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Next Big Gov't Housing Bailout: Federal Housing Administration

By: Mark A. Calabria – January 7th, 2013

The Federal Housing Administration (FHA)'s 2012 audit confirmed what has been obvious for some time: The FHA is deeply underwater, with a negative economic value of $34 billion.

With over $1 trillion in mortgages backed by the FHA, even minor changes in the housing market could add tens of billions to that total. A taxpayer bailout is inevitable.

What isn't inevitable is the size of that bailout. The FHA has been sunk not by a housing bust, but by policy choices. Better choices can reduce the size of the hole.

At the height of the housing bubble, in 2005 and 2006, the FHA's market share, by dollar volume, hovered around 2%.

Although its loan quality at the time was poor, characterized by the combination of low borrower equity and poor credit quality, the ultimate losses should have been relatively small.

FHA officials, however, chose to see the contraction of private lending as an opportunity. The decision was made to blow more hot air into the deflating housing bubble.

The outcome was all too predictable. Despite being almost nonexistent at the bubble's peak, the FHA now serves about a third of all underwater borrowers. The number of homebuyer policies the FHA holds has increased almost 400% since the bursting of the bubble.

Taxpayers face a rescue likely in the tens of billions of dollars unless Congress and the FHA immediately reform the FHA's practices.

The FHA has succeeded over the years in offering lenders something almost no one else will: a cheap way to pass on risk to the taxpayer.

Unlike private mortgage insurers who usually cover the first 20% to 30% of losses, the FHA protects the lender from 100% of loss.

Even in today's real estate market, it should not be possible for a loan to go 100% bad unless there's some fraud or negligence on the part of the lender.

Reducing the FHA's coverage to 80% would incentivize better lender behavior without harming well-performing lenders.

Ultimately, the FHA's guarantee should be reduced to no more than 50 to better align lenders' interests with those of taxpayers — and borrowers.

Just as few honest loans go all bad, few honest loans go bad right away. Standard practice even in the subprime mortgage market was for banks to take back any mortgage that went bad within the first six months.

The FHA should adopt similar procedures. A loan where the first few payments are missed is likely one approved under fraudulent circumstances.

Of course, not every sour loan is the fault of the lender. Much of the FHA's troubles have come from its increasing practice of allowing poor-quality borrowers to acquire mortgages with little or no down payment.

High-down-payment loans make sense for subprime borrowers, as do low-down-payment loans for prime borrowers; however, mixing the two will result in higher delinquencies.

For all borrowers, the FHA should immediately require a 5% cash down payment. It should come from the borrower and not in the form of a gift from third parties.

A significant portion of the FHA's past losses resulted from "gift" down payments. For borrowers with a credit history below a 680 FICO equivalent, the FHA should immediately require a 10% down payment.

In addition, for borrowers with a credit history equivalent to a FICO between 600 and 680, pre-purchase in-class counseling should be required.

Borrowers with FICO equivalents below 600 should be limited to re-financing only, and even then only with the original lender retaining a significant portion of the default risk.

The question for renters with FICOs under 600 should not be "how do we make you a homeowner," but "how do we help you fix your credit?"

As important as the preceding changes is the need for the FHA to increase its premiums to cover both embedded and future losses. Being the only option today for low-down-payment borrowers, the FHA can easily increase its premiums without significant reductions to either its volumes or to borrowing opportunities for those looking to purchase a home.

The FHA should also include its administrative costs within its premium structure.

Currently, the taxpayer directly covers the FHA's administrative costs — employee salaries and benefits, etc.

Premiums should also be increased to reflect the fair market value of the risk being assumed by the taxpayer.

Washington fiddled while Fannie Mae and Freddie Mac burned tens of billions, ultimately covered by the taxpayer.

Congress and the White House have largely repeated that behavior, using the FHA to slow the inevitable correction in the housing market.

Before the cost of such policies increase any further, Washington can and should take immediate action to minimize the burden on responsible taxpayers.