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FHA New Foreclosures Jump as Modified Loans Default

By Kathleen M. Howley on May 09, 2012

The number of Federal Housing Administration-insured home loans entering foreclosure jumped in March after half the mortgages it modified to ease repayment terms were in default again a year or more later.

The FHA's role in lending to first-time buyers with poor credit and limited cash expanded after the 2008 collapse of the mortgage market put it at the center of government efforts to revive housing. The FHA allows down payments as low as 3.5 percent for borrowers with a credit score of 580, below the 640 defined as subprime by the Federal Reserve.

"The credit standards are way too loose -- you can get into a house with very little skin in the game, and if home prices drop by a small amount, you're underwater," said David Lykken, managing partner at Mortgage Banking Solutions, an Austin, Texas-based consulting firm. "We've got to start getting reasonable about standards. What they've done so far, some very slight attempts at tightening, don't really count."

An increase in FHA foreclosures may lead to further demands for stricter standards that could shut buyers out of the real estate market as it shows signs of stabilizing after a six-year slump. Mark Calabria, director of financial regulation studies at the Cato Institute in Washington, in a February report called for Congress to tighten the agency's lending qualifications to protect taxpayers, who insure the loans. First-time homebuyers accounted for 33

percent of real estate sales in March, according to the National Association of Realtors.

Treasury Study

Borrowers with mortgages for homes bought in 2010, the FHA's peak lending year, now owe almost 7 percent more than their homes are worth if they used the minimum down payment, according to S&P/Case-Shiller home price index data. That year, the agency insured 1.1 million loans to purchase single-family homes, more than four times the total of 261,165 in 2007.

Lenders initiated foreclosures on 36,400 FHA-backed mortgages, twice the number in April 2011, according to Lender Processing Services. The increase for Fannie Mae and Freddie Mac loans was 13 percent, the Jacksonville, Florida-based mortgage- data company said.

A Treasury Department study of modified government- guaranteed mortgages in the fourth quarter found that 49 percent were delinquent again after 12 months. The Treasury report analyzed a group of loans that was 80 percent FHA, 15 percent Veterans Administration mortgages and 5 percent Department of Agriculture rural home loans. The rate for Fannie Mae and Freddie Mac was 27 percent.

Brian Sullivan, a spokesman for the Department of Housing and Urban Development, which oversees the FHA, declined to comment beyond citing the limited scope of the Treasury's study covering 60 percent of the mortgage market.

Paid on Time

The share of government-guaranteed loans being paid on time dropped to 84.2 percent in the fourth quarter from 85.2 percent in the prior three months, the Treasury's Office of the Comptroller of

the Currency said in its March 28 report. It was the third consecutive quarterly decline.

The U.S. housing market is showing signs of having hit a bottom after prices fell 35 percent since peaking in 2006. Values in 20 U.S. cities fell 3.5 percent in February, the smallest 12-month drop since February 2011, the S&P/Case-Shiller index showed last month. New homes sold at an annual pace of 328,000 in March, up 7.5 percent from a year earlier, the Commerce Department said.

Uneven Recovery

The recovery is uneven, with the annualized pace of existing home sales falling to 4.48 million in March, the second consecutive decline, according to the National Association of Realtors. Housing starts fell 5.8 percent in March after a 2.8 drop in February, according to Commerce Department data.

About 4.4 percent of all U.S. mortgages were in foreclosure in the fourth quarter, according to the Mortgage Bankers Association in Washington. That translates into more than 2 million homes that will have to be sold for the market to return to equilibrium, said Diane Swonk, chief economist of Mesirow Financial Inc. in Chicago.

“The main issue is we have a housing market that can’t clear,” said Swonk. “Right now, for a lot of people, the FHA is the only game in town.”

About 26 percent of the FHA-insured loans originated in 2007 are seriously delinquent, meaning overdue by 90 days or in foreclosure, according to a March 26 FHA report to Congress. For 2008 mortgages, the share is 24 percent. For 2009, the rate is 11 percent, for loans originated in 2010 it is 4.1 percent, and for last year, it’s 1 percent. In September 2011, 638,000 FHA mortgages were in their second default, the agency said in a November report to Congress.

The agency in 2010 began mandating credit scores of at least 580 for borrowers who use its minimum down payment -- which was raised to 3.5 percent from 3 percent in 2009. Last year the FHA cut the amount that sellers can give to buyers for down payments to 3 percent from 6 percent.

“If prices have hit bottom, or they’re going to bump along in the range we’ve seen recently, it probably won’t destabilize the more recent mortgages,” said Richard Green, director of the Lusk Center for Real Estate at the University of Southern California in Los Angeles. “If prices keep going down, the FHA might require some help from taxpayers.”

By law, the FHA must maintain a 2 percent capital ratio, measuring assets against risks. The measure in the FHA’s November report to Congress was 0.24 percent, based on an independent actuarial study by Rockville, Maryland-based IFE Group. A surge of defaults that started in 2008 drained the agency’s funds as it ratcheted up reimbursements to lenders for unpaid balances of defaulted loans and portions of foreclosure costs.

Hiked Fees

Additions to the FHA’s income in February means the agency won’t need federal funds to meet its insurance obligations, Shaun Donovan, head of HUD, said in Feb. 28 Congressional testimony. The FHA hiked fees to add about $1.25 billion to its income, increasing its upfront insurance fee for most loans to 1.75 percent of the loan amount from 0.75 percent.

Also in February, the $25 billion national loan servicer settlement included a payout of about $1 billion for the FHA. Helped by the funds, the agency will meet the mandated capital ratio by 2015, Donovan said.

The agency “has acted aggressively to strengthen and protect the mortgage insurance fund and put FHA on a sustainable path for the long term,” Carol Galante, acting FHA commissioner, said in a March 27 blog. “FHA programs remain vital to ensuring more Americans have the opportunity to realize or maintain the economic security of the middle class.”

Lax Standards

Other FHA guidelines have remained intact. All of the down payment can be funded by relatives or employers. Buyers can cite income from future roommates to qualify for a loan. Cash reserves, required by Fannie Mae and Freddie Mac to show a borrower’s ability to pay a mortgage if a hot water tank bursts or if the roof leaks, aren’t required for many FHA loans.

“Certainly the FHA standards are more lax than Fannie Mae or Freddie Mac, but at the moment it’s filling a gap that Fannie and Freddie aren’t,” said Mesirow’s Swonk. “It would be an even more constrained housing market without the agency.”

The FHA was created by President Franklin Delano Roosevelt in 1934 during the Great Depression. The agency’s mission was to insure mortgages for low-income and first-time buyers. On its website, it still describes its goal as expanding homeownership for “underserved” communities.

“Their book of business is riskier than Fannie and Freddie, which results in a higher foreclosure rate, and that’s likely going to continue until the economy improves,” said Susan Wachter, professor of real estate and finance at the University of Pennsylvania’s Wharton School in Philadelphia.

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