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FHA Loans Plunge 19% as Lenders Haggle With Officials

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Home loans to lower-income Americans are dwindling as Washington regulators and major banks continue to haggle over who pays when riskier mortgages go bad.

Federal Housing Administration loans, given to borrowers with weaker credit scores and requiring small down payments, plummeted 19 percent in the nine months ending June 30 compared with a year earlier. A meeting on Wednesday at the White House between government officials and banking executives ended without an announcement of any breakthroughs on the dispute.

The largest U.S. home lenders are curtailing FHA mortgages because of concerns that they will be penalized for what they consider immaterial underwriting errors when loans default.

JPMorgan Chase & Co. (JPM), Bank of America Corp. and other lenders have paid more than $3 billion in fines for originating faulty FHA loans during the housing bubble following lawsuits brought by the Department of Justice and state attorneys general. Julian Castro, secretary of the Department of Housing and Urban Development that oversees FHA, said the agency wants to ease credit by rewriting its handbook to clearly spell out when lenders can be forced to bear the cost of soured loans.

“A big issue is the DOJ settlements and their impact on the lending attitudes of the banks, which is clearly the elephant in the room,” said Brian Chappelle, a former FHA official and partner at Potomac Partners LLC, a consulting firm for lenders in Washington. “The government is worried about access to credit. They’re looking at volume numbers and they know it’s a serious problem.”

FHA insured 420,709 purchase loans in the nine months through June 30, compared with 516,588 mortgages during the same period a year earlier, according to HUD data. A record 1.1 million loans were backed by FHA in the 12 months ending Sept. 30, 2010. The annual average for the prior 10 years was 589,242.

David Stevens, president of the Mortgage Bankers Association, which organized the White House meeting with HUD and Treasury officials and executives from banks including Wells Fargo & Co., declined to answer questions about the meeting. In a statement, Stevens said there was productive dialogue and improving FHA processes and programs was one of the issues discussed.

"We have the unintended consequences of well-intended legislators or regulators who are actually hurting the marketplace," Wells Fargo Chief Executive Officer John Stumpf said Sept. 17 at an event at the National Press Club in Washington, referring to tight credit.

Banks raised their credit requirements after the government filed a lawsuit in 2011 against Deutsche Bank AG for FHA loans under the False Claims Act, which allows for penalties that are triple the damages. Other settlements followed as the Justice Department punished banks that submitted FHA mortgages for government insurance that contained underwriting errors. Defaults on these mortgages led to losses that forced the FHA to take a $1.7 billion taxpayer bailout last year -- the first in its 80-year history.

Tight Standards

"Years' worth of profits can be wiped out with not that many loans that go bad if the government sues you over them," said Jaret Seiberg, an analyst at Guggenheim Securities LLC. "Banks feel like they have to protect themselves by keeping standards tight."

The average credit score for an FHA loan was 680 for the second quarter -- well above FHA's minimum of 580 for low down payments, according to HUD. An increased FHA focus on loan defects could make lenders less likely to originate mortgages to people with lower FICO scores who still meet FHA guidelines since their loan files may be thicker and more complicated, increasing risks of minor errors in applications, said Scott Olson, executive director of the Community Home Lenders Association.

Wells Fargo (WFC), the largest home lender, had the biggest drop in FHA originations among the five biggest FHA lenders. They fell 82 percent to $2.6 billion in the first six months of this year compared with the same time period in 2013, according to Inside Mortgage Finance, a trade publication. Bank of America's 72 percent drop was the second biggest, followed by JPMorgan, with a 55-percent decline.

Holder's Replacement

"The real question to me is, should we be in the FHA business at all?" JPMorgan CEO Jamie Dimon said during an earnings call in July. "And we're still struggling with that."

Increasing FHA lending and improving the homeownership rate over the next six months will depend on whether Eric Holder steps down as Attorney General this year and if the new AG continues to target banks for mortgage-related transgressions, Guggenheim's Seiberg said.

“They can tell the lenders until they’re blue in the face they don’t have to worry about immaterial errors or technical snafus,” Seiberg said. “Yet there’s nothing to protect that lender if the Justice Department says ‘No, that’s a mistake, you violated an underwriting criteria and we’re going to sue you.’”

The first section of HUD’s handbook, which is scheduled for release by the end of September, will provide guidelines for lenders on underwriting. The agency also asked for public feedback on proposed changes to the way it identifies mortgage defects, with comments due by Oct. 15.

Castro’s Plea

Cameron French, a spokesman for HUD, declined to provide additional comments on what HUD is doing to reverse the decline in FHA lending.

“With all our efforts, I want to send a simple message to lenders: let’s work together,” Castro said in prepared remarks at the Bipartisan Policy Center Housing Summit on Sept. 16. “Many have been reluctant to lend because they fear unanticipated consequences. They need to be able to manage their risk better –- and so does FHA.”

Defining material errors is very subjective and guidance around that isn’t likely to fix the situation, said Guggenheim’s Seiberg. For example, if an applicant’s loan file is missing a page of a tax return, and the mortgage defaults three years later because a spouse gets sick, should lenders be responsible due to the missing document, he asked.

An FHA review of 6,654 loans in the first quarter found that lenders make a lot of mistakes on applications. The audit revealed that 48 percent of mortgages were deemed initially unacceptable, which means they had a material defect at the time of endorsement. A subsequent audit as of July 1 found just 8 percent of those loans were unacceptable after lenders provided additional documentation.

Sunset Period

“I think lenders should do a better job of delivering a higher quality underwritten product, not just say, ‘OK, we’ll pull out of the market and cut out lending,’” said Jim Carr, a senior fellow at the Center for American Progress, and a housing finance, banking and urban policy consultant.

HUD and lenders have disagreed over a government proposal that the agency be able to review more loans at the time of closing to catch errors early. Lenders are apprehensive about that, Chappelle of Potomac said.

Banks want a provision that would set the amount of time after which they wouldn’t be responsible for soured loans, said Mark Calabria, who directs financial regulation studies at the Cato Institute. If timely payments were made for at least that period, then lenders wouldn’t be responsible if the loan defaulted. HUD hasn’t specified a sunset period after which banks would be off the hook.

First-Time Buyers

Both sides have agreed on changing the so-called compare ratio, which benchmarks lenders against each other for default rates. Instead of an industrywide average, the ratio will take into account loans made to borrowers in the same credit score range.

Spokesmen for JPMorgan, Wells Fargo and Bank of America declined to comment for this story.

In 2013, 39 percent of first-time buyers used FHA loans, which generally require 3.5 percent down, compared with 56 percent in 2010, according to data from the National Association of Realtors.

“Access to credit is tightening across the board and the number of people who can get a home is shrinking to the point of code red,” said Anthony Hsieh, CEO of LoanDepot.com, the third largest FHA lender.

A dearth of first-time buyers is pushing down the national homeownership rate, which fell in the second quarter to its lowest level since 1995, according to Census Bureau data.

Insurance Premiums

Higher FHA mortgage insurance premiums are also depressing demand for its loans and the ability of homebuyers to qualify for them. Borrowers must now pay an up-front fee of 1.75 percent of the loan balance and up to 1.35 percentage points in annual mortgage-insurance premiums.

If FHA’s financial report, which will be released later this year, shows the insurer is in better fiscal health, there will be pressure to reduce premiums, said Lawrence Yun, chief economist at NAR.

John Weicher, who served as FHA commissioner from 2001 to 2005, said he can’t remember a time of such tension between lenders and regulators and blames it on the slow housing recovery.

“There hasn’t been anything like this weak recovery we’ve had over the last five years, which has to be fraying tempers on both sides,” Weicher said.