TESTIMONY

Reform of the FHA Single-Family Insurance Fund

Basil N. Petrou
Managing Partner
Federal Financial Analytics, Inc.

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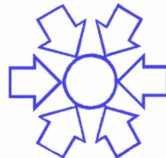

It is an honor to appear today before this Subcommittee to discuss reform of the Federal Housing Administration (FHA). My comments today will be limited to discussion of the FHA single-family mortgage insurance program. I am managing partner of Federal Financial Analytics, a consulting firm that advises on U.S. legislative, regulatory and policy issues affecting financial institution strategic planning. We thus advise a variety of companies on the implications of legislation and regulation in the mortgage and housing markets. Clients in this practice include trade associations, mortgage insurers, and mortgage lenders.

Key points to consider for FHA reform include:

- As a government program, FHA should serve its targeted borrowers if they are not already being adequately served by the private sector. It is not appropriate for FHA, as a government program, to launch initiatives to expand its "market share."
- Recent General Accountability Office (GAO) and Department of Housing and Urban Development (HUD) Inspector-General reports, as well as the President's FY 2007 budget raise serious questions about the Mutual Mortgage Insurance (MMI) Fund's financial soundness. The most recent available MMI Fund data are for only mid-FY 2005, and these show a serious reduction in the economic value of the fund that undermines its capital adequacy. Mortgage-market trends since then have shown significant weakening, as evident by recent guidance from the federal bank regulatory agencies designed to protect insured depository institutions.

- The FHA should not seek to grow its way out of its current financial problems. Doing so is reminiscent of the actions taken by distressed savings-and-loans during the 1980s.
- The MMI Fund is already taking financial risks. For example, 50% of all FHA loans insured in 2004 had downpayment assistance, with nonprofit organizations that received seller funding accounting for 30 percent of these loans. GAO analysis indicates that these sellers raised the price of their properties to recover their contribution to the seller-funded nonprofit—placing FHA buyers in mortgages that were above the true market value of the house. The Internal Revenue Service (IRS) is curtailing these programs, but the significantly higher claim rates FHA has experienced from these loans will continue for those remaining on its books. Indicative of FHA's problems is that its delinquency rates are higher than those associated with private subprime loans. Adding yet more risk means potentially profound FHA losses that will heighten the risk of calls upon the taxpayer.
- From a budgetary perspective, the MMI Fund now is only breaking even, but even this is based only on out-dated information. Any shift in the MMI Fund's financial condition will convert the program into a net cost to taxpayers, increasing the federal budget deficit.

Concerns about specific reform proposals made by the FHA and others include:

- Raising FHA area loan limits – both the base limit and high-cost area ones -- will not help low- and moderate-income families to become

homeowners. Raising the base limit would push the FHA insured loan amount in low-cost areas to $271,000 and the income of borrowers qualifying for a mortgage of this size is over $86,000. Raising the high-cost limit would push the mortgage amount that could be insured by the FHA to $417,000, which would only reach borrowers with incomes over $132,000.

- In key markets, raising the base limit would mean that the FHA would insure homes well above the median house price in an entire state. This would further distance the FHA from its mission, as well as expose the MMI Fund to increased risk from regional economic downturns.
- Giving FHA authority to replace its current premium structure with a risk-based premium is a very risky proposition. It raises serious questions about whether some low- and moderate- income borrowers and minorities will be priced out of the entire mortgage market. Further, GAO and HUD reports indicate that FHA does not have the necessary data or analytical capability to establish a successful risk-based premium. A mis-priced FHA premium structure would be devastating to the MMI Fund and the borrowers it was meant to serve.
- Eliminating the 3% minimum downpayment requirement must be carefully structured to prevent risk to borrowers, communities, and the rest of the MMI Fund. Careful underwriting is critical. HUD should rely only on proven FHA lenders, validated by increased sampling of the loans they underwrite. A zero downpayment program should begin only as a pilot

program and, if subsequently expanded, should always be limited to low- and moderate-income buyers who prove they do not have the necessary 3% minimum downpayment.

Although the pending proposed changes to the FHA pose serious concerns, the program can be and should be revised to assure it meets its mission. Recommended changes include:

- It is time that FHA became an income-targeted – rather than a loan amount targeted – housing program. The current system for setting FHA area loan limits is skewed toward raising these limits above the true median house price for an area, never lowering them, even if house prices fall. Income targeting FHA's single-family program will assure that low- and moderate-income borrowers become the primary focus of the program. It should also make housing more affordable for these targeted borrowers.
- The 100% federal guarantee behind FHA insurance undercuts the financial health of the MMI Fund, provides incentives for lax underwriting, and is not needed to make FHA insurance useful for most of its target borrowers.

I now will address in more detail the current health of the FHA and the serious problems posed by several proposals: implementing a zero downpayment program, raising the FHA loan limits and replacing the current premium structure with a risk-based premium.

Implementing a Zero Downpayment Program

- Zero downpayment loans are viewed by the private sector as higher risk, resulting in reliance on careful underwriting. Thus, FHA entry into zero downpayment loans must be carefully structured to prevent risk to borrowers, communities, and the rest of the FHA Mutual Mortgage Insurance (MMI) Fund.
- It is critical to the health of the FHA Fund that the zero downpayment program be designed to bring new borrowers into the FHA, rather than serve as a means for those borrowers who have the wherewithal to make a 3% downpayment simply to avoid doing so. Some lenders and real estate brokers may look to the zero downpayment program as a way to move an FHA borrower into a larger mortgage rather than bringing low- and moderate-income potential borrowers who otherwise would not qualify for an FHA-insured loan into a starter home.
- The latest Actuarial Report for the MMI Fund notes that, "nearly 80 percent of the mortgages originated in FY 2005 have LTV ratios of 95 percent or more, and over 85 percent have LTV ratios above 90 percent. LTV ratios between 95 percent and 98 percent comprise the most popular category with 80 percent of loans falling in this range."[1] Clearly, FHA is already exposed to the risk associated with very high LTV loans. The addition of a zero downpayment program will increase this exposure. Thus, an FHA fund with a relatively large share of zero downpayment

[1] Actuarial Study of the MMI Fund for FY 2005 available on the HUD website in sections at: www.hud.gov/offices/hsg/rpts/actr/2005actr.cfm. Section IV, pp.38-39.

borrowers would significantly increase the MMI Fund's risk exposure during periods of regional house price declines or economic contraction. For this reason, the program should begin as a pilot program to test the success of FHA's new underwriting criteria.

- Since the zero downpayment borrower starts homeownership owing more on a mortgage than the house is worth, an inflated appraisal puts that borrower further behind the goal of building equity. The combination of a bad appraisal, economic problems for the zero-downpayment borrower and stagnant home values can result in a high level of foreclosures in those inner city and moderate income areas where these FHA mortgages will be concentrated. The result of concentrated foreclosures is further downward pressure on home prices that escalate the downward spiral for that neighborhood.
- To protect borrowers, communities and the MMI Fund, HUD should impose limits beyond those currently proposed for zero downpayment loans. These should include starting the program as a pilot program, targeting it to low- and moderate-income borrowers, limiting it only to proven FHA lenders with low claim rates, and higher sampling rates for these loans.

Financial Condition of the MMI Fund

MMI Fund Actuarial Study

The most recent actuarial study released in early 2006 for FY 2005[2] indicates the MMI Fund has a 6.2 percent capital ratio but this does not indicate that the Fund is financially healthy:

- Loan data for the second half of the fiscal year was not available and not analyzed.
- The MMI Fund's capital ratio improved from the FY 2004 level because FHA's market share fell. Thus, current and future capital ratios cannot be inferred from this data. FHA's decrease in market share took place at a time when homeownership rates were high and there is no indication that FHA target borrowers were not served by private sector alternatives.
- The Fund's economic value fell by $2.8 billion -- 11 percent below its projected value from the previous year. The significant decrease in the economic value of the MMI Fund is to a great extent attributable to factors that remain today and actually worsened during the past year
- Negative factors include an alarming new trend in FHA. Loans with non-relative third-party downpayment assistance comprised 18% of FHA's new business for the time covered by the actuarial study and the losses on those loans reduced the MMI Fund's economic value by $1.7 billion.

[2] Actuarial Study of the MMI Fund for FY 2005 available on the HUD website in sections at: www.hud.gov/offices/hsg/rpts/actr/2005actr.cfm.

- A subsequent November 2005 study by the GAO reported that FHA's share of these types of loans was actually 50% with 30% accounted for by seller contributions to nonprofit organizations.[3] This report also had the disturbing conclusion that "property sellers often raised the sales price of their properties in order to recover the contribution to the seller-funded nonprofit that provided the down payment assistance. In these cases, homebuyers may have mortgages that were higher than the true market value price of the house and would have acquired no equity through the transaction."[4] This fact may partially explain the significantly higher claim rates suffered by these products.

HUD Inspector General Report

A November 2005 HUD Inspector General (IG) report[5] notes the inadequacy of the actuarial study which FHA uses to predict losses. The IG report concluded that FHA does not have enough historical data on the various risk factors of its own borrowers to effectively evaluate loan performance:

- It noted as a material weakness that "FHA must incorporate better risk factors and monitoring tools into its single-family insured mortgage program risk analysis and liability estimation process." [6] Specifically, it found that FHA lacks a formal process to effectively evaluate the impact

[3] GAO-06-24, Mortgage Financing, Additional Action Needed to Manage Risks of FHA-Insured Loans with Down Payment Assistance. November 2005.
[4] Ibid., pp.19-20.
[5] Audit of the Federal Housing Administration's Financial Statements for Fiscal Years 2005 and 2004, November 07,2005, Audit Case Number 2006-FO-0002.
[6] Ibid., Appendix A, p.7.

on the MMI Fund of loan factors, "such as borrower credit scores, down payment assistance sources, and other portfolio characteristics." [7]

- It concludes that "FHA also cannot determine current risk trends in its active insured mortgage portfolio."[8] That is, FHA is not sure what is driving the current surge in its claims. As a critical example of this failure, the HUD IG notes that the MMI Fund's independent actuary determined that the claim rates for loans where the borrowers received non-relative assistance for the initial loan down payment was "as high as three times those that did not receive assistance."[9] However, the report concludes that "FHA has not had sufficient data to segregate these loans into a separate risk category for loss estimation purposes."[10]

GAO Study of September, 2005

A GAO study released in September, 2005 detailed the reasons behind a $7 billion reestimate for the MMI Fund[11]. The points raised in this study include:

- Actual claim activity in FY 2003 exceeded estimated claim activity "by twice as much in some cases – for majority of loan cohorts."[12]
- Events that may explain the reasons for this increase "include changes to underwriting guidelines, competition from the private sector, and an increase in the use of downpayment assistance."[13]

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[7] Ibid.
[8] Ibid.
[9] Ibid.
[10] Ibid.
[11] GAO-05-875, Mortgage Financing, FHA's $7 Billion Reestimate Reflects Higher Claims and Changing Loan Performance Estimates.
[12] Ibid. p.3.
[13] Ibid.

- GAO concludes that while "FHA has taken some steps to tighten underwriting guidelines and better estimate loan performance…it is not clear that these steps are sufficient to reverse recent increases in actual and estimated claims and prepayments or help FHA to more reliably predict future claim and prepayment activity."[14]
- Importantly, with respect to future MMI Fund Actuarial reports the GAO notes that "Because the loan performance variables underlying the $7 billion reestimate will likely persist to varying degrees, they are also likely to affect estimates of the Fund's long-term viability…if the Fund's economic value declines or is restated at a lower level than previously estimated because of higher claims, and if the insurance in force remains steady, because of declining prepayments, then the capital ratio will decline."[15]
- Finally, with respect to the MMI Fund actuarial analysis, GAO makes the telling point that "neither Congress nor HUD has established criteria to determine how severe a stress test the Fund should be able to withstand."[16]

The President's FY 2007 Budget

The President's FY 2007 budget notes that FHA has serious risk-assessment issues. Specifically, it notes that "…the program's credit model does not accurately predict losses to the insurance fund."[17] The results of this failure are serious:

[14] Ibid.
[15] Ibid. p.4
[16] Ibid.
[17] FY 2007 Budget, Analytical Perspectives, Credit and Insurance, p.70.

- It shows the impact of the $7 billion reestimates noted above by GAO for each year of business. Each book of business for the last ten years essentially experienced reductions of 30% to 50% or more in their net budget impact.[18]
- While the MMI Fund had been estimated last year to generate a net negative subsidy rate of 1.7%, the re-estimates resulted in the Fund only just breaking even for FY 2007 with a 0.37% net negative subsidy rate.[19] The bottom line is that the MMI Fund is on the verge of costing taxpayers money for the first time in its history.
- The budget states that "despite FHA efforts to deter fraud in the program, it has not demonstrated that these steps have reduced such fraud."[20] FHA needs to remedy this problem before it expands through introduction of riskier products to penetrate subprime markets.

GAO Study of April 2006

The latest GAO report on FHA dated April 2006 [21] notes technological problems within FHA that raise questions about expanding its operations into riskier markets:

- GAO studied the Technology Open to Approved Lenders (TOTAL) scorecard through which credit factors are input by the loan originator and, if a target score is achieved, the loan is determined to be eligible for FHA insurance. Otherwise, the loan requires manual underwriting.

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[18] FY 2007 Budget, Federal Credit Supplement, Table 8. Loan Guarantees: Subsidy Reestimates, pp.51-52.
[19] FY 2007 Budget, Appendix, p.556, Table entitled Summary of Loan Levels, Subsidy Budget Authority and Outlays by Program, line 232901.
[20] Ibid., FY 2007 Budget, Analytical Perspectives.
[21] Op. Cit., GAO 06-24.

- GAO suggested that, conceptually, this system could be used to do risk-based pricing, but HUD is far from ready for use to this effect. In addition, HUD in a March 31, 2006 letter to GAO included in the report notes that, while TOTAL was not intended for risk-based pricing, that FHA "is exploring how it might be used for that purpose," but that “[t]his could be a lengthy exercise with an unknown outcome…” and that if FHA is given authority by Congress for new products, FHA "will certainly explore the benefits that TOTAL may present in developing such products."[22]
- The reasons why TOTAL is not ready for risk-based pricing include: antiquated data inputs, absence of a formal plan to update data, absence of key variables such as type of loan instrument type of home and exclusion of data from loans that FHA had rejected. GAO notes that this latter point could mean that a higher percentage of loans that are likely to default will be accepted rather than referred to manual underwriting.

CBO Report of June 14, 2006

- The Congressional Budget office in its analysis of the FHA Reform bill, H.R. 5121, released on June 14, 2006 reflects the 0.37% net negative subsidy rate in its estimate of any additional business that may accrue to FHA as a result of an increase in the loan limits. It is interesting to note that even with a 10% annual increase in the volume of FHA borrowers the budget benefits of higher loan limits are minimal – literally only $11 to $15 million a year because of the performance of existing FHA loans. Of

[22] Ibid., Appendix III, p.30.

course, should FHA performance worsen the estimated budget benefits would turn into budget costs.[23]

High Relative Delinquency Rates

- Delinquency data compiled by the Mortgage Bankers Association for the fourth quarter of 2005[24]shows that FHA loans have a 13.18% total delinquency rate versus 2.47% for prime conventional loans and 11.73% for subprime loans –the market FHA seeks to enter.
- These comparatively high delinquency rates do not augur well for the Fund in light of the problems noted above by GAO and the HUD IG.

Raising FHA Loan Limits

Current FHA Area Limits Are Higher Than Median Area House Prices

- The current structure for setting FHA loan limits is skewed toward setting them at a level above the true area median house price. The current system ties the calculation of the median house price for an MSA to the median house price in the highest cost county within the MSA.[25] The result is that the FHA loan limit for the MSA is clearly not reflective of the true median house price for the entire MSA – it is higher. Moreover, anyone can request a higher limit for the MSA by presenting data to HUD that house

[23] Congressional Budget Office Cost Estimate dated June 14, 2006, H.R. 5121, Expanding American Homeownership Act of 2006, p.2.
[24] Mortgage Banker's Association, National Delinquency Survey, Fourth Quarter, 2005, pp.10-11.
[25] For FHA limit setting process see HUD Mortgagee Letters 2003-23 and 95-27. As evidence of how quickly real estate brokers and others took advantage of the new law to seek higher area FHA limits see "HUD Raises Limits for FHA-Insured Mortgages in 1999, Numerous Appeals Are in the Works." *Inside Mortgage Finance*, January 8, 1999, page 9.

prices within a single county within the MSA have gone up to a level above that reflected in the current FHA area loan limit.[26]

- Further aggravating the bias toward an artificially high MSA median house price is that, when data are compiled to show recent house price sales, new house sales are over-weighted. That is, if new house sales comprise less than 25% of all house sales in the county and the value of existing house prices is static or declining, then the median price for new houses is calculated separately but given equal weight to the median sales price for existing house sales. Since new home prices are generally higher than existing house sales prices this acts to raise the FHA limit above what would be the true area median house price.[27]

Which Borrowers Will Benefit From Even Higher FHA Loan Limits?

- Raising the FHA base loan limit or the FHA high cost area limit will not allow a borrower with a $50,000 income to qualify for a $271,000 FHA-insured 30 year fixed rate mortgage —even at today's low – but rising -- interest rates. As interest rates rise, the larger FHA loan is placed that much further out of the reach of the moderate-income borrower.
- The base FHA loan limit nationwide is set at 48% of the Freddie Mac national loan limit. Today, this is equivalent to a mortgage of $200,160. Thus, even if the median house price in an area is well below $200,000 the FHA will insure loans in that area up to $200,160. On the other hand, the

[26] See HUD website at www.hud.gov/offices/hsg/sfh/lender/sfhmolin.cfm
[27] FHA has proposed shifting the FHA area limit calculation from 95% to 100% of "median house price" as calculated under the existing formula. This change would aggravate the current distortion in the calculation.

ceiling on the maximum FHA loan amount is set at 87% of the Freddie Mac loan limit. Today, this is equivalent to $362,790. This means that, if the FHA process determines that 95% of the median house price in an area is greater than $200,160, then that amount will be the FHA limit for that area up to a maximum ceiling of $362,790.

- FHA seeks to raise the FHA base limit to 65% of the Freddie Mac national limit and to raise the high cost area limit to 100% of the Freddie Mac limit.[28] Today, this proposal would mean that the base limit would increase from $200,160 to $271,050 and the high cost area limit would increase to $417,000.
- If we assume a borrower fully qualifies for the FHA loan on an income basis and has no other debt that would act to limit the loan amount for which they would qualify, then, assuming current FHA mortgage rates and average property taxes and property insurance[29] the borrower income needed to qualify for the current $200,160 base FHA loan is over $63,000. Raising the base limit to $271,050 would mean that the base limit would reach borrowers with incomes of over $86,000. For the current FHA high cost area loan of $362,790, the needed borrower income is over $115,000. Raising the high cost area limit to $417,000 would mean that the FHA loan would reach borrowers with incomes of over $132,000.

[28] See Testimony of FHA Commissioner Montgomery before the Housing Subcommittee of the House Financial Service Committee on April 5, 2006, p.5.
[29] Interest rate of 6.75% for a 30 year fixed rate FHA loan. Annual property taxes and insurance were assumed at a combined 2% of house price. FHA's recently raised income ratio of 31% was also factored into these calculations.

- No matter how one looks at the proposed new FHA loan limits they target the top level of individual taxpayers on a nationwide basis. IRS data for 2003 shows that only the top 8.8% of all individual income tax returns had adjusted gross income of over $100,000 and only 16% had incomes over $75,000. [30] Furthermore, looking only at individual income tax returns with adjusted gross income between $75,000 and $100,000, we find that 70% of these returns reported a deduction for home mortgage interest – indicating that the filer already owned a residence with a mortgage – and 72% took a deduction for real estate taxes, indicating that they owned a residence. For returns with incomes between $100,000 and $200,000 the percentage reporting a home mortgage interest deduction was 79% and the percentage paying real estate taxes was 85%.[31] In short, if the FHA base and high cost area limits are raised to the levels suggested by the FHA Commissioner, then the borrowers taking advantage of these higher limits are almost assuredly not first-time homebuyers and are certainly not buyers with low, moderate or middle tier incomes.

<u>Raising the FHA Base Loan Limit Causes Special Problems</u>

- The critical policy issue for Congress to consider is whether raising the base limit of FHA in low cost areas to 65% of the Freddie Mac nationwide limit will bring in more first-time, low and moderate income and minority home buyers or otherwise serve these borrowers. Across the country the

[30] See Individual Income Tax Returns, 2003, article by Michael Parisi and Scott Hollenbeck , available on IRS website at http://www.irs.gov/pub/irs-soi/03indtr.pdf.

current FHA base loan limit of $200,190 is now higher – often significantly higher -- than the median existing house price.[32] Raising the FHA base limit to 65% of the GSE loan limit would move the FHA limit for these areas to $271,000 -- two to three times the current median existing house price in many areas.

- Entire states – for example Texas, Louisiana, and Mississippi -- are now within the FHA base limit. Analysis of NAR median existing sales price data shows that raising the FHA base limit to $271,000 would bring roughly 83% of the metropolitan areas it covers within the new FHA base limit. This means that additional states will likely fall within this higher limit. This further means that, in many low- and moderate- priced areas of the country, the additional homes insured under the higher FHA base limit would only be affordable to borrowers with the highest incomes in the area. These are the borrowers who can afford homes priced well above the entire state's median priced house. These borrowers are unlikely to be first-time, moderate-income, or minority ones. A recent study by the Brookings Institution notes that counties with higher mean incomes also had higher homeownership rates, while counties with lower incomes had lower ownership rates.[33]
- Raising the FHA base limits thus means that FHA could become over-exposed to risk in entire states and MSAs. With this concentrated risk

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[31] Ibid.
[32] See generally, National Association of Realtors Median Sales Price of Existing Single-Family Homes for Metropolitan Areas available on NAR website.

position, FHA would take on heightened risk in periods of economic stress. If this over-exposure were done to serve moderate- income first-time homebuyers, then it might be justified. However, this would not be the case because higher FHA base limits would serve only those borrowers who can afford the highest priced homes in their area.

<u>Targeting Higher Income Borrowers Will Add to FHA Risk</u>

- It is commonly assumed that borrowers with higher incomes are safer credits than low- and moderate-income borrowers. Evidence from the private mortgage insurance industry shows that this is not the case for low-downpayment borrowers during periods of regional economic stress and falling home prices.[34] It is one thing to have a relatively high income and owe a large mortgage on a home with equity of 20% or more. It is quite another issue to have a large mortgage with very little or no equity at all in the house during a period of falling house values. When borrowers start the ownership process with little or no downpayment, using an FHA-insured mortgage loan, they are extremely dependent on a continuing advance in home prices to build their equity. Any reversal in personal fortunes will find them underwater on their mortgage – owing more than the house is worth after real estate brokerage and other fees

[33] <u>Credit Scores, Reports, and Getting Ahead in America</u>, May 2006, The Brookings Institution, Survey Series, Matt Fellowes, see p.1.
[34] For evidence of loan performance during stress periods see testimony of Charles Reid, President of the Mortgage Insurance Companies of America, before the Subcommittee in Housing and Community Development, on FHA's Mutual Mortgage Insurance Fund, July 27, 1993, Attachment A, Incremental Risk of Higher Mortgage Amounts, 1981-1989.

have been paid. This is especially the case for zero downpayment mortgages.

- The nature of the residential real estate market in the past decade has been very good to most risk-takers. Home prices have appreciated across the board – although with wide geographic variations. Unfortunately, there is no assurance that rapid house price appreciation will continue and signs of weakening home prices have already begun to materialize in certain areas of the country. Furthermore, past experience with regional downturns in house prices has shown that houses at the upper end of the price distribution are likely to suffer more serious declines in property values than more moderately priced houses.[35] This is not surprising. By definition, there are fewer people with the wherewithal to purchase higher priced homes than those able to purchase more moderately priced homes. During a period of economic stress and falling home prices, the lack of liquidity at the higher end of the house price market will hurt these borrowers.[36] Since FHA insures 100% of the loan amount, the FHA stands to lose a great deal in this situation.
- The potential loss for FHA from raising its loan limits will be significant during a period of falling regional house prices. A 30% loss on a foreclosed $100,000 FHA insured loan costs the single family Fund $30,000. A 30% loss on a $271,000 loan costs the Fund $81,000 and a

[35] There are already some early signs of declining prices for higher priced houses. See for example, the *Wall Street Journal* for Friday, June 16, 2006.

similar loss on a $417,000 loan would cost the Fund $125,000. If, as is the case in the private sector, larger FHA loan amounts that go to foreclosure during periods of severe economic stress suffer larger percentage reductions in value, then the Fund would suffer still greater, unanticipated losses.

- New moderate- income borrowers seeking to qualify for an FHA loan during this period of economic stress will feel the impact of these losses to the Fund. Just as new borrowers paid the higher FHA loan premiums needed to return the single family Fund to economic solvency in the early 1990s, so too will future moderate- income borrowers bear the higher costs associated with the losses resulting from defaults on larger loans. Will there be a regional house price decline resulting in heavy losses to FHA? We don't know. However, we do know that low- and moderate-income borrowers gain nothing and may well lose from retargeting FHA to higher-income borrowers because FHA would suffer larger losses than would otherwise have been the case.

A Risky Proposition: A Risk-Based FHA Insurance Premium

FHA proposes to change its premium structure from one relying on cross subsidization to a risk-based structure. This will be a significant change from FHA's current premium structure and poses new risks on FHA and its traditional borrowers.

[36] In this regard it is interesting to note that the FHA loan limits that existed in the late 1980s and early 1990s may well have protected the MMI Fund from the severe losses that were incurred in the private

The Present Premium Structure

- The present FHA premium allows FHA to charge a fully financed upfront premium of as high as 2.25% and an annual premium of as high as 50 basis points for loans with initial LTVs of 95% or less and 55 basis points for loans with initial LTVs above 95%. The upfront premium does not count as part of the borrower's loan-to-value (LTV) calculation for purposes of the annual premium calculation. Currently, HUD charges a 1.5% upfront premium and 50 basis points annual premium for all loans. FHA has also implemented a mortgage cancellation program whereby the insurance premium payments are cancelled for the borrower when the LTV reaches 78% (5 years of payments required). Although the borrower no longer must pay the premium, FHA continues to insure the loan.
- Cross subsidization is the key to this system. Borrowers with the same downpayment pay the same premium regardless of different credit characteristics –provided they cross a minimum credit hurdle. This is a key reason why FHA has had such a large share of minority and low-income borrowers and why it continues to serve this market. As the Brookings Institution report notes, the borrower with a poor credit rating often has comparatively lower income.[37] These are the borrowers who benefit under cross subsidization.

sector by the house price declines in New England and Southern California during these years.

[37] Brookings, Op. Cit. p.1

Low-Income and Minority FHA Borrowers Are Likely to Pay More

- The Brookings Institution study concluded that low- income and minority borrowers are often the ones with the lower credit scores. Specifically the report found that "counties with relatively high proportions of racial and ethnic minorities are more likely to have lower average credit scores."[38] The report noted that "this evidence does not suggest that a bias exists, or that there is a causal relationship between race and credit scores, raising questions for future research."[39] With respect to income distribution, the report found that "[t]he average county with a low, mean credit score had a per capita income of $26,636 and a homeownership rate of 63 percent in 2000. Meanwhile, the typical county with high average credit scores had higher per capita incomes ($40,941) and a higher share of homeowners (73 percent)." [40] If FHA is seeking to lower the premium price for higher credit score borrowers and raise the premiums for lower scored borrowers, then higher- income borrowers in areas where homeownership is already high would benefit.
- FHA staff harbor concerns about using credit scores to set premium prices. The November 2005 report from the HUD IG mentioned above notes, "[m]anagement has indicated some sensitivity to focusing solely on credit scores because of the risk of discouraging lenders from underwriting loans to some of FHA's target borrowers who may have low credit scores."[41]

[38] Ibid., p.8.
[39] Ibid., p.1
[40] Ibid. see also p.10.
[41] HUD IG Report, Op. Cit. Appendix A, p.7

- The Congressional Budget office also suggest that FHA will get few if any net new borrowers as a result of a risk-based premium. in its analysis of the FHA Reform bill, H.R. 5121, released on June 14, 2006 it sees no net increase in the number of FHA loans guaranteed through a risk-based premium because "while some borrowers may turn to FHA because of better pricing and the ability to obtain insurance for more attractive loan products, other borrowers may turn away from FHA because of higher pricing."[42] Those other borrowers who would turn away from FHA are likely to be those who FHA perceives to be weaker credit risks.

<u>FHA Could Well Get a Risk-Based Premium Wrong</u>

The HUD IG report, the MMI Actuarial study and GAO reports all conclude that FHA does not have adequate data to correctly evaluate the credit risk associated with its borrowers.

- The HUD IG notes that, "[w]ithout adequate data on borrower credit scores, FHA is unable to determine whether … declining borrower credit scores have contributed to significant unexpected upward re-estimates of its insured loan guarantee liability in recent years."[43]
- CBO in its analysis of the FHA Reform bill, H.R. 5121, notes that risk-based pricing is "complicated, requiring much precision in the underwriting process."[44] CBO also references the GAO report on the TOTAL scorecard noted above, which raised concerns about the effectiveness of the underwriting system that exists today and

[42] CBO Report, Op. Cit., p.7.
[43] HUD IG Report, Op. Cit. Appendix A p.7

recommends improvements. As a result of FHA's current systems inadequacies, CBO expects that developing and maintaining appropriate systems for managing a risk-based pricing structure would take FHA "several years to implement." [45] In short, CBO recognizes that a risk-based premium is a difficult process to effectively implement and requires sophisticated systems that FHA simply does not now have that would take years to develop.

Market Impact of a Risk-Based FHA Premium

- FHA does not operate in a market vacuum. A decision by FHA to set a risk-based premium will pressure its private sector alternatives to follow suit to remain attractive to those low-downpayment borrowers that are perceived to be lower risk under whatever risk-based premium structure FHA develops. Today's FHA and private premiums serve low- income and minority low-downpayment borrowers so that they too can take the first step of building equity in a home. However, a turn to a market-wide risk-based premium structure would undermine potential homeownership for this group.

Broad-Based Reform Recommendations

- The current system for setting FHA eligibility on loan size, rather than the income of the borrower, makes no sense for a government insurance

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[44] CBO Op. Cit, p.7.
[45] Ibid.

program. A government program must focus on the people it serves and this is best determined by looking at them, not abstract indicators, proxies, or substitute factors.

- It is time that FHA became an income-targeted – rather than a loan amount targeted – housing program. The current system for setting FHA area loan limits is skewed toward raising these limits above the true median house price for an area, never lowering them, even if house prices fall. Income targeting FHA's single-family program will assure that low- and moderate-income borrowers become the primary focus of the program. It should also make housing more affordable for these targeted borrowers.
- Income targeting would also be simple to implement. Borrowers would bring to the lender their most recent tax returns (as they currently do) and, if their income was within the parameters for their area, then they could qualify for an FHA-insured loan. Their loan size would depend on their income and interest rates – much as it does now. Incentives for sellers to raise their prices as area loan limits are increased would end.
- The 100% federal guarantee behind FHA insurance undercuts the financial health of the MMI Fund, provides incentives for lax underwriting, and is not needed to make FHA insurance useful for most of its target borrowers.
- A logical approach would be to set a maximum FHA coverage ratio and have it apply only to the lowest income borrowers. As the income of the borrower increases, the level of the FHA insurance coverage would fall. In

this way, the protection of federal insurance coverage would go to lenders making loans to lower income borrowers. Further, linking insurance coverage to income in this way creates a positive incentive for the market to serve these borrowers.