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The FHA Admirably Fills the Void

BY MARK ZANDI — JANUARY 7, 2014

The FHA Admirably Fills the Void

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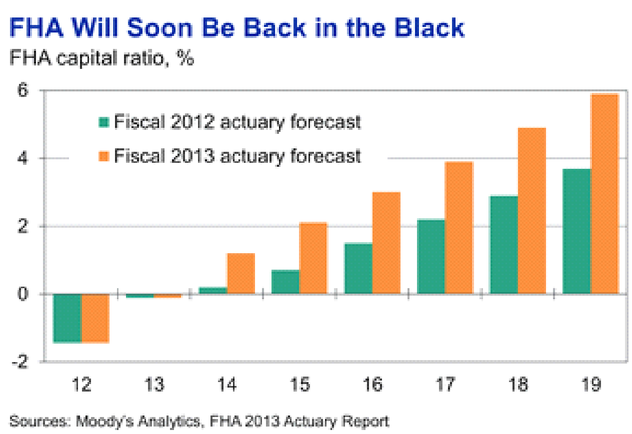
- The FHA played a vital role during the recession, stepping in when private lenders stopped making loans.
- The agency's recent financial weakness reflects both the recession and some odd forecasting by the FHA actuary.
- A brighter outlook for housing and tighter underwriting standards will soon put the FHA back into the black.
- Keeping the FHA solvent and functioning until private lending revives is well worth the cost to taxpayers.

The Federal Housing Administration was badly hurt in the Great Recession. According to the agency's own actuary, the FHA is currently in the red for the second year in a row. That is, the cost of future defaults on the mortgages the agency insures is greater than the insurance premiums it will collect. For first time in its 79-year history, the FHA needed help from taxpayers, via the U.S. Treasury, to remain solvent.

The good news is the actuary also expects the FHA to get its finances in order quickly. Prospects for a better housing market and economy will help, as will increases in insurance premiums and tighter underwriting policies. The agency's capital ratio—what it holds in reserve in its insurance fund as a percentage of its insurance in force—should exceed its congressionally mandated 2% as soon as 2015.



Still, the need for taxpayer help is disconcerting, and legislative reform is necessary to ensure that doesn't happen again. Yet the cost was well worth it to make sure the FHA fulfilled its responsibility as mortgage lender of last resort. Without the FHA's aggressive intervention in the mortgage market, the housing crash and recession would have been much more severe and the cost to taxpayers much greater.

With housing and the economy on a more solid foundation, the FHA has steadily reduced its footprint in the mortgage market. While this is appropriate, the agency's withdrawal must not be too rapid, since private mortgage lenders remain largely sidelined. The FHA is a critical source of mortgage loans to creditworthy first-time and minority homebuyers who would be unable to obtain loans otherwise. These homebuyers will be key to the housing and economic recovery in 2014.

Odd forecasting

The FHA probably would already be back in the black if not for some odd forecasting by its actuary. In the actuary's forecasting model, the outlook for mortgage defaults depends on the outlook for house prices and interest rates. (House price and interest rate projections used by the actuary are supplied by Moody's Analytics.) While rates rose over the past year, they didn't rise quite as fast as forecast, and while additional increases are expected, this year's forecast calls for rates to rise more slowly than in 2013.

Most credit-risk managers would say that lower interest rates should mean fewer defaults. Lower rates make it easier for troubled homeowners to refinance their mortgages and lower their monthly payments. The FHA has been working hard to refinance underwater homeowners. Lower rates also support a stronger economy, which in turn lowers unemployment, also reducing the frequency of defaults.

However, the FHA's actuary uses a model in which lower interest rates result in more, not less, defaults. The actuary's view is that many at-risk FHA borrowers can't take advantage of lower rates through refinancing, and will instead default and rent to lower their housing costs. This makes sense only if the very significant costs of defaulting are meaningfully less than the drop in housing costs.

Stretched logic

The actuary also posits that a significant number of higher-quality FHA borrowers, who can refinance, will do so into non-FHA loans, leaving the FHA with less premium revenue in the future. This logic is not implausible, but it is a stretch in the currently tight lending environment. The FHA's traditional first-time and minority borrowers will have difficulty obtaining loans elsewhere.

More significantly, the actuary's model does not include unemployment. Homeowners generally default on their mortgages when they are under water and their incomes are disrupted. Nothing is more disruptive than unemployment. While the jobless rate is still high, it is falling more quickly than anticipated, and the outlook has improved. This should reduce future expected defaults on FHA loans, but the actuary's forecast does not reflect this.

It is also worth noting that a disproportionate share of the FHA's projected losses are in its long-troubled Home Equity Conversion Mortgage program. Without HECM's severe financial problems, the FHA might not have needed funds from the Treasury. And while the FHA is insolvent based on projections of its losses and premiums including HECM, it currently has a positive cash flow and will very likely maintain it. The FHA probably will never actually need the Treasury's funds to make its insurance payments. These aren't excuses, but they do suggest that outside of HECM—which has already undergone significant changes—the agency needs moderate reform rather than a radical change.

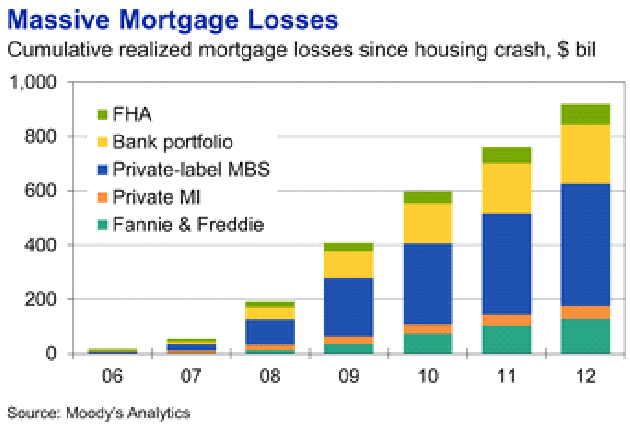
Lender of last resort

While the FHA required taxpayer help to weather the Great Recession, so did every other large U.S. private financial institution that received aid through the Troubled Asset Relief Program or the Federal Reserve's many emergency programs. Supporting the FHA was well worth the cost, moreover. Had the agency not been there to act as mortgage lender of last resort, the financial system and economy would have fared much worse during the downturn, ultimately costing taxpayers substantially more.

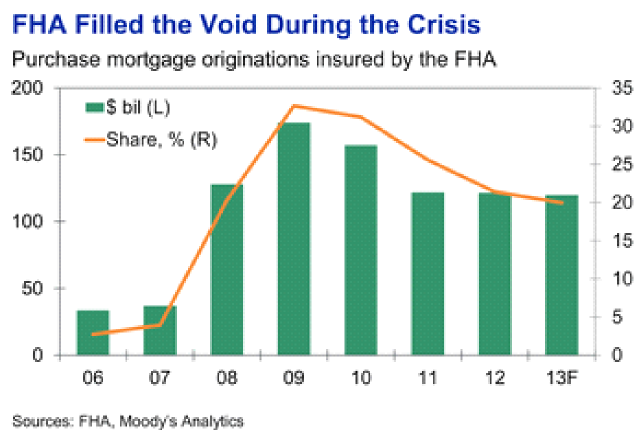
Prior to the housing crash, the FHA's role in the mortgage market was small, accounting for only a small percentage of the loans made to homebuyers. The FHA could not compete with private lenders who offered no-down payment loans to borrowers with very low credit scores and little if any income documentation. Many of these loans sported exceptionally low initial interest rates, and even allowed borrowers to defer payments, adding them into the mortgage balance.

A trillion-dollar loss

Millions of such loans subsequently defaulted as housing prices fell. Nearly $1 trillion was lost on busted mortgages, undermining the global financial system and causing private mortgage lending to collapse. Since then, private mortgage loans have been made only to borrowers with high-paying jobs, lofty credit scores, and the ability to make large down payments.



The FHA stepped into this breach, increasing the volume of loans it backed from $34 billion in 2006 to $174 billion in 2009. Without such a rapid expansion, the credit crunch would have wiped out the housing market. As it was, U.S. house prices fell by more than a third; without the FHA, the decline would have been substantially greater. Many more homes would have been lost in foreclosure, and private financial institutions would have faced measurably greater losses. Aggressive intervention by the FHA saved the housing market and the economy from a much darker fate.



Just how much darker is evident in a simulation of the Moody's Analytics model of the U.S. economy using the assumption that Congress had curtailed FHA lending. In this simulation, which was conducted in summer 2010, the FHA was no longer able to insure new loans after October 1, 2010. Mortgage rates spiked as Fannie Mae, Freddie Mac, and the private mortgage insurance industry were unable to fill the void. Private mortgage insurance was the major constraint at the time, as that industry's capital was largely depleted, limiting its ability to insure new loans.

A major mortgage spike

To sufficiently ration the mortgage credit that was available, fixed mortgage rates under this scenario spiked by nearly 8 percentage points. Rates drifted lower as private capital flowed back into the mortgage insurance industry to meet increased demand, but rates ultimately settled around a percentage point above where they would have if the FHA had remained a substantial player in the mortgage market. The private mortgage insurance industry would have needed to charge higher premiums to achieve the 15% return on capital it has historically enjoyed.

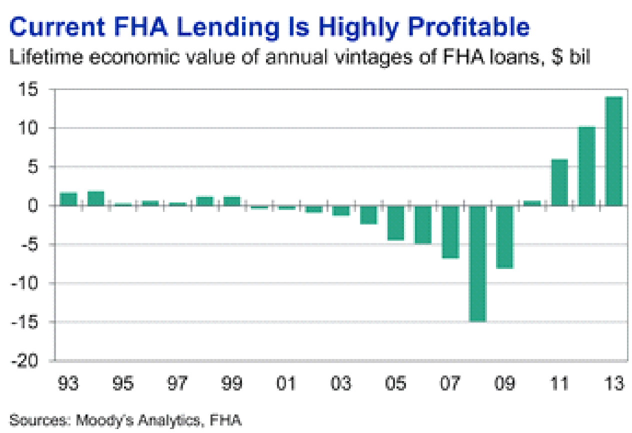
The fallout on the housing market and economy would have been severe. In the simulation, new housing starts plunged to pre-World War II levels in 2011, and house prices declined an additional 25%. With housing once again in free fall, the economy would have suffered a double-dip recession, eliminating nearly 3 million jobs and sending the unemployment rate to 12% in late 2012.

Bright outlook

Fortunately, this dark scenario was never realized. The housing market and economy have since found their footing, and the FHA is quickly repairing its finances.

The FHA's recent credit performance is much improved. Delinquencies are falling quickly and recovery rates on repossessed homes are rising significantly. This is substantially better than the FHA actuary anticipated just a year ago. Losses on FHA-insured mortgage loans net of recoveries in 2013 were less than half of what had been projected.

The FHA's recent lending should be extraordinarily profitable. According to the actuary, the FHA's 2013 book of loans has a record net economic value—the present value of the actual and projected premiums and losses on FHA loans insured in 2013—of almost $15 billion. For context, the net economic value of FHA loans in any given year during the 1990s, prior the housing boom, was no more than $2 billion. The worst vintage of loans was that insured in 2009; this book has a net economic value of negative $15 billion.



Unless things go badly off script, the FHA's 2014 book of loans should be about as profitable as its 2013 book. Moreover, as better-quality loans replace those made during the housing crash, the FHA is set to quickly swing into the black. It is expected to have a capital ratio near the congressionally mandated 2% as soon as 2015, and a rock-solid capital ratio of 5% by 2018.

Behind the FHA's bright financial outlook are a better housing market and economy, as well as increases in the FHA's insurance premiums and tighter lending standards. The FHA has substantially increased upfront and annual premiums over the past four years, and annual premiums are no longer automatically canceled once homeowners build up enough equity in their homes.

FHA Mortgage Insurance Premiums

For typical FHA loan, bps

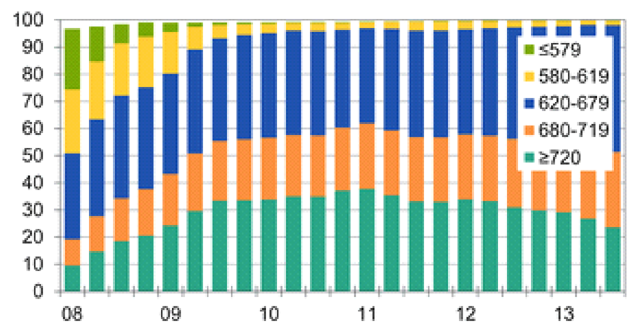
Period	Upfront Premium	Annual Premium
Jan '01 - July '08	150	50
July '08 - Sep '08	175	55
Oct '08 - April '10	175	55
April '10 - Oct '10	225	55
Oct '10 - April '11	100	90
April '11 - April '12	100	115
April '12 - June '12	175	125
June '12 - Mar '13	175	125
Mar '13 - present	175	135

Sources: Ginnie Mae, Moody's Analytics

FHA's stiffer lending standards are most evident in the credit scores of borrowers receiving FHA loans. Close to half of all current borrowers have scores above 680, a level achieved by fewer than one-fifth of borrowers during the recession. Borrowers with scores below 620 are effectively locked out of FHA loans, as they are required to be manually underwritten, significantly increasing lenders' underwriting costs and thus reducing their incentive to originate them. Five years ago, almost half of FHA loans went to borrowers with scores this low.

FHA Tightens Its Underwriting

Distribution of FHA borrower credit score



Sources: Moody's Analytics, Dealogic

As it has become more costly and difficult to obtain a FHA loan, the agency's footprint in the mortgage market has shrunk. At the peak of its lending in 2009, the FHA insured almost one-third of all new purchase mortgages by dollar volume. The agency currently accounts for less than one-fifth of purchase originations.

New competition

The FHA's share is set to decline further as it plans to roll back its loan limits closer to what they were prior to the recession. Low-down payment Fannie and Freddie loans backed by private mortgage insurance will also remain solid competition, as new leadership at the Federal Housing Finance Administration likely means that Fannie and Freddie will hold the line on any further increase in their guarantee fees.

Yet while the FHA needs to continue moving in this direction, it must be careful not to move too quickly. Private mortgage lending to borrowers with low down payments and credit scores remains dormant. Banks are lending almost exclusively to wealthier households with pristine credit. And uncertainty over the new qualified-mortgage rule, which determines which kinds of lending will be legally protected, could reinforce this. Moreover, the qualified residential mortgage rule, which determines the amount of equity mortgage securitizers must hold, has yet to be codified. Until it is, private securitization and lending will not revive.

Until bank lending and private securitization are back up and running, it is important that the FHA remain a significant source of mortgage credit. This will be especially important during the 2014 spring selling season, when the market will need first-time occupant buyers to step in as investors grow less enthusiastic. Since the FHA is vital to first-time buyers, an even more reluctant FHA could short-circuit this demand, threatening the housing recovery.

Conclusions

The Great Recession did significant damage to the FHA. That it had to accept taxpayer help to remain solvent for the first time in its history was a serious failure. Legislation to ensure that the agency won't ever again require taxpayer support is much needed.

Despite the mistakes, however, the FHA was critical to limiting financial damage in the recession. If it had not stepped in when private mortgage lending collapsed, the housing crash would have been more severe, and the ultimate cost to taxpayers measurably greater. Government intervention in the economy during the recession was messy and costly, but things would have been a lot messier and costlier without it.

The FHA is now working to exit from its intervention, and so far has been largely successful. Its financial prospects have considerably brightened, and while it has tightened its lending standards, it remains the most important source of credit for first-time and minority homebuyers. Gracefully balancing the need to provide adequate mortgage credit to keep the housing recovery going, but not squeezing out private lending will be tough to pull off. So far so good.

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