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HOW CONGRESS CAN DEFUSE THE FEDERAL HOUSING ADMINISTRATION TIME BOMB

INTRODUCTION

The housing industry is booming. With mortgage interest rates dipping to their most affordable levels since 1978, the housing market in many areas is so vibrant that homes are routinely selling within a day of listing. Predicts Kenneth Rosen, chairman of the Center for Real Estate and Urban Economics at the University of California, "This should be the best year in mortgage-origination volume in American history."[1]

That is the good news. The bad news is that in the process of this housing boom the Federal Housing Administration, the government's popular home mortgage insurer, has become a fiscal time bomb that may eventually explode in the American taxpayer's lap. In the past year, the FHA has accommodated the surge in home ownership by more than doubling its credit ceiling, from $57 billion to a record level of $132 billion. The frightening aspect of this growth in FHA credit is that the agency is failing to take prudent measures to protect itself, and thus the American taxpayer, against the huge contingent liability the agency carries. Should the economy slide into a deep recession, the FHA could easily be facing multi-billion dollar losses. And because the FHA's reserves fall far below industry standards, taxpayers would be forced to pay the bill.

1. "Lower Mortgage Rates Spur Sales of Houses in Much of the U.S.," The Wall Street Journal, March 3, 1986, p. 1.

And to make matters worse, the FHA is much more susceptible to large losses now than it ever has been. The reasons:

First, the FHA is insuring increasingly risky loans. Down payments on FHA-backed mortgages, for instance, have declined significantly since 1980, and the lower the downpayment, the greater the likelihood of default.

Second, FHA premiums have not been adjusted to reflect changed market conditions. The premiums are based on the default rate on home mortgages during the 1960s and 1970s, but during the 1980s, default rates have been about twice as high. Private mortgage insurers have raised their premium rates about 25 percent to protect against this greater risk, but FHA premium rates have remained unchanged.

Third, the FHA's recently initiated direct endorsement program, by which the agency forgoes its own loan verification procedures and relies on those of the lender, could send FHA claim rates skyrocketing. In fact, FHA's direct endorsement already has been criticized sternly by the Department of Housing and Urban Development's Inspector General, who found that under the new procedures "HUD has little assurance that [FHA's] quality controls are effective."

Congress soon will have a chance to review FHA behavior. Later this summer, the lawmakers will consider legislation to determine the level of FHA funding for FY 1987. In doing so, Congress should require the FHA to provide adequate protection against the huge risk it is placing on taxpayer's shoulders. FHA should be forced to make its level of reserves comply with those imposed on private insurers by state law. Since these are the levels considered "safe," the FHA should not be permitted to fall below them. FHA premiums, moreover, should be adjusted to actuarially sound levels taking into account the recent explosion in claim rates experienced by the entire industry. Finally, the FHA should impose a small coinsurance requirement on lenders under its direct endorsement program to discourage fraud and misrepresentation.

These changes will place the FHA on more firm financial footing and thus minimize the taxpayer's risk. They will also assure that, as the FHA competes with the private mortgage insurance industry, the competition takes place on an even playing surface.

In addition to assuming disaster-courting risk, the FHA has strayed far from its legislative mandate. It was established a half century ago to provide mortgage protection to those of low and moderate income possibly underserved by the private mortgage insurance industry. Today, however, more than one of every four FHA recipients has an income of over $40,000. This makes FHA one of the largest yet most inconspicuous federal subsidies to America's upper middle- and upper-income classes. Under current law, there is no income ceiling for recipients of federal mortgage insurance; there should be.

Where the FHA perhaps veers farthest from its legislative intent is in the guarantees given to second homes. Last year the agency wrote about $700 million worth of insurance for vacation homes.[2] Yet it seems unfair for taxpayers to have to subsidize the purchase of mountain or beachfront properties by the wealthy.

Investor-owned properties, meanwhile, constitute about 11 percent of the FHA's insurance portfolio. These real estate acquisitions by business syndicates are made purely for investment purposes, rather than for promoting home ownership, which was and is the sole justification for FHA. Syndicate acquisitions also are particularly bad risks: investor property losses will cost the FHA an estimated $700 million this year, a figure that could soar if the real estate sections of the pending tax reform bills are enacted. Also, the HUD Inspector General is currently investigating potential fraudulent activities associated with 500 investor loans. In its review of the FHA, therefore, Congress should consider prohibiting FHA insurance on vacation homes and investor properties.

The FHA has strayed far from its original charter. Rather than focusing on helping Americans with modest incomes to buy homes, it is increasingly supporting the real estate deals of the rich. And it is doing so in a manner that could be very costly to the American taxpayer. Congress should rein in the agency and return it to its original purpose.

PRIVATE AND GOVERNMENT MORTGAGE INSURANCE

The Federal Housing Administration was established under the National Housing Act of 1934 to provide government-backed mortgage insurance to lower- and middle-income families unable to receive mortgages during the early years of the Depression. The purpose of the federal insurance has been to promote home ownership by encouraging banks, savings and loans, mortgage companies, and other lenders to grant mortgages to applicants otherwise viewed as too risky. Between four and five million homeowners currently enjoy FHA mortgage protection, for which the agency charges the home buyer a flat one-time premium of 3.8 percent of the loan principal. In the event the homeowner defaults, the FHA typically reimburses the lending institution the full value of the covered mortgage and acquires title to the defaulted property.

2. Office of Management and Budget, unpublished data, 1986.

By the late 1950s, the private mortgage insurance industry, which had collapsed during the Depression years, was enjoying a resurrection. By the mid-1970s, the for-profit industry had captured over half of the mortgage insurance market from the FHA.[3] Leo Grebler, formerly of the Federal Home Loan Bank Board and now an economist at UCLA, describes this phenomenal business success as "A case of private enterprise beating a firmly entrenched government agency at its own game."[4] Today there are twelve private mortgage insurance companies underwriting over $200 billion worth of housing loans of all types. These private businesses compete directly with the FHA for customers.

A 1975 study by the Arthur D. Little international consulting firm concluded that the private mortgage insurance industry could withstand mortgage default rates as high as 10 percent--far higher even than those during the Depression.[5] A more recent assessment by Standard and Poor's noted that, despite suffering large losses during the early 1980s, "Implementation of more conservative industry-wide underwriting, favorable premium structures, and emphasis on profitability rather than market share should lead to better operating performance for the industry."[6]

HOW THE FHA CROWDS OUT PRIVATE INSURANCE

The role of the FHA always has been to complement private insurance, not to supplant it. This was reaffirmed explicitly by Congress with the passage of the 1948 National Housing Policy Act. According to this law, "The policy to be followed in attaining the national housing objective hereby established shall be (1) private enterprise shall be encouraged to serve as large a part of the total need as it can; (2) government assistance shall be utilized where

3. For a detailed discussion of the growth rate of the private mortgage insurers, see Robert L. Waldo, "The Role of Private Mortgage Insurance," Mortgage Banking, February 1982, pp. 32-38.

4. Leo Grebler, "Deal the FHA Out of the Housing Markets," Op-Ed in The Wall Street Journal, March 20, 1986.

5. Arthur D. Little, Incorporated, The Private Mortgage Insurance Industry, Final Report to the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, April 1975.

6. Standard and Poor's, "Credit Comment," Credit Week, June 23, 1986, p. 12.

feasible to enable private enterprise to serve more of the total need."[7]

In practice, however, the FHA has ignored this unambiguous mandate. The agency has operated as if it were created to compete aggressively with the private sector. Exploiting its subsidized premium rates, its unique access to unlimited funds from the federal Treasury, and its exemption from industry regulations and taxes, the FHA seems intent on stifling the private mortgage insurance market, not encouraging it. If the FHA were a private business, it would no doubt be accused of engaging in predatory pricing. Private insurers' share of the market has shrunk from 70 percent in 1984 to 60 percent in 1985, and it is anticipated that it will fall to 45 percent by the end of this year. This is at least partially attributable to FHA subsidized rates.[8]

A key advantage enjoyed by the FHA is that it is exempt from the rules imposed by every state that mortgage insurers hold 4 percent of the risk they underwrite in capital reserves. This protects against the natural temptation for mortgage insurers to overinvest their premium income in good times and thus not hold sufficient capital reserves to handle claims in the event of unexpectedly large numbers of mortgage defaults.

Last year, however, the FHA mortgage insurance program accumulated equity (the closest equivalent to capital reserve) of only $2.02 billion on its $190 billion contingent liability.[9] This represents a capital reserve ratio of 1.0 percent, far below the minimum required of private firms by the states and far below the level a self-sustaining business would have to hold. The FHA can do this, of course, because it enjoys a special privilege unavailable to private insurers: in the event of an unexpectedly large number of defaults, the FHA will be bailed out by the Treasury Department.

Nor does the FHA pay any premium taxes, sales taxes, or state and federal income taxes,[10] as private mortgage firms must.

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7. Public Law 171, 81st Congress; 63 Stat. 413, 42 U.S.C. 1441.

8. Mortgage Insurance Companies of America, Fact Book and Directory, 1985.

9. Office of Management and Budget, Budget of the United States Government, Fiscal Year 1987.

10. Waldo, op. cit., p. 36.

THE FHA'S FISCAL TIME BOMB

Mortgage insurance is very different from other types of insurance in that its purpose is not to protect lenders against random events, such as a robbery, a fire, or an injury, where the risk can be assessed according to actuarial tables. Rather, mortgage insurance, as explained by the Mortgage Insurance Companies of America, is issued to protect lending institutions against the hazards of "catastrophic economic risks stemming from a national recession or a regional depression, or systematic overbuilding in housing markets."[11]

Claims against mortgage insurers tend to come in clusters; such claims are highly sensitive to the state of the economy. Chester C. Foster and Thomas N. Herzog, financial officers at the Department of Housing and Urban Development, explain that "Under favorable economic conditions, losses are likely to be small. The great risk in the residential mortgage loan insurance field would appear to be a period of adverse general economic conditions of sustainable duration."[12]

Because of this peculiarity of mortgage insurance, it is misleading to use the deficit/surplus situation of a mortgage insurer in any given year to draw conclusions about the long-term financial viability of that institution. To do so would be as misleading as to look at a department store's revenues and expenses during the Christmas shopping season and then to suppose that the same level of profits would continue throughout the following year. Thus though FHA had a paper profit of $160 million in 1985, this does not mean that the agency is in sound financial condition. Indeed, an examination of the FHA's entire portfolio of risk in the perspective of potential claim rates during severe downturns of the business cycle renders a far bleaker picture. This is because of four recent trends in FHA lending practices.

1) <u>The FHA's Worsening Loan Portfolio</u>

The agency is underwriting record numbers of risky loans. On average, down payments on FHA-insured homes declined from 10 percent

11. The Mortgage Insurance Companies of America, <u>Factbook and Directory</u>, 1985, p. 1.

12. Chester C. Foster and Thomas N. Herzog, "The Role of FHA," <u>Mortgage Banking</u>, November 1981, p. 33.

in 1982 to 7.8 percent in 1985.[13] In 1985, 40 percent of the agency's insured mortgages had loan-to-value ratios[14] of 96 percent or greater.[15] There is near unanimous agreement among housing experts that the less equity homebuyers have tied up in their homes, the greater is their likelihood of default.[16] According to David O. Maxwell, Chairman of the Federal National Mortgage Association, "the conclusion is inescapable that the most central element in weighing the soundness of a mortgage loan is the amount of the homeowner's equity."[17] Recent FHA claim experience substantiates this: claim rates on FHA-insured mortgages originated during 1981 with loan-to-value ratios over 96 percent have default rates twice as high as those with ratios of less than 90 percent.[18] This means that FHA default rates are very likely to grow substantially in the future.

2) FHA's Relaxed Underwriting Guidelines

The agency historically has adopted more liberal underwriting practices than the private mortgage insurance industry. As Table 1 demonstrates, the industry standards for Debt to Income Ratio and Expense to Income Ratio on any single loan are 28 and 36 percent respectively. Prior to 1982, FHA guidelines were 35 and 50 percent. What is worrisome is that in 1982, when interest rates were high and housing affordability low, these ratios were raised, putting them

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13. Office of Management and Budget, unpublished data, 1986.

14. The loan-to-value ratio is the amount of the mortgage divided by the value of the home. The higher the ratio, the less equity the home buyer has put into his home, and thus the higher the likelihood that he will walk away from the loan. A loan-to-value ratio over 95 percent is considered quite high.

15. B. Ellington Foote, "Federal Housing Administration: An Examination of the Proposed Program Changes," Congressional Research Service, March 1986, p. 10.

16. The literature on this subject is lengthy and incontrovertible. Some of the better analyses include: Tim S. Campbell and J. Kimball Dietrich, "The Determinants of Default on Insured Conventional Residential Mortgage Loans," Journal of Finance, December 1983, pp. 1569-1581; James R. Barth, et al., "Financial Institution Regulations, Redlining and Mortgage Markets," in The Regulation of Financial Institutions (Boston: Federal Reserve Bank, 1979); and John P. Herzog and James S. Early, Home Mortgage Delinquency and Foreclosure (New York: National Bureau of Economic Research, 1970).

17. David O. Maxwell, Address before the National Press Club, August 5, 1985.

18. Office of Management and Budget, unpublished data, 1986.

TABLE 1
FINANCIAL STATISTICS FOR THE FHA AND PRIVATE INSURERS

	FHA Pre-1982	FHA Post-1982	Private Insurers 1985
Total Debt to Income	35%	38%	28%
Total Expense to Income	50%	53%	36%

Source: Office of Management and Budget, 1986.

even farther out of line with the private sector guidelines.[19] And the FHA does not even adhere to these loose standards: in recent years about 30 percent of FHA's insured mortgages exceeded these ratios. This would suggest that the industry is far more unstable than its 1984 budget "surplus" might indicate to lawmakers.

3) FHA's Move toward Direct Endorsement

The FHA recently initiated a "direct endorsement" program. With this, the agency forgoes its own verification on the soundness of loans and relies instead on the credit and property appraisal procedures of the bank or other lender granting the mortgage. Direct endorsement speeds the underwriting process greatly and thus is enormously popular with mortgage bankers and the real estate industry. But direct endorsement without proper guidelines or without careful monitoring also compromises the integrity of the underwriting function by inviting misrepresentation and fraud. Private insurers learned this the hard way in the early 1980s when they adopted direct endorsement on a wide scale. According to Steve Doehler, executive vice president of the Mortgage Insurance Companies of America, "some insurers had loss rates three to five times higher on the direct endorsement loans than the traditional loans."[20]

There are already signs that the FHA is having severe problems with direct endorsement. The Inspector General of the Department of Housing and Urban Development released an audit of FHA activities criticizing the appraisal activities of lenders whose loans FHA had underwritten with direct endorsement. The report notes that "property

19. The FHA calculates these rates in a slightly different manner than private mortgage insurers. However, this does not significantly alter their comparability.

20. Telephone conversation, July 1986.

values and project net income estimated by lenders consistently exceeded supportable market values."[21] The report also complains that, because of the unexpectedly high volume of requests for FHA insurance over the past six months, HUD "could not effectively monitor direct endorsement lenders," to detect "possible adverse trends and patterns....As a result, HUD has little assurance that its quality controls are effective or that its risks or insurance losses are minimized."[22] Direct endorsement, in other words, has been adopted at the expense of compromising underwriting standards.

4) FHA's Underpriced Premiums

In 1984 President Reagan signed OMB Circular A-70, which established long overdue reforms in the setting of fees under federal credit programs, such as the FHA. Among these guidelines, the presidential directive mandates that: a) "agencies set fees by reference to insurance premiums charged by private financial intermediaries or other private sources"; and b) "programs whose fees recover only a portion of expected default costs should be reviewed at least annually, and adjusted as necessary to recover the prescribed percentage of the estimated cost to the government of expected liabilities." FHA's low premium rates violate both of these guidelines.

The FHA set its premium at 3.8 percent by examining the claims and loss rates on all FHA insurance policies originated between 1957 and 1981.[23] Since 1981, however, the FHA claim rate has risen from the 3.5 percent typical of the 1960s to 8.3 percent. Claim rates of the past five years are the highest in the program's history.[24] Yet the FHA refuses to raise its premiums to take into account these changed market conditions and the increased risk associated with mortgage insurance, as is required by OMB Circular A-70.

Worse yet, FHA premiums today average 30 to 35 percent below those of private industry. This policy also flaunts the recent presidential directive. As long as the FHA offers subsidized premium rates, the program will remain financially remiss and will continue to attract record numbers of new customers at the expense of the private market. These new customers, of course, are particularly risky, and

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21. Office of Inspector General, Report to the Congress for the Six Month Period October 1, 1985, through March 31, 1986, p. 10.

22. Ibid.

23. A claim rate is the percentage of FHA-insured mortgages that go into default.

24. Ibid.

the greater likelihood of their default will burden the federal taxpayer.

HOW THE FHA SUBSIDIZES THE RICH

Putting the taxpayer at risk might be reasonable if the FHA only assisted low- and moderate-income homeowners who could not afford insurance at market rates. But it helps many upper-income home buyers, vacation home buyers, and real estate investors. None of these groups warrant federal subsidies, and each could be adequately serviced by private mortgage insurance companies.

The FHA imposes no income cap of any kind on program participants. It only restricts the size of the mortgage it will insure: in most areas, the cap is now about $75,000, with a $90,000 mortgage ceiling in certain high cost areas such as New York City. Between 1982 and 1985, nearly 30 percent of homeowners receiving FHA assistance had incomes over $40,000, almost twice the national average.[25] One in eight FHA beneficiaries are in the top 5 percent household earnings bracket. Low- and moderate-income families constitute just 45 percent of the FHA portfolio, not much above the 38 percent of private insurers' business. The FHA, therefore, does not serve a special market neglected by private insurers.

Allowing real estate investors to qualify for FHA insurance has exposed the agency to huge losses. Though FHA-insured properties purchased for business investment purposes rather than home ownership constitute only 12 percent of FHA endorsements, they account for an astounding 30 percent of FHA defaults.[26] The latest estimates are that defaults on investor-owned properties will cost the federal government $630 million in claims during 1986.[27]

POLICY RECOMMENDATIONS

When Congress reauthorizes the FHA this year, it should consider a number of reforms to place the agency on more solid long-term financial footing. Policies to consider include:

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25. Department of Housing and Urban Development, Division of Policy Studies, "An Assessment of FHA's Section 203(b) Program," March 1986, p. 3-3.

26. These HUD statistics were cited in: The Wall Street Journal, "Curbs on Government-Backed Mortgages Are Instituted by Reagan to Battle Fraud," April 4, 1986, p. 3.

27. Office of Management and Budget, unpublished data, 1986.

1) Requiring the FHA to build sufficient reserves. These should equal 4 percent of FHA contingent liability, as is required by private insurers. This would assure that the agency holds funds sufficient to cover catastrophic losses.

2) Requiring that FHA premium rates be at least 80 percent of the level charged by private industry. This would move FHA policies toward conforming with OMB Circular A-70, while still providing a subsidy to low-income homebuyers.

3) Requiring the FHA to establish debt-to-income and expense-to-income ratios compatible with industry standards. This would reduce the risk of default on FHA-insured mortgages.

4) Requiring the FHA to revise its premium rates every year in conformance with OMB Circular A-70. The agency should take into account the latest changes in market conditions in setting premium rates. This would be less stringent than the Administration's proposal to raise the premium level to 5 percent of the mortgage, to be paid at the time of the home purchase.

5) Imposing a 5 percent coinsurance requirement on the lender on direct endorsement loans. By requiring the lender to underwrite a portion of the insurance on the loans it originates, the FHA would have greater protection against fraudulent claims.

6) Phasing in an income cap on participation in the FHA mortgage insurance program. In the first year of the phase in, only families with incomes less than 200 percent of an area's median income might be eligible. This cap would decline to 180 percent the following year, then 160 percent and so forth. A permanent cap could be set at 140 percent of the area's median family income, thus assuring access to the housing credit market to low- and many middle-income families. By phasing in the income limit slowly, Congress would minimize any possible short-term disruptions to the housing market that might be caused by FHA's contraction.

7) Discontinuing FHA mortgage insurance protection for vacation home buyers and investors. Both these groups should turn to readily available private mortgage insurers.

CONCLUSION

With demand for Federal Housing Administration mortgage insurance now shattering previous records, and the agency on the way to Capitol Hill to argue for a greatly increased 1987 budget, Congress must rethink FHA's role in the housing markets. To do so, it should move the agency's policies back in line with its original mandate to service low- and moderate-income home buyers who might be excluded from the private market. The FHA should not require taxpayers to carry the ultimate risk of providing subsidized mortgage insurance rates to upper-income homeowners, purchasers of vacation homes, and real estate investors. Each of these groups should be required to turn to one of the twelve private insurers.

Over the next five years, it is estimated that Americans will seek half a trillion dollars worth of mortgage insurance protection. It is essential to the housing market that there be a strong private mortgage insurance industry to underwrite most of this insurance. Yet it seems undeniable that the FHA is driving private insurers out of the market by using its access to the taxpayer's pockets to encourage homeowners to opt for federally subsidized insurance. At the very least, the FHA should be required to compete with private insurers on an even playing surface.

With the housing market in its best financial shape in years, and the near future looking equally bright, this is the right moment for Congress to start weaning the mortgage bankers and upper-income families from direct federal assistance. By establishing actuarially sound premiums on FHA insurance, and allowing program access only to low- and moderate-income families, Congress could push the FHA toward equity and fiscal responsibility.

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