CATO INSTITUTE BRIEFING PAPERS

Fixing Mortgage Finance
What to Do with the Federal Housing Administration?

by Mark Calabria

No. 123 **February 6, 2012**

Executive Summary

While Fannie Mae, Freddie Mac, and private subprime lenders have deservedly garnered the bulk of attention and blame for the mortgage crisis, other federal programs also distort our mortgage market and put taxpayers at risk of having to finance massive financial bailouts. The most prominent of these risky agencies is the Federal Housing Administration (FHA).

The FHA currently backs an activity portfolio of over $1 trillion. With an economic value of only $2.6 billion, representing a capital ratio of 0.24 percent, relatively small changes in the performance of the FHA's portfolio could result in significant losses to the taxpayer. As the taxpayer is, by law, obligated for any losses above the FHA's current capital reserves, these are not losses that can be avoided. Reasonably foreseeable changes to the FHA's performance could easily cost the taxpayer tens of billions of dollars, surpassing the ultimate cost of the Troubled Asset Relief Program (TARP) bank bailouts.

To protect the taxpayer and the broader economy, the FHA should be scaled back immediately, and an emphasis should be placed on improving its credit quality. At the same time, the agency should be placed on a path to ultimately be eliminated, with its risk-taking being transferred back to the private sector.

Mark Calabria is the director of financial regulation studies at the Cato Institute. He served on the staff of the U.S. Senate Committee on Banking, Housing and Urban Affairs and drafted significant portions of the FHA Modernization Act of 2008. He also served as deputy assistant secretary for regulatory affairs at the U.S. Department of Housing and Urban Development, where he oversaw FHA's minimum property standards program.

Payments from the FHA are made directly to the lender and benefit the borrower only insofar as the presence of the FHA either lowers the cost of borrowing or increases the availability of credit.

Introduction

The Federal Housing Administration (FHA), currently housed within the Department of Housing and Urban Development, insures lenders against the risk of borrower default. The FHA does not make loans itself, but rather sets guidelines for the mortgages it will insure. Mortgages are originated by the lender and can be either held by the lender on its balance sheet or sold to investors or other financial institutions. Payments from the FHA are made directly to the lender and benefit the borrower only insofar as the presence of the FHA either lowers the cost of borrowing or increases the availability of credit.

Lenders pay premiums to the FHA for this insurance, the cost of which is passed along to the borrower. The basic premise is that by mutualizing default risk across lenders and borrowers, the FHA creates overall efficiencies that offset the premiums that would exist under a purely private system of mortgage insurance.

The FHA currently backs an activity portfolio of over $1 trillion. With an economic value of only $2.6 billion, representing a capital ratio of 0.24 percent, relatively small changes in the performance of the FHA's portfolio could result in significant losses to the taxpayer. As the taxpayer is, by law, obligated for any losses above the FHA's current capital reserves, these are not losses that can be avoided. Reasonably foreseeable changes to the FHA's performance could easily cost the taxpayer tens of billions of dollars, surpassing the ultimate cost of the TARP bank bailouts.

History of the FHA

The FHA did not create the concept of guaranteeing mortgages against default. The first private mortgage insurance company appears to have been the Title and Guarantee Company of Rochester, New York, which opened in 1887.[1] By the time of the stock market crash in 1929, some 37 private mortgage insurance companies operated in the state of New York alone.

The initial years of the Great Depression actually saw an increase in the provision of private mortgage insurance. Private mortgage insurers did not begin failing *en masse* until 1933, in tandem with the wave of bank failures occurring that same year. As nominal house prices were flat by 1932, with real prices actually rising,[2] the failure of the private mortgage insurance appears to have been more the result of high unemployment and the banking crisis rather than stress in the housing market.

The combined failure of the mortgage insurance industry and the reduction of credit availability from some 4,000 bank failures in 1933 led Congress to pass the National Housing Act of 1934, Title II of which created the FHA. This paper will focus solely on the FHA's single-family business, generally referred to as its 203(b) program, authorized in Section 203(b) of the National Housing Act, but the agency also provides insurance for multifamily housing (apartments, co-operatives, and condominiums), manufactured housing, and hospitals.

Although FHA requirements were considered quite radical and risky at the time, the FHA's initial loan requirements would be viewed as rather stringent under today's standards. At its inception, the agency required a minimum down payment of 20 percent with a maximum loan term of 20 years. The FHA also limited its insurance to loans we would today call "prime"—maintaining credit standards that would have excluded borrowers with poor or marginal credit. FHA loans were also required to have an annual interest rate of 5.5 percent, along with an annual insurance premium of 0.5 percent. By comparison, private mortgages that were available during that time were generally priced around 4 or 4.5 percent, making FHA loans a relatively expensive option.

The FHA also attempted to minimize credit losses via restrictions on both the properties and neighborhoods that would be eligible. Property quality restrictions were quite extensive, with the agency maintaining an exhaustive handbook detailing various mini-

mum quality standards that would have to be verified via inspection before FHA insurance was written. The agency, rather than the private sector, was also the creator of mortgage "redlining," a policy by which the FHA refused to write insurance on loans located on properties within communities with high concentrations of racial and ethnic minorities.[3]

Despite its promise to be the heart of the New Deal solution to the housing problems of the Great Depression, the FHA maintained a relatively small role in the U.S. mortgage market, rarely rising beyond 10 percent of total mortgage debt outstanding during its first decade of operation.[4] Indeed, the agency's market share did not break 15 percent until the beginning of World War II. During the 1950s and 1960s, the FHA's market share hovered between 15 and 20 percent.[5]

Due to its relatively low activity and high credit standards, coupled with its higher pricing, the FHA posed little financial threat to the taxpayer during its initial decades. Over its first 20 years, the agency maintained an income of almost $500 million in premiums with claims payments of only half that amount.[6] With housing prices and employment steadily rising throughout the 1940s and 1950s, the agency was able to maintain a position of financial health and stability, with both defaults and foreclosures remaining low.

The 1960s witnessed a dramatic turn for the FHA, as the program was among many federal programs that were increasingly seen as not simply a backstop for the market but as a tool of social engineering. President Lyndon Johnson, in his first State of the Union Address, asked Congress to allow the agency to postpone foreclosure for those homeowners who defaulted due to circumstances beyond their control. The Housing Act of 1964 and the Housing and Urban Development Act of 1968 both expanded the reach of the FHA, while adding a mandate to "assist families with incomes so low that they could not otherwise decently house themselves." While it would take some time for these seeds to bear fruit, the FHA entered the 1970s with a mandate to reduce its underwriting standards.

The inflation of the 1970s was not kind to the agency's traditional fixed-rate mortgage product.[7] The FHA's market share, by dollar volume, plunged from over 24 percent in 1970 to just 6 percent by 1976.[8] Its market share remained just above that level for most of the 1980s, while its activity increased along with the rest of the mortgage market as declines in mortgage rates, due to reduced inflation, led to a massive expansion in mortgage lending. Unfortunately, the FHA was not immune from the mortgage market boom and bust of the late 1980s. It required restructuring and reform. In 1989, for the first time, Congress required annual audited financial statements for the agency and established the Mortgagee Review Board, intended to reduce lender fraud and abuse within the agency.

The 1970s also witnessed the rebirth of the private mortgage insurance industry, which provided direct competition with the FHA. While a number of private mortgage insurance companies went public in the 1960s—the most prominent of which was the Mortgage Guaranty Insurance Corporation—it was not until 1972 that the level of private mortgage insurance issued surpassed that of the FHA. Since that time, private mortgage insurers have maintained a market share comparable to that of the FHA, while presenting no risk to the taxpayer.

During the 1980s the agency underwent several program expansions that would eventually result in significant costs to both the FHA insurance fund and the taxpayer. Foremost among these costly expansions was the reduction of the required down payment from 10 percent to 3 percent. Congress also eliminated the agency's maximum interest rate cap, allowing lenders to charge rates above the previous cap. Repeatedly Congress also raised the size limit on FHA loans, expanding the agency's market share in higher-cost housing markets. When the housing market eventually turned south, the FHA insurance fund lost about $6 billion, while its economic value plunged toward zero.[9] The early 1980s were some of the worst years witnessed by the agency. Loans written in 1981 displayed a life-

The 1970s also witnessed the rebirth of the private mortgage insurance industry, which provided direct competition with the FHA.

time foreclosure rate of 22 percent, while the loss rate per foreclosed FHA loan reached 45 percent in 1982.[10]

If there can be said to have been a time of stability for the FHA, that time was the 1990s. As the housing market began to recover from the late 1980s boom and bust, with the market hitting bottom by 1993, the FHA increased its volume, along with the rest of the mortgage market, keeping a market share of between 15 and 18 percent for the entire decade. Even in the wake of the current contraction, FHA loans written between 1991 and 1999 have maintained a positive net present value (ignoring administrative costs). The FHA entered the great housing boom of the 2000s in relatively sound financial shape.

FHA during the Housing Bubble

The housing market boom of 2002 to 2006 seemed to be great for almost everyone in the housing and mortgage markets, with the exception of the FHA. The agency's loan volume and market share both collapsed, while credit quality declined dramatically. FHA loans truly became the choice of borrowers who had no other choices.

The year 2001 marked the beginning of a quick decline for the agency. Its share of home purchase mortgage originations dropped from about 14 percent in 2001 to just below 5 percent in 2005. Perhaps not coincidently, 2001 also witnessed a significant increase in the mandated housing goals for the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac. In 2000 the GSEs introduced zero down payment products. Given the historical central role of the FHA in low down payment lending, products such as Freddie Mac's Home Possible Mortgage were clearly intended to compete with the FHA. It would appear that the GSEs met their housing goals, in part, by taking business from the FHA.[11] There is also some evidence that increased bank lending under the Community Reinvestment Act came at the expense of the FHA, although this effect has been found to be small.[12]

The period 2001–2006 also witnessed a boom in subprime mortgage lending. Much of this also came at the expense of the FHA, particularly among borrowers with the worst credit histories. For instance up until 2001, the FHA's market share in census tracts with median credit scores in the bottom quarter of the distribution declined from just over 40 percent to around 15 percent.[13] The decline in FHA lending relative to subprime lending has also been associated with the growth of independent nondepository mortgage brokers and bankers. While nondepositories did constitute a large share of FHA originations, about 45 percent in 2005, their involvement in subprime was considerably higher at 85 percent (see Table 1).

Contrary to conventional wisdom, most subprime loans were not to "low income" households, but rather to households with poor credit. Even after its relative decline, the FHA maintained a much higher share of its lending to low- and moderate- income borrowers than did subprime lending. For instance in 2005, over 14 percent of FHA borrowers were low income, while only 7 percent of subprime lending went to low- income households, as illustrated in Table 1. The opposite relationship is found on the upper end of the income distribution, with 14 percent of FHA borrowers being high income, compared to 27 percent for subprime borrowers.[14] Given the prominent role of Fannie Mae and Freddie Mac in the subprime market,[15] particularly their purchase of private label subprime securities, it is difficult to disentangle the relative importance of subprime lending and the GSEs in driving down the FHA's presence in the mortgage market, although a survey of FHA lenders reported that such lenders believe almost two-thirds of the decline of their FHA business was due to Fannie Mae and Freddie Mac.[16]

Even after its relative decline, the FHA maintained a much higher share of its lending to low- and moderate-income borrowers than did subprime lending.

While the FHA's footprint in the mortgage market shrunk during the housing boom, its business increasingly became characterized by two high-risk features: the growing percentage of subprime-quality borrowers and reduced equity on the part of the borrower.[17] Either of these factors can generally be managed in isolation. At the height of the bubble, in 2005, over 55 percent of FHA originations were for

Table 1
Home Purchase Loans (2005)

	FHA (%)	Subprime (%)
Income – Low	14.4	7.3
Income – Moderate	40.1	28.8
Income – Middle	31.2	36.5
Income – High	14.3	27.4
Originator		
Despository	55.3	15.0
Mortgage Co.	44.7	85.0
Loan Not Sold	9.6	16.7

Source: John Karikari, Ioan Voicu, and Irene Fang, "FHA vs. Subprime Mortgage Originations: Is FHA the Answer to Subprime Lending?" *Journal of Real Estate Economics and Finance* 43 (2011): 441–58.

borrowers with an initial loan-to-value (LTV) ratio of 97 percent or more. That meant that a minor decline in prices—as little as 3 percent—would have eliminated all home equity for the majority of FHA loans insured in 2005. Another 23 percent of 2005-vintage FHA loans had LTVs between 95 and 97 percent. Given that a home seller's transactions costs usually run between 5 and 7 percent of the sales price, almost 80 percent of 2005 FHA borrowers would have needed to *contribute* cash in order to sell their homes even in the *absence* of a price decline. To illustrate how far the FHA has drifted from its original mission, over 90 percent of FHA loans insured in 2005 would not have even qualified for FHA insurance in 1935.

Even more troubling was the FHA's high concentration of poor credit quality borrowers. Trends are difficult to analyze, as the agency did not begin collecting borrower credit scores until May 2004, and prior to that point, loans were accepted or rejected on the basis of an internal "scorecard." Once the agency started collecting FICO credit scores, the facts were clear: over half of new FHA borrowers had subprime credit scores every year from 2005 through 2008. As will be examined further, the FHA's combination of poor-quality borrowers with their relatively little equity is a recipe for disaster.

The FHA to the Rescue?

Where the boom wasn't so good for the FHA, the bust has oddly enough provided the agency with some level of salvation, at least in terms of activity and relevance. With the implosion of the private subprime market and the retrenchment of the GSEs, the FHA's market share more than tripled from 2007 to 2008, followed by further expansions in 2009 and 2010. It seemed like the agency was "back in the game."

The FHA also made administrative changes in 2006, just as the bubble was about to pop, improving its attractiveness to lenders. According to mortgage lenders, one of the reasons for the agency's decline in the early 2000s was the difficulty and expense of complying with various FHA rules.[18] For instance, the agency had long required lenders to submit loan files by mail, after which it would review and return the file to the lender. The agency also maintained a variety of property inspection requirements that went beyond other market participants. The year 2006, however, brought several administrative changes that allowed "higher-performing" lenders to self-approve FHA insurance endorsements, as well as simplifying the FHA's appraisal process.

These administrative changes occurred

Over 90 percent of FHA loans insured in 2005 would not have even qualified for FHA insurance in 1935.

after the agency requested Congress to grant it expanded authorities. Such authorities would have included

1. allowing the insurance of zero down payment loans;
2. having the agency move to a system of "risk-based" insurance premiums; and
3. increasing the agency's loan limit.

Then–FHA head Brian Montgomery was explicit in saying "FHA reform is designed to give homebuyers who can't qualify for prime financing a choice again."[19] The FHA recognized that many of its worst borrowers had gone elsewhere, and it intended to get them back.

Both during and after the housing boom, the potential for the agency to serve as a replacement for private subprime was hotly debated.[20] Some, such as Montgomery, argued that subprime loans were "expensive" for borrowers relative to what they would pay under the FHA. It was also felt that some occasional features of subprime loans, such as pre-payment penalties, teaser rates, or simply higher interest rates, were inherently "unfair." This, of course, touches upon one of the central issues in the mortgage crisis: was it caused by the borrower or the loan? I will not attempt to resolve that debate here, only to note that many arguments for expanding or preserving the FHA center around the agency offering a better deal for the borrower. That better deal for the borrower may very well, however, come at the expense of the taxpayer. If anything, the failure of hundreds of subprime lenders, along with the rescue of Fannie Mae and Freddie Mac, should illustrate that rather than subprime loans being too "expensive," they were actually too cheap relative to their ultimate losses.

During the bubble and up until 2009, over half of FHA borrowers did not even fund their own down payment.

One of the few market segments that the FHA did dominate, both during and after the bubble, was the acceptance of "seller-provided" down payments. During the bubble and up until 2009, over half of FHA borrowers did not even fund their own down payment. In many cases, the down payment was provided by a "nonprofit" entity that was compensated by the seller, often a builder. These nonprofits were generally little more than fronts, and the seller increased the total house price in order to earn back the fronted money. The end result was that the buyer had no equity in a property that itself was likely overvalued. Given the ability to finance the FHA insurance premium into the loan, borrowers could leave the closing table with loan-to-values in excess of 100 percent.

Eventually Congress banned the use of seller-provided down payments in 2008, after which the FHA's share of business with LTVs over 97 percent declined dramatically. However, the impact of this policy change was relatively minor, as the share of mortgages with LTVs between 95 and 97 percent increased more than enough to offset the decline in LTVs over 97 percent. Interestingly enough, part of the disappearance of seller-provided down payments has been replaced by relative-funded down payments. Among FHA loans made in 2011, there are still almost a quarter where the borrowers did not provide the down payment themselves.

The improvement in credit quality was more pronounced. Whereas the majority of FHA business between 2005 and 2008 was of subprime credit, the subprime share contracted to around a third of originations in 2009 and 2010. In 2011 only about 4 percent of FHA borrowers had FICO scores below 620. Interestingly enough, the percent of highest-quality borrowers—with FICOs above 720—dramatically increased from around 9 percent in 2007 to around 35 percent in 2011. The future health of the FHA will greatly depend upon keeping a significant share of these higher-quality borrowers. The FHA's current forecast of avoiding a taxpayer rescue depends heavily on its assumption that its percentage of borrowers with FICOs above 720 will remain at least 22 percent in future years. A reversion to 2007 credit quality would guarantee the necessity of a rescue.

The FHA's Financial Health

Since the end of 2007, the FHA's capital reserves have declined from $22 billion

to around $4.7 billion in the fall of 2011. While some decline is to be expected, given the bursting of the housing bubble and continued weakness in the labor market, further declines could easily erode the remaining reserves and require direct appropriations to cover future claims.

The possibility of an FHA bailout is not remote. According to the FY2011 Actuarial Review, the net present value of future cash flows from the FHA's current 203(b) book of business is a *negative* $26.9 billion. The FY11 Actuarial Review projects a positive economic value for the agency solely on the basis of assuming that future business will generate revenues sufficient to cover embedded losses. In order for that assumption to materialize, the credit quality of the FHA's lending must be improved considerably, and then maintained. It should be noted that a critical assumption driving the positive expected value of future business is the continued prohibition of seller-financed down payments. The FHA's actuaries have estimated that had this ban been in place before the bubble, the agency would have avoided $14 billion in losses.

Although the FHA's market share was relatively small during the height of the housing boom, that did not protect the agency from guaranteeing loans that currently have a negative net present value. Values for loans originated in Fiscal Year 2006 are -$1.6 billion. Of course, this becomes relatively small when compared to the values for FY08 (-$7.8 billion) and FY09 (-$6.6 billion) books of business. These values also depend heavily on what I believe are relatively optimistic projections for the housing market. Further price declines will dig these holes even deeper. For instance, the FHA's base case assumes that national house price appreciation will turn positive (1.2 percent) in 2012, even reaching a 6.1 percent growth rate in 2014. Given that the last 100 years have seen an annual average growth in nominal house prices of only 3.1 percent, such high expected rates of appreciation appear optimistic. Were house price appreciation to revert simply to its historical average, the FHA would still likely require a taxpayer rescue.[21]

The following sections will offer a more detailed account of the costs involved in combining poor borrower credit with little equity. Various policy proposals will also be offered that would significantly improve the financial health of the FHA, helping to avoid a potential taxpayer-financed rescue. The policy changes presented are generally modest and work within the agency's existing structure. While such modifications would likely shift risk from the federal government to private actors, they should be best viewed as interim steps toward eventual elimination of the FHA.

Toward a Fuller Accounting of Cost

If there is any lesson we should take away from the recent financial crisis, it is that when borrowers, lenders, investors, and governments do not face (or are insulated from) the actual costs of their decisions, those decisions are likely to have negative consequences. The FHA and its congressional oversight have long suffered from poor decisionmaking due to gross underestimates of cost.

For example, FHA premiums are not structured to cover the administrative costs (including salaries) of running the agency. No private business would last long if it did not price to cover the costs of its employees. Such costs for the FHA, however, are covered by appropriations that directly come at the expense of the taxpayer. In recent years, these costs have averaged about $350 million. Given that FY10 insurance-related cash flows were approximately a negative $510 million, excluding administrative costs underestimates current negative cash flows by at least 40 percent.

Subsidy rates for the FHA are calculated under procedures specified by the Federal Credit Reform Act of 1990 (FCRA). In addition to excluding administrative program costs, the FCRA excludes any adjustment for market risk. Under insurance programs such as the FHA, where the private sector pays to transfer risk-bearing to the government, the private sector is also protected from market risk. A clear benefit is being provided that is not included under the FCRA. The Congressional Budget Office has estimated that

Were house price appreciation to revert simply to its historical average, the FHA would still likely require a taxpayer rescue.

The bias of estimates has consistently been in one direction: the underestimation of costs.

calculating the FHA's subsidy costs under a fair-value method—which the CBO believes "provides a more comprehensive measure of the cost"—would shift an expected budgetary savings of $4.4 billion in FY12 to a budgetary cost of $3.5 billion.[22] It should be noted that fair-value accounting has been used in other federal contexts; for instance Section 123 of the Emergency Economic Stabilization Act of 2008 requires the treasury secretary to take into account market risk in the context of the Troubled Asset Relief Program (TARP).

When one ignores administrative expenses and fair value, the FHA could be considered, as it has long been presented, to be "making money." Yet these assumed "negative subsidies" were based on erroneous estimates by the agency. A comparison of original estimates and subsequent reestimates of FHA subsidy rates for the 203(b) program show that, from 1999 to 2011, actual subsidy costs were revised upward by a net total of $44 billion. These reestimates have been large enough, in the years from 2002 and 2009, to change "negative subsidies" into actual positive subsidies. Figure 1 clearly illustrates that the errors in the FHA's subsidy estimates have been quite large. For instance, the FY06 book was initially projected to create cash equal to 2 percent of book. Upon reestimation, FY06 actually cost the agency over 4 percent of its book—an error that has cost almost $4 billion for just FY06. The figure also illustrates that the bias of estimates has consistently been in one direction: the underestimation of costs.

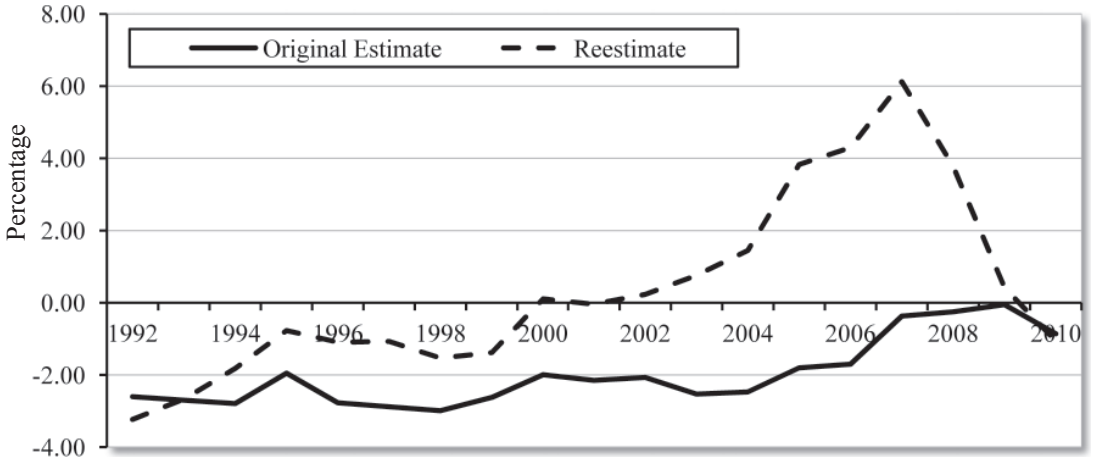
Given the gross underpricing of actual risk by the FHA, the following changes should be made to the agency's premium pricing:

- Require charged premiums to cover projected administrative costs, including employee compensation.
- Require charged premiums to be estimated on a fair-value basis.

Toward Sustainable Homeownership

The performance of FHA single-family mortgages during the last decade has, at times,

Figure 1
FHA's Original Estimates and Reestimates of Subsidy Rates for Its Single-Family Mortgage Insurance Program, by Loan Cohort Year



Source: Congressional Budget Office based on data from Office of Management and Budget, *Buget of the U.S. Government, Fiscal Year 2012: Federal Credit Supplement* (February 2011).
Notes: The subsidy rate is the dollar amount of the federal subsidy expressed as a percentage of the dollar amount of mortgage principal guaranteed. The subsidy rate shown for each "loan cohort year" is the rate estimated for the group of loans disbursed in that year.

Table 2
Distribution of New FHA Loans by Credit Score

Books of Business	Missing	300–499	500–559	560–599	600–639	640–679	680–850	Total Subprime
2005	4.92	0.93	9.34	16.96	24.58	20.26	23.00	56.73
2006	4.56	0.92	8.70	16.57	24.41	20.71	24.12	55.16
2007	4.28	1.44	11.68	19.47	24.86	18.84	19.45	61.73
2008	1.99	0.81	7.15	14.81	24.71	22.46	28.08	49.47
2009	0.47	0.05	1.20	5.63	19.43	25.45	47.76	26.78
2010	0.35	0.01	0.20	1.08	14.45	26.80	57.09	16.09

Source: FY2010 Actuarial Review of Mutual Mortgage Insurance Fund, Integrated Financial Engineering Group.

made subprime lending look safe by comparison. From 2002 to 2007 the delinquency rate of FHA mortgages actually exceeded that of subprime. This should come as no surprise given that in the 2005 book of business about 60 percent of FHA borrowers had FICO scores under 640 (see Table 2). As mentioned above, once it began the collection of credit scores, it readily became apparently that the FHA was one of the largest sources of credit for subprime borrowers. In 2009 the credit profile of FHA borrowers improved considerably, raising the expectation that future books of business may see a reduced incidence of loss.

Losses from subprime borrower credit are usually manageable when there is significant equity on the part of the borrower. It is the combination of poor credit history and low or no down payment that have resulted in tremendous losses, both for the FHA and private subprime mortgage lending. As Table 3 illustrates, when low equity is combined with weak credit, defaults skyrocket. Note that the table is normalized so that a loan with a credit score between 680 and 720 and a LTV between 71 and 80 percent equals "1." Other figures are either fractions or multiples of this number. The magnitudes are nothing short of shocking. Loans with a FICO below 620 and down payments of less than 10 percent display default rates 20 times that of the base group.

Such high levels of default are not healthy for the borrower, the lender, or the taxpayer—not to mention the economy. We know, with near certainty, that borrower credit quality and equity are the drivers of default, both in the FHA and in the mortgage market generally. If we wish to protect the taxpayer and avoid a future bailout of the FHA, these are the policy margins along which we must make substantive changes. Given the relatively "safe" features of an FHA loan, we do not have to guess about loan characteristics driving the borrower into default. We know it is equity and credit history that drive losses.

Recent congressional testimony from FHA officials illustrates this relationship within the agency's current portfolio (see Table 4).[23] FHA loans with either high credit scores or significant equity have performed reasonably well. Loans lacking both those features have performed poorly and threaten the solvency of the FHA.

Of course, the relationship between high default and size of down payment is nothing new. A 1969 study of FHA defaults showed that as the down payment fell from just 10

FHA was one of the largest sources of credit for subprime borrowers.

Table 3
Loan to Value Ratio

Credit Score	<70%	71–80%	81–90%	91–95%
<620	1.0	4.8	11	20
620–679	0.5	2.3	5.3	9.4
680–720	0.2	1.0	2.3	4.1
>720	0.1	0.4	0.9	1.6

Source: Charles Anderson, Dennis Capozza, and Robert Van Order, "Deconstructing the Subprime Debacle Using New Indices of Underwriting Quality and Economic Conditions: A First Look," Homer Hovt Advanced Studies Institute, July 2008, http://www.hovt.org/documents/first look.pdf.

Table 4
FHA Single Family Insured Loan Claim Rates
Relative Experience by Loan-to-Value and Credit Score Values-Ratios of each Combination's Claim Rate to that of the Lowest Risk Cell

Loan-to-Value Ratio Ranges	Credit Score Ranges			
	500–579	580–619	620–679	680–850
Up to 90%	2.6	2.5	1.9	1.0
90.1–95%	5.9	4.7	3.8	1.7
Above 95%	8.2	5.6	3.5	1.5

Source: U.S. Department of Housing and Urban Development/Federal Housing Administration, March 2010.

percent to 3 percent, the likelihood of default increased by over 500 percent.[24] Even FHA loans with a 10 percent down payment were twice as likely to default as those with a 20 percent down payment. Significant differences in default were observed even along relatively small changes in the down payment, say from just 4 to 5 percent. Policymakers have, however, repeatedly chosen to accept or hide this increased level of default in exchange for increasing the access to homeownership.

Even FHA loans with a 10 percent down payment were twice as likely to default as those with a 20 percent down payment.

To insure that the FHA guarantees loans that are sustainable on the part of the borrower and represent a minimum risk to the taxpayer, the following policy changes should be implemented:

- Immediately require a 5 percent cash down payment on the part of the borrower.
- Require the FHA to allow only reasonable debt-to-income ratios.
- Restrict borrower eligibility to a credit history that is no worse than a 600 FICO score or its equivalent.
- Require pre-purchase counseling for borrowers with a credit history that is equivalent to a FICO score between 600 and 680.
- Require a 10 percent down payment, immediately, for borrowers with a credit history equivalent to below a 680 FICO score.

- Borrower eligibility should also be limited to borrowers whose incomes do not exceed 115 percent of median area income, so as to mirror the requirements of section 502(h)(2), as amended, of the Housing Act of 1949.

A Fairer Sharing of Risk

It is not solely the behavior of the borrower that matters for default. Incentives facing the lender also greatly contribute to default. Where the lender bears the full cost of default, we can expect prudent and careful underwriting to prevail in the long run (as the imprudent eventually fail, unless we rescue them). Where the lender, with little penalty, can pass along the cost of default to another party, for instance the taxpayer, poor or negligent underwriting is to be expected. Accordingly, we must change lender incentives under the FHA program. As has been repeatedly detailed by HUD's inspector general,[25] the FHA has long shown a lax attitude toward lender fraud and misbehavior. Given the legitimate due process concerns that arise when any party receives a government benefit or participates in a government program, the FHA's ability to effectively eliminate fraud ex post will always be somewhat limited. Of course, this does not eliminate the necessity of doing so. It does imply, however, that alternative means must be found for improving the incentives facing lenders.

To provide the appropriate incentives for lenders to conduct sufficient due diligence and quality underwriting, the following policy changes should be implemented:

- Immediately reduce maximum claim coverage from 100 percent of loan to 80 percent, and over time reduce coverage to a maximum of 50 percent.
- Require lenders to "take back" any loan that defaults within six months of origination.
- The FHA should also end the process of letting the lender choose the appraiser and return to the safeguard of an appraisal board.

Every other provider of mortgage default insurance leaves some risk with the lender so as to create proper incentives for the lender to reduce default risk. Private mortgage insurance companies generally cover only the first 20 to 30 percent of loss, as compared to the FHA's 100 percent coverage. The Veterans Administration (VA) mortgage guarantee is also a partial guarantee, covering somewhere from 25 to 50 percent of losses depending upon the size of the loan. Prior to 1985 the VA followed a model similar to the FHA's, usually taking possession of the property and paying the lender 100 percent of the mortgage. Not surprisingly, when the VA proposed to move toward its current "no-bid" system, where less than 100 percent is provided, mortgage lenders predicted a "mass exodus" out of VA loans.[26] Lenders also predicted that mortgage rates would "skyrocket" on VA loans without full coverage. Neither of these predictions came true. As lenders continue to make the same arguments today in regard to the FHA (not surprising given their financial interest), such claims should be viewed in the same light as when they were asserted in regard to the VA loan program.

Once Congress banned the use of seller-financed down payments, the rate of early-payment default, where the borrower becomes more than 90 days delinquent within six months of origination, fell dramatically from 2.2 percent at the beginning of 2008 to 0.36 percent by January of 2011. As these numbers have become relatively small, barring insurance claims within the first six months should have little impact on lender costs while improving lender due diligence.

Benefits Lost

The FHA has long been defended by the real estate industry and consumer advocates, as well as politicians in both major parties. Recent years have witnessed expansions of the agency's responsibilities passed by Congresses controlled by both Republicans and Democrats. Clearly there is a perception that the agency provides a social benefit. But what exactly is that benefit?

Where the lender can pass along the cost of default to another party, for instance the taxpayer, poor or negligent underwriting is to be expected.

Contrary to conventional wisdom, minority homeownership has expanded most when the FHA's share of minority loans has declined.

The most readily touted benefit is an increase in homeownership. But the empirical literature suggests the FHA homeownership benefits are little to none. The studies most favorable to the agency suggest increased homeownership rates of around 0.6 percent.[27] The more skeptical studies suggest the agency simply accelerates homeownership and has little impact on the overall trend rate.[28]

Ironically, given the FHA's role in the creation of redlining, the agency is seen as an important tool for expanding minority homeownership. During the 1990s, the FHA's market share among minority households was around 10 percentage points higher than for white households. This differential almost disappeared from 2004 to 2007, not only at the peak of the bubble but also during the largest expansion of minority homeownership. Contrary to conventional wisdom, minority homeownership has expanded most when the FHA's share of minority loans has declined. As its loan limits have historically been significantly below that of Fannie Mae and Freddie Mac, one would expect a higher percentage of FHA business to be lower-income relative to the conforming market. Given the correlation of race and income, one would also expect the FHA's share of the minority market to be higher relative to the conforming.

A curtailment, if not outright elimination, of the FHA would likely have a negative, but small, impact on long-term homeownership rates. While it would seem such an impact would be felt most in minority homeownership, recent trends in minority homeownership suggest the impact would be ambiguous at best. As FHA loans are rarely used for mortgages with substantial borrower equity, the most significant impact of either eliminating the FHA or requiring larger down payments would be felt by borrowers unable to produce reasonable down payments. Accordingly, estimates that examine increases in down payment requirements across the mortgage market provide an upper bound for such changes imposed on the FHA. Economists at the Federal Reserve Bank of St. Louis recently estimated that a minimum down payment requirement of 15 percent for all mortgages would reduce homeownership rates by only 0.2 percentage points.[29] Given that this estimate assumes no decline in house prices, the actual impact is likely closer to zero and prices would decline to clear the market. The same study estimates that price declines of 0.7 percent would be needed for there to be no reduction in the homeownership rate. The study also estimates that a 15 percent down payment requirement would reduce defaults by 30 percent. Such a large reduction in defaults with only a minor decline in either homeownership or house prices would appear to pass any cost-benefit test.

Questions of reforming the FHA can rarely avoid the issue of race. This is particularly so given the agency's early role in the establishment of redlining and use of racial deed covenants. As argued above, modest reforms to the FHA would likely have little impact on overall homeownership rates or rates for African Americans. Census Bureau estimates indicate that a down payment requirement of 10 percent would result in only 2.2 percent of African-American renters being able to afford the median-priced home.[30] Lowering the down payment requirement to 2.5 percent, as is currently the FHA standard, only increased that to 2.7 percent. For the vast majority of African-American renters, the predominant obstacle to homeownership is not a reasonable down payment, but sufficient income, something beyond the FHA's ability of to address. This is in no way an attempt to make light of longstanding differences in wealth across racial groups, but rather to question the efficacy of using the FHA, or mortgage finance in general, to address those differences. Mortgage finance represents a fairly ineffective method for transferring wealth, and also one that can come at significant cost to the overall economy.[31] Not to mention that such redistribution has generally been found to be both regressive[32] and relatively more beneficial to white households than to African-American households.[33]

Conclusions

The history of the FHA has been one of an almost constant reduction in standards, usually as an excuse to "restart" the housing market. Indeed, the first substantial legislation changes were made just four years after its creation, when Congress lowered down payment requirements from 20 to 10 percent and extended the maximum loan duration from 20 years to 25 in 1938. This did little for the housing market, which did not begin to recover until after World War II.

The recent housing boom and bust have garnered a similar reaction: governmental attempts to restart the bubble by transferring massive amounts of risk to the taxpayer. Again, these efforts have accomplished little despite their great cost. We should not repeat the same mistake that has followed almost every housing bust in the last 100 years. Instead of leaving these additional stimulants in place, we should begin moving federal mortgage policy toward a sounder footing. Only then can we hope to avoid leaving the taxpayer holding the bag when the next bubble inevitably bursts.

Future projections of the FHA's financial health depend critically upon a significant increase in credit quality. In order to protect the taxpayer, Congress should begin making efforts to guarantee that increase in credit quality today.

Notes

1. For a general history, see Thomas Herzog, "History of Mortgage Finance with an Emphasis on Mortgage Insurance," Society of Actuaries, 2009.

2. For real and nominal house prices, see http://www.econ.yale.edu/~shiller/data/Fig2-1.xls.

3. For the FHA's role in redlining, see John Kimble, "Insuring Inequality: The Role of the Federal Housing Administration in the Urban Ghettoization of African Americans," *Law and Social Inquiry* 32, no. 2 (June 2007), 399–434. See also Adam Gordon, "The Creation of Homeownership: How New Deal Changes in Banking Regulation Simultaneously Made Homeownership Accessible to Whites and out of Reach for Blacks," *Yale Law Journal* 115, no. 1 (October 2005): 186–226. For an alternate view of redlining more generally, see Andrew Holmes and Paul Horvitz, "Mortgage Redlining: Race, Risk, and Demand," *Journal of Finance* 49, no. 1 (1994): 81–99.

4. Spurgeon Bell, "Shifts in the Sources of Funds for Home Financing, 1930–1937," *Law and Contemporary Problems* 5, no. 4 (1938): 510–16.

5. See "Historical Statistics of the United States, 1890 to 1970," United States Bureau of the Census.

6. Arthur M. Weimer, "The Work of the Federal Housing Administration," *Journal of Political Economy* 45, no. 4 (1937): 466–83.

7. David L. Kaserman, "Evidence on the Decline of FHA," *Journal of Money, Credit, and Banking* 10, no. 2 (1978): 194–205.

8. Survey of Mortgage Lending Activity, U.S. Department of Housing and Urban Development, various years.

9. Patric Hendershott and James Waddell, "Changing Fortunes of FHA's Mutual Mortgage Insurance Fund and the Legislative Response," *Journal of Real Estate Economics and Finance* 5, no. 2 (June 1992): 119–32.

10. United States Government Accountability Office, "Homeownership: Potential Effects of Reducing FHA's Insurance Coverage for Home Mortgages," GAO/RCED-97-93, May 1997.

11. Xudong An and Raphael Bostic, "GSE Activity, FHA Feedback, and Implications for the Efficacy of the Affordable Housing Goals," *Journal of Real Estate Economics and Finance* 36, no. 2 (2008): 207–31.

12. Jonathan Spader and Roberto Quercia, "CRA Lending in a Changing Context: Evidence of Interaction with FHA and Subprime Originations," *Journal of Real Estate Economics and Finance* 41, no. 2 (2010).

13. United States Government Accountability Office, "Report to Congressional Requesters, Federal Housing Administration: Decline in the Agency's Market Share Was Associated with Product and Process Developments of Other Mortgage Market Participants," June 2007, GAO-07-645.

14. John Karikari, Ioan Voicu, and Irene Fang, "FHA vs. Subprime Mortgage Originations: Is FHA the Answer to Subprime Lending?" *Journal of Real Estate Economics and Finance* 43 (2011): 441–58.

15. Mark Calabria, "Fannie, Freddie, and the Subprime Mortgage Market," Cato Institute Briefing

Paper no. 120, March 7, 2011, http://www.cato.org/pub_display.php?pub_id=12846.

16. Bernadette Kogler, Anne Schnare, and Tim Willis, *Lender Perspectives on FHA's Declining Market Share* (Washington: Research Institute for Housing America, 2006), http://www.housingamerica.org/RIHA/RIHA/Publications/54184_5945_Lender-Perspectives_080106.pdf.

17. United States Government Accountability Office, "Mortgage Financing: Actions Needed to Help FHA Manage Risks from New Mortgage Loan Products," February 2005, GAO-05-194.

18. United States Government Accountability Office, "Report to Congressional Requesters."

19. Testimony of Brian Montgomery, FHA Commissioner, before the United States Senate Committee on Banking, Housing and Urban Affairs, Subcommittee on Housing and Transportation, June 20, 2006.

20. Karikari, Voicu, and Fang.

21. For historical house price series, see Robert Shiller's estimates, http://www.econ.yale.edu/~shiller/data/Fig2-1.xls. See also Deigo Aragon et al., "Reassessing FHA Risk," NBER Working Paper 15802, March 2010.

22. Congressional Budget Office, "Accounting for FHA's Single-Family Mortgage Insurance Program on a Fair-Value Basis," May 18, 2011.

23. Testimony of Carol Galante, Acting FHA Commissioner, before the United States House of Representatives, Subcommittee on Insurance, Housing and Community Opportunity, September 8, 2011.

24. George M. Von Furstenberg, "Default Risk on FHA-Insured Home Mortgages as a Function of the Terms of Financing: A Quantitative Analysis" *Journal of Finance* 24, no. 3 (1969): 459–77. For similar evidence on FHA performance in 1980s, see Patric Hendershott and William Schultz, "Equity and Nonequity Determinants of FHA Single-Family Mortgage Foreclosures in the 1980s" *Journal of the American Real Estate and Urban Economics Association* 21, no. 4 (1993).

25. Testimony of Ken Donohue, Inspector General, HUD, before the United States Senate Committee on Banking, Housing and Urban Affairs, July 18, 2007.

26. United States Government Accountability Office, "Homeownership: Potential Effects of Reducing FHA's Insurance Coverage for Home Mortgages."

27. Albert Monroe, "How the Federal Housing Administration Affects Homeownership," Harvard University, Joint Center for Housing Studies, 2001.

28. John L. Goodman, Jr., and Joseph B. Nichols, "Does FHA Increase Home Ownership or Just Accelerate It?" *Journal of Housing Economics* 6, no. 2 (1997): 184–202. Similar findings of a small FHA impact on homeownership are found in Zeynep Onder, "Homeownership and FHA Mortgage Activity in Neighborhoods and Metropolitan Areas," *Journal of Housing Economics* 11, no. 2 (2002): 152–81.

29. Juan Carlos Hatchondo, Leonardo Martinez, and Juan Sanchez, "Mortgage Defaults," Working Paper 2011-019A, Federal Reserve Bank of St. Louis, August 2011, http://research.stlouisfed.org/wp/more/2011-019.

30. United States Bureau of the Census, Department of Commerce, *Who Can Afford to Buy a House?* various years, http://www.census.gov/hhes/www/housing/hsgaffrd/hsgaffrd.html.

31. On the costs of low down payment subsidies, see Yongheng Deng, John M. Quigley, and Robert Van Order, "Mortgage Default and Low Downpayment Loans: The Costs of Public Subsidy," *Regional Science and Urban Economics* 26, no. 3-4 (1996): 263–85.

32. For regressive impact see Karsten Jeske, Dirk Krueger, and Kurt Mitman, *Housing and the Macroeconomy: The Role of Bailout Guarantees for Government Sponsored Enterprises*, NBER Working Paper 17537, October 2011, http://www.nber.org/papers/w17537.

33. For racial differences in benefits, see Onder.

RECENT STUDIES IN THE BRIEFING PAPER SERIES

122. **Herbert Hoover: Father of the New Deal** by Steven Horwitz (September 29, 11)

121. **Publication Practices for Transparent Government** by Jim Harper (September 23, 2011)

120. **Fannie, Freddie, and the Subprime Mortgage Market** by Mark Calabria (March 7, 2011)

119. **Short Sales Bans: Shooting the Messenger?** by Laurence Copeland (September 14, 2010)

118. **The Case for Auditing the Fed Is Obvious** by Arnold Kling (April 27, 2010)

117. **Scientific Misconduct: The Manipulation of Evidence for Political Advocacy in Health Care and Climate Policy** by George Avery (February 8, 2010)

116. **The Citizens' Guide to Transportation Reauthorization** by Randal O'Toole (December 10, 2009)

115. **ObamaCare: A Bad Deal for Young Adults** by Aaron Yelowitz (November 9, 2009)

114. **All the President's Mandates: Compulsory Health Insurance Is a Government Takeover** by Michael F. Cannon (September 23, 2009)

113. **High-Speed Rail Is Not "Interstate 2.0"** by Randal O'Toole (September 9, 2009)

112. **Massachusetts Miracle or Massachusetts Miserable: What the Failure of the "Massachusetts Model" Tells Us about Health Care Reform** by Michael Tanner (June 9, 2009)

111. **Does the Doctor Need a Boss?** by Arnold Kling and Michael F. Cannon (January 13, 2009)

110. **How Did We Get into This Financial Mess?** by Lawrence H. White (November 18, 2008)

109. **Greenspan's Monetary Policy in Retrospect: Discretion or Rules?** by David R. Henderson and Jeffrey Rogers Hummel (November 3, 2008)

108. **Does Barack Obama Support Socialized Medicine?** by Michael F. Cannon (October 7, 2008)

107. **Rails Won't Save America** by Randal O'Toole (October 7, 2008)

106. **Freddie Mac and Fannie Mae: An Exit Strategy for the Taxpayer** by Arnold Kling (September 8, 2008)

105. **FASB: Making Financial Statements Mysterious** by T. J. Rodgers (August 19, 2008)

104. **A Fork in the Road: Obama, McCain, and Health Care** by Michael Tanner (July 29, 2008)

RELATED STUDIES FROM THE POLICY ANALYSIS SERIES

665. **The Inefficiency of Clearing Mandates** by Craig Pirrong (July 21, 2010)

660. **Lawless Policy: TARP as Congressional Failure** by John Samples (February 4, 2010)

659. **Globalization: Curse or Cure? Policies to Harness Global Economic Integration to Solve Our Economic Challenge** by Jagadeesh Gokhale (February 1, 2010)

648. **Would a Stricter Fed Policy and Financial Regulation Have Averted the Financial Crisis?** by Jagadeesh Gokhale and Peter Van Doren (October 8, 2009)

646. **How Urban Planners Caused the Housing Bubble** by Randal O'Toole (October 1, 2009)

637. **Bright Lines and Bailouts: To Bail or Not To Bail, That Is the Question** by Vern McKinley and Gary Gegenheimer (April 20, 2009)

634. **Financial Crisis and Public Policy** by Jagadeesh Gokhale (March 23, 2009)

WORKING PAPER

2. **Has the Fed Been a Failure?** by George A. Selgin, William D. Lastrapes, and Lawrence H. White (November 9, 2010)

Published by the Cato Institute, Cato Briefing Papers is a regular series evaluating government policies and offering proposals for reform. Nothing in Cato Briefing Papers should be construed as necessarily reflecting the views of the Cato Institute or as an attempt to aid or hinder the passage of any bill before Congress.

CATO INSTITUTE

Contact the Cato Institute for reprint permission. Additional copies of Cato Briefing Papers are $2.00 each ($1.00 in bulk). To order, call toll free (800) 767-1241 or write to the Cato Institute, 1000 Massachusetts Avenue, N.W., Washington, D.C., 20001; phone (202) 842-0200; or fax (202) 842-3490. All policy studies can be viewed online at www.cato.org.