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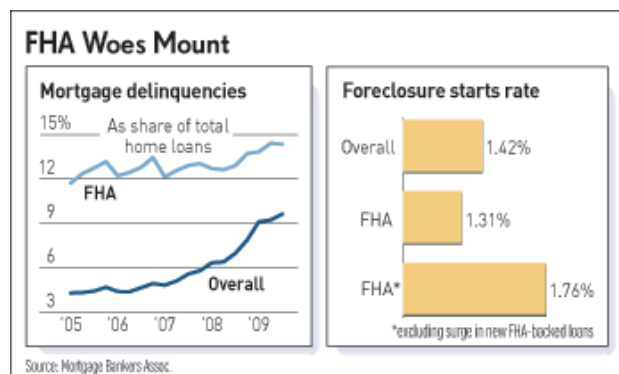
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BUSINESS

## Late Mortgages Hit All-Time High In Q3; New Fears For FHA

By MARILYN ALVA, INVESTOR'S BUSINESS DAILY

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Will borrowers and banks have to pitch in to lift the Federal Housing Administration's dangerously dwindling reserves?

The FHA could raise minimum down payments and borrower fees or make banks assume more loan risk. But those proposals aren't politically popular. A third option, a taxpayer bailout, isn't on the table yet but could wind up there if the issue isn't solved, government officials say.

Meantime, mortgage delinquencies continue to soar. Home loans with late payments rose to an all-time high of 9.64% in Q3 from 9.24% in Q2 and 6.99% a year earlier, the Mortgage Bankers Association said Thursday. Some 14.36% of FHA-backed loans are behind, down slightly from Q2 but up from 12.92% a year earlier.

FHA-insured loans, with their low down payment requirements, have become a crucial support for the wobbly housing market, making a pullback difficult. As subprime loans vanished from the marketplace, FHA loans shot from just 3% of all home loans in 2007 to 25% today.

But the FHA is running all out on a near-empty fuel tank. Officials disclosed Nov. 12 that its cash reserves have fallen below the mandated 2% capital ratio — to just 0.53%. That's \$3.6 billion against \$685 billion of total insured loans.

Last year, the capital ratio was 3%. In 2007, it was 6.4%.

"Yesterday's subprime is today's FHA, and I think it's nuts," said Robert Toll, CEO of luxury homebuilder Toll Bros., on Wednesday. "It's a definite train wreck. The flag will go up within the next few months: ... Bail us out, give us some more money."

Housing and Urban Development Secretary Shaun Donovan, who oversees the FHA, says predictions the agency will be the next subprime are "dead wrong."

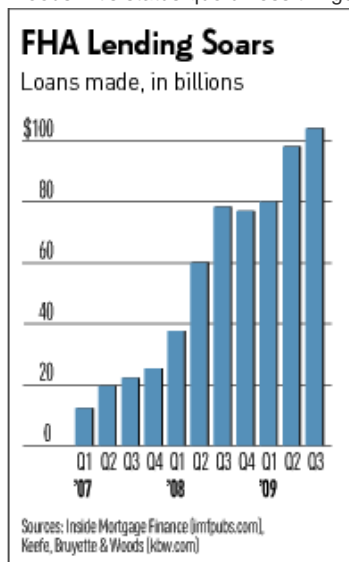
But some experts and lawmakers fear taxpayers will end up paying.

"Will we have to bail out the FHA?" asked Mark Calabria, director of financial regulation studies at the libertarian Cato Institute. "The only way the FHA makes it through this without a bailout is if we see a quick turnaround."

Meant to be self-funding, the FHA took a heavy hit from bad loans as the housing bust played out. It is now on the hook for a surging number of defaults, including many refinanced loans.

The government deems the FHA too important to fail. It insures loans with down payments as low as 3.5% and helps delinquent owners stay in their homes.

"Politically, there's no interest in changing the role of the FHA," said Bose George, mortgage and housing analyst for Keefe, Bruyette & Woods. "It's status quo unless things deteriorate further."



Keefe, Bruyette & Woods closely monitors the mortgage finance industry. It expects government support for the FHA to remain strong and FHA volume to stay high for the next two to three years.

Despite the FHA's low capital cushion, HUD officials point to a backup financing fund that brings combined reserves to \$31 billion, or about 4.5% of insured mortgages.

#### Foreclosures Mount

Critics argue the FHA will need a lot more than that to cover future losses as foreclosures keep rising.

The rate of FHA loans going into foreclosure rose to 1.31% in Q3 from 1.15% in Q2, MBA said. That's less than the overall new foreclosure rate of 1.42%. But that's only because of the surge in FHA-backed loans — more than 1 million in the past year. They haven't had much time to go bad. Exclude them and FHA's foreclosure start rate hit 1.76%.

The FHA could shore up finances by raising fees on borrowers and upping the 3.5% down payment. Higher down payments would reduce the FHA's exposure and give borrowers a greater incentive to stay current.

HUD's Donovan said last week he is "actively looking" at down payment requirements.

Rep. Scott Garrett, R-N.J., a member of the House Financial Services Committee, has proposed legislation to raise the minimum down payment on FHA-backed loans to 5%.

"That way we are prepared if the rosy scenario (officials' predictions that housing will recover) doesn't play out," he said.

But the real estate industry says such action would drain what life there is from housing. And legislation to raise FHA down payments has gotten little traction.

"Those claiming that we should immediately restrain FHA need to remember that FHA insurance is a critical tool to ensure our economic recovery," said Rep. Maxine Waters, D-Calif. "FHA stepped into the void created by the failure of many private mortgage companies through their risky lending practices."

Housing conditions may continue to deteriorate. A HUD annual report to Congress Nov. 12 cited independent forecasts that suggested home prices will continue to fall into 2010.

In that report on FHA's finances, HUD said it doesn't expect FHA's capital ratio to get back above 2% until the end of fiscal 2011. By then, FHA's insurance book will likely top \$1 trillion, according to government estimates.



The rate of FHA loans going into foreclosure rose to 1.31% in Q3 from 1.15% in Q2, according to the Mortgage Bankers Association.

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The FHA insures loans by approved lenders vs. potential default. It was set up in the throes of the Great Depression to help cash-strapped Americans buy homes.

It can be argued that the FHA is doing what it was meant to do. About half of all first-time buyers used FHA-backed loans this year.

FHA Commissioner David Stevens, who took the helm in July, has taken steps to beef up controls. That includes tighter underwriting requirements, fraud-protection measures to weed out unscrupulous lenders and a new chief risk officer.

But in the face of rising unemployment and still-falling home prices in many areas, these new measures are Band-Aids, some watchers say.

"The bigger issue longer term is not occasional fraud, but that the FHA gives out 3.5% loans to people with low credit scores," Gorge said. "If the reserve falld further in fiscal 2010, then thr government will have to do something a little more proactive."

Credit scores on FHA loans, while still relatively low, have risen to an average 681 vs. 647 in 2008 and 630 in 2007. Meanwhile, the FHA has

boosted loan limits to almost \$730,000 in high-priced markets.

#### **Jobs, Home Prices Vital**

Housing experts generally agree that falling home prices and rising unemployment are the main drivers of defaults. Many economists expect the jobless rate to remain above 10% through most of 2010.

"HUD's capital study doesn't make much mention of unemployment," said Guy Cecala, publisher of Inside Mortgage Finance. "That's the biggest reason for defaults and people not being able to pay their mortgage."

National home prices have fallen about 10% this year, Cecala notes.

"A case can be made that all FHA mortgages originated this year will be underwater by the end of this year," he said.

The FHA insured about \$360 billion in single-family mortgages in fiscal 2009, which ended Sept. 30. That's 31% of the value of its entire outstanding insurance book. So far, delinquencies on those loans have been relatively low vs. older loans.

But 2009 loans are "still fresh," said Matthew Anderson, partner at Foresight Analytics. "There's a sharper rise in defaults after three years from the loan origination."

Last year's ban of seller-funded FHA down payments — which made for risky zero-down loans — could make FHA 2009 loans perform better, analysts say.

But the \$8,000 first-time homebuyer tax credit — recently extended and expanded to include \$6,500 for current homeowners to move up — means many FHA borrowers can still put little or nothing down.

David Hogberg contributed to this article.

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