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FHA Confuses Taxpayers With Capital Claims

What would Confucius have to say about the insolvency of the Federal Housing Administration, which has been so insightfully analyzed by my colleague, Ed Pinto?

By: Alex J. Pollock – January 4th, 2013

In addition to doing the math right (which led Ed to conclude that the FHA on a standard accounting or GAAP basis has a net worth of negative $25 billion), Confucius would demand the "the rectification of names." This means matching what we call things to reality, a key tenet of his philosophy. If we don't do that, we begin by fooling others and end by fooling ourselves. On behalf of Confucius and not fooling ourselves, I propose two rectifications of names with respect to the FHA.

First: As an article from the Cato Institute says, "defenders of the FHA brag that the agency is self-funded and that it has never taken a dime of taxpayer money." Many articles often state, like this one published in the *Seattle Times*, that "the agency ... has never required taxpayer assistance." The recurring claim that the FHA has never taken any money from taxpayers needs to be rectified to: "The FHA takes money from the taxpayers every year." This is because the taxpayers pay all its operating expenses, including its expenses of managing credit risks, and contribute to its working capital, in addition to being on the hook for underestimates of the FHA's credit losses.

In order to be self-sustaining, any entity, including one that issues mortgage insurance, must, first of all, pay its own operating expenses. The FHA does not do this and, therefore, is not self-sustaining or self-funding. Its operating expenses and contributions to its working capital, which are paid by the taxpayers, total more than $200 million per year, or a rate of more than $2 billion per decade. On top of that, as we now know, the FHA may need a lot more taxpayer money to pay its future credit losses on the risky loans it has already made.

Second: Discussions of the FHA frequently refer to its "capital ratio," formally called its "capital reserve ratio." This ratio has a congressionally set minimum requirement of 2% of the FHA's insurance at risk – a tiny bit of capital even if it were real —but in recent years it has been 0.5% or less and now it is admitted to be significantly negative. But it is not a capital ratio.

No bank or insurance company would ever be allowed to add up the profits it thinks it will make in the future, and call this "capital" or "capital reserves" or use it to calculate a "capital ratio." But that is exactly what the FHA does: As explained in its own "Financial Status" report, it makes 30-year projections of future income and credit losses, which is obviously a process of large and inescapable uncertainty. To show how prone to error

this process is, in 2011 and 2012, the FHA had to confess to $8.8 billion and $7.8 billion, respectively, of federal budget corrections, to make up for its previous overly optimistic estimates of credit losses.

Taking these uncertain estimates, the FHA then adds up all the profit (while never paying for its own operating expenses) it thinks it will make in the future, and adds the present value of that to its current net assets to get its alleged "capital" to calculate the alleged capital ratio. It is apparent that you can turn negative capital into positive "capital" with this method. Wouldn't any bank, especially an insolvent one, love to adopt this accounting for capital? Of course, everyone would find any such proposal laughable and absurd.

Let us note that there is nothing wrong with making such a projection, but the result simply should not be called capital or a capital ratio.

So we need to rectify the title of the FHA's "capital" calculation to: "our capital plus all the profits we think we might make in the future."

If a number with as much estimating room in it as this one has goes substantially negative, as is the case at the FHA, there is no doubt the problems are very serious. In addition, if 30 years of all the future operating expenses were taken into account – which is not the case – the negative number would be bigger still. The rectified name for this is "bad news."

The FHA should calculate and publish its properly called capital under standard Mortgage Insurance Company GAAP accounting. It should then divide the capital by its total insurance in force to get its proper capital ratio, and publish that. Then it should, by all means, also publish its "capital plus all the profits we think we might make in the future" (after subtracting all operating expenses). Taxpayers could thereby be much better informed about what the FHA is charging up on their credit card.

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