" by funds that were apportioned to the capital reserve account. Furthermore, in years that the FHA program generates a net loss of income *and* shows a capital reserve account of less than 2 percent, the FHA requires an additional appropriation to cover the deficit for that fiscal year.

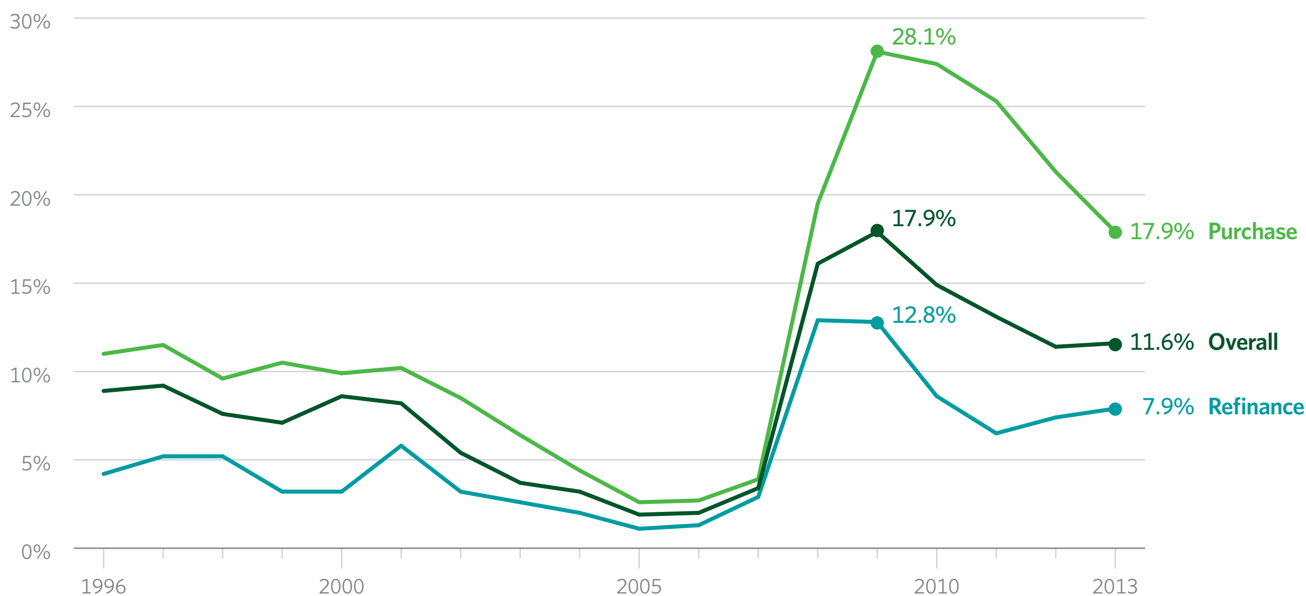
Historically, the FHA program has not needed to draw appropriations to cover annual deficits, but in

25. Even assuming that the FHA holds 2 percent in capital reserves, the FHA generally has higher claim rates due to higher rates of borrower default than its private-sector competitors. If the FHA were to manage its loan insurance portfolio with its high rate of insurance claims similar to the private mortgage insurance industry, which generally requires 4 percent capital reserves, it would surely hold significantly higher reserve capital—likely tens of billions of dollars annually in higher reserve funds. American Enterprise Institute scholar Edward Pinto calculates that the FHA would face approximately a $35 billion capital shortfall if using the 2 percent capital reserve requirement and the same private industry accounting method. Moreover, when using the 4 percent capital reserve requirement generally governing the private mortgage insurance industry and using the same private industry accounting method, the reserve shortfall is $52 billion. University of Pennsylvania economist Joseph Gyourko estimates the loss reserve shortfall somewhere between $50 billion and $100 billion. See Edward Pinto, *FHA Watch*, December 2013, http://www.aei.org/wp-content/uploads/2013/12/-fha-watch-no-12-december-2013_085951181504.pdf (accessed April 1, 2015). See also Gyourko, "Rethinking the FHA," pp. 7–8.

CHART 3

FHA Remains a Major Player in the Mortgage Market

During the financial crisis, the FHA doubled the maximum value of its mortgage loans to nearly $730,000. As a result, the FHA rapidly increased its market share in the mortgage finance system, at one point holding 18 percent of the overall market.



Source: U.S. Department of Housing and Urban Development, "FHA Single-Family Market Share," p. 2, http://portal.hud.gov/hudportal/documents/huddoc?id=FHA_SF_MarketShare_2014Q3.pdf (accessed April 17, 2015).

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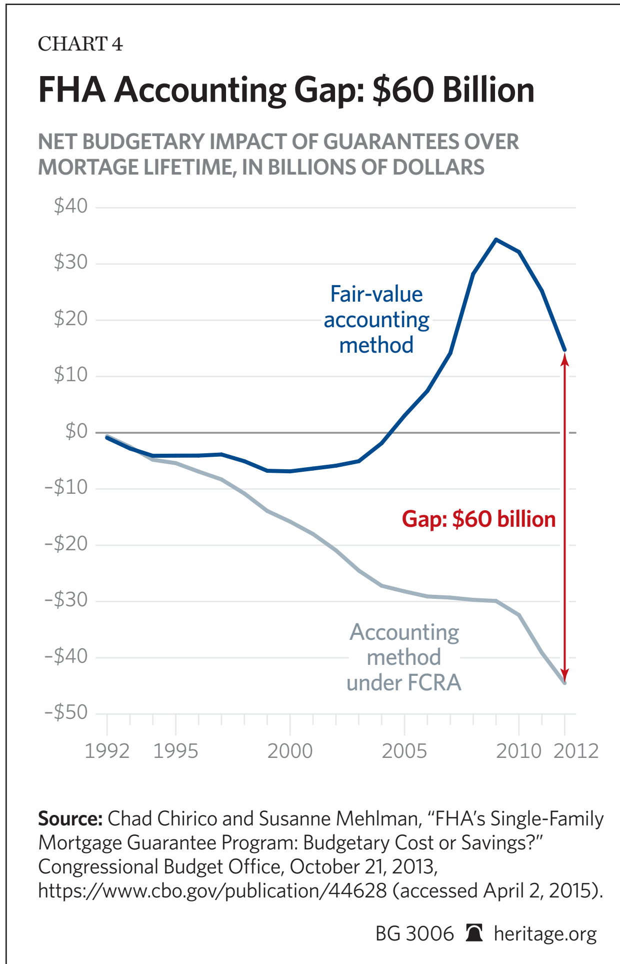
recent years, the capital reserve account has been too low to cover the deficit in the MMIF program.[26] The MMIF subsidy cost estimate is sensitive to the choice of accounting methodology. Crucially, the FCRA accrual method significantly understates the costs of these insurance guarantee subsidies in the FHA single-family mortgage insurance practice.[27] In fact, between 1992 and 2012, there was a $60

26. In FY 2013, the capital ratio—a ratio of the fund's economic value over the level of insurance-in-force—was still negative (–0.11 percent). Yet according to the actuarial reports to the FHA, the capital reserve ratio increased to 0.41 percent in fiscal year 2014. This is substantially below the statutory *minimum of 2 percent at all times* required in the Omnibus Budget Reconciliation Act of 1990 (Public Law 101–508). U.S. Department of Housing and Urban Development, "Regarding the Financial Status of the FHA Mutual Mortgage Insurance Fund Fiscal Year 2014," November 17, 2014, pp. 34–44, http://portal.hud.gov/hudportal/documents/huddoc?id=FY2014FHAAnnRep11_17_14.pdf (accessed March 3, 2015). See also Scirè, "Mortgage Financing," p. 4.

27. The accrual method required under the FCRA relies on a Treasury interest rate to calculate the present value of the discounted cash flows—essentially a risk-free interest rate compared with a market-based interest rate that would more accurately account for the actual risk associated with the loan insurance. The FCRA method also ignores any administrative costs of managing the insurance portfolio. The FHA notes that these administrative costs in the multifamily are particularly relevant. The general critique of the accrual accounting method required under the FCRA is that it understates certain risks associated with the credit guarantee and insurance programs run by the federal government. While applying a fair-value-type approach when evaluating the subsidy benefits to these credit guarantee and insurance programs may have some benefits, the method also has some drawbacks. For assets that are readily tradable in nature and practice, the fair-value, mark-to-market accounting approach may be perfectly reasonable to employ. In private industry, however, many companies that rely on accounting methods to value longer-held assets and liabilities affecting their income and balance sheet statements generally want the flexibility to apply different pricing methods in this particular exercise. For the assets (and liabilities) generally held to maturity, a measurement approach that accounts for average historical cost basis can be preferable to the fair-value, mark-to-market approach that remains more pro-cyclical in nature and can understate or overstate these valuations depending on the particular state of the business cycle firms face when calculating the valuation.



Source: Chad Chirico and Susanne Mehlman, "FHA's Single-Family Mortgage Guarantee Program: Budgetary Cost or Savings?" Congressional Budget Office, October 21, 2013, https://www.cbo.gov/publication/44628 (accessed April 2, 2015).

billion difference between the accounting method required under the FCRA and a method that would more appropriately reflect market risk. The accrual accounting method shows the single-family mortgage insurance practice "saving" the taxpayer $45 billion compared with a "cost" of $15 billion using the fair-value accounting method.[28] In recent years, the FHA has treated the 2 percent capital reserve requirement casually. In 2012 and 2013, the FHA required several billion in appropriated funds to cover deficits in the MMIF program and the lack of loss reserves in the capital reserve account.

In summary, the on-budget subsidy treatment, federal taxpayer credit guarantee, and the relaxed capital reserve requirement are crucial market advantages for the FHA program. These funding advantages crowd out a portion of borrowers that would take up mortgages in the conventional market with credit enhancement through private mortgage insurers, as well as potential private mortgage insurance providers.

What Congress Should Do

The FHA has outlived its usefulness to taxpayers and homeowners. Federal policymakers should eliminate the federal government support and guidance in its single-family and multifamily mortgage insurance programs. This change would leave the mortgage insurance industry, outside of the guarantees in VA mortgage programs, principally in the domain of private market insurers.

Ideally, Congress would eliminate the FHA's role in providing taxpayer-backed credit guarantees and mandating underwriting guidance affecting mortgages. Short of immediately ending the FHA mortgage insurance programs, Congress should phase down its presence in the mortgage market by:

- **Increasing lender loan-loss liability.** At a minimum, Congress should ensure that capital reserve requirement standards and recourse actions against lenders achieve parity with the private mortgage insurance industry. One reasonable step to take in the immediate future is to reduce the loan-loss coverage in the single-family mortgage insurance program from the current approximately 100 percent to 50 percent.[29] The ultimate goal should be to reduce the level of loan coverage to the private industry standard of 20 percent to 30 percent.

- **Maintaining the statutorily required 2 percent capital reserves.** The FHA must maintain at least a minimum of 2 percent reserves in its

28. CBO analysts completed a re-estimate using a fair-value accounting method and posit this $60 billion cost differential between the two estimates. Chad Chirico and Susanne Mehlman, "FHA's Single-Family Mortgage Guarantee Program: Budgetary Cost or Savings?" Congressional Budget Office, October 21, 2013, https://www.cbo.gov/publication/44628 (accessed February 19, 2015). See also Congressional Budget Office, "Accounting for FHA's Single-Family Mortgage Insurance Program on a Fair-Value Basis," May 18, 2011, p. 9, https://www.cbo.gov/sites/default/files/05-18-fha_letter.pdf (accessed February 19, 2015).
29. The VA home loan program provides lender loan-loss coverage between 25 percent and 50 percent, and the private mortgage insurance industry generally provides 20 percent to 30 percent coverage of loan loss.

capital account. These reserve funds are necessary to maintain solvency and avoid appropriations from Congress to cover any shortfalls in the capital account. The FHA should immediately and aggressively take steps to ensure the capital reserve fund achieves the 2 percent capital ratio as required by law. One possibility is that the FHA could move from its tiered flat-rate premium structure toward a risk-based premium structure.

- **Limiting the scope of eligible single-family mortgages.** Congress should limit the FHA's single-family insurance portfolio to first-time homebuyers, without any refinance eligibility over the tenure of the loans in force. Additionally, the value of loan limits eligible for FHA single-family mortgage insurance should decrease to the median home price in a given locality. These two reform measures would substantially reduce the FHA's scope and move the FHA away from support of high-cost mortgages.

- **Ending the multifamily mortgage insurance and the mortgage programs for health care facility and hospital construction.** The federal taxpayer does not need to finance these commercial-based development initiatives. The FHA claims that it has a unique market advantage in providing "long-term loan amortization [up to 40 years in some cases] not found with conventional lending sources."[30] All of these projects together comprise a small share of the overall FHA mortgage portfolio, and they have a longer history of needing appropriated capital transfers to cover financial shortfalls. These programs have also had the most problems with corruption and waste.[31] Despite recent efforts to increase efficiency in managing these mortgage programs, they are not necessary to maintain robust financing within the housing finance system.[32] Numerous other direct and indirect federal subsidies already support affordable rental assistance projects and other community development construction projects.

Conclusion

Over its more than 80 years of existence, the Federal Housing Administration has contributed to the long-run expansion in federally guaranteed mortgage debt in the U.S. financial system, increasing financial risk to both homeowners and taxpayers. In return for the substantial costs to taxpayers, the FHA's mortgage insurance programs have had minimal impact on homeownership rates. Moreover, history suggests that additional reforms to the various FHA insurance programs will, at best, merely provide temporary financial improvements to the agency, without appreciable benefits to the housing market. Congress should therefore eliminate the FHA and get the federal government out of the home financing business.

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30. U.S. Department of Housing and Urban Development, "Housing," pp. Z-25–Z-27.
31. These programs are "staff-intensive" and require frequent appropriations from Congress to remain solvent. "[I]t is political—each project is large, and both the project and the developer are locally important; and it is where the HUD scandals most often occur. Twice I've come to HUD in the aftermath of multi-family scandals—the first time knowing that's what I was doing and the second time finding out when I got there." Weicher, "Commentary on the Federal Housing Administration," p. 313. See also John M. Quigley, "Federal Credit and Insurance Programs: Housing," Federal Reserve Bank of St. Louis *Review*, Vol. 88, No. 4 (July/August 2006), p. 288, http://research.stlouisfed.org/publications/review/article/5373 (accessed February 12, 2015), and Vandell, "FHA Restructuring Proposals," pp. 370–371.
32. U.S. Department of Housing and Urban Development, "Housing," p. Z-24; Quigley, "Federal Credit and Insurance Programs"; and Weicher, "Commentary on the Federal Housing Administration."