FHA Watch

November 2012
Volume 1, No. 11

Edward J. Pinto

Edward J. Pinto (edward.pinto@aei.org) is a resident fellow at AEI.

Getting *FHA Watch* from a colleague? To receive your own copy, e-mail edward.pinto@aei.org.

This Issue's Highlight

FHA Has a −$34 Billion Economic Value

The Federal Housing Administration's (FHA's) recently released FY 2012 Actuarial Study confirmed the decline in financial condition that *FHA Watch* has been tracking over the past year. While the Department of Housing and Urban Development (HUD) attempted to downplay the report, the FHA's economic value is currently −$34 billion given today's low interest rate environment.

The FHA's insurance in force has been growing, as have its capital shortfalls. These trends and the FHA's poor financial condition are cause for significant concern for Congress and taxpayers.

This Month's Features

Spotlight on FHA's Economic Value

FHA Has a −$34 Billion Economic Value

Spotlight on Insolvency

FHA's Estimated GAAP Net Worth Equals –$25.38 Billion, with a Capital Shortfall of $45–67 Billion

Spotlight on Delinquency

Delinquency Rates Decline

Spotlight on Best Price Execution

FHA's Pricing Dominance Eases as the FHA Announces Premium Changes

The Road Map to FHA Reform

Immediate Action Needed to Address the FHA's Fiscal Crisis

Spotlight on FHA's Economic Value

FHA Has a −$34 Billion Economic Value

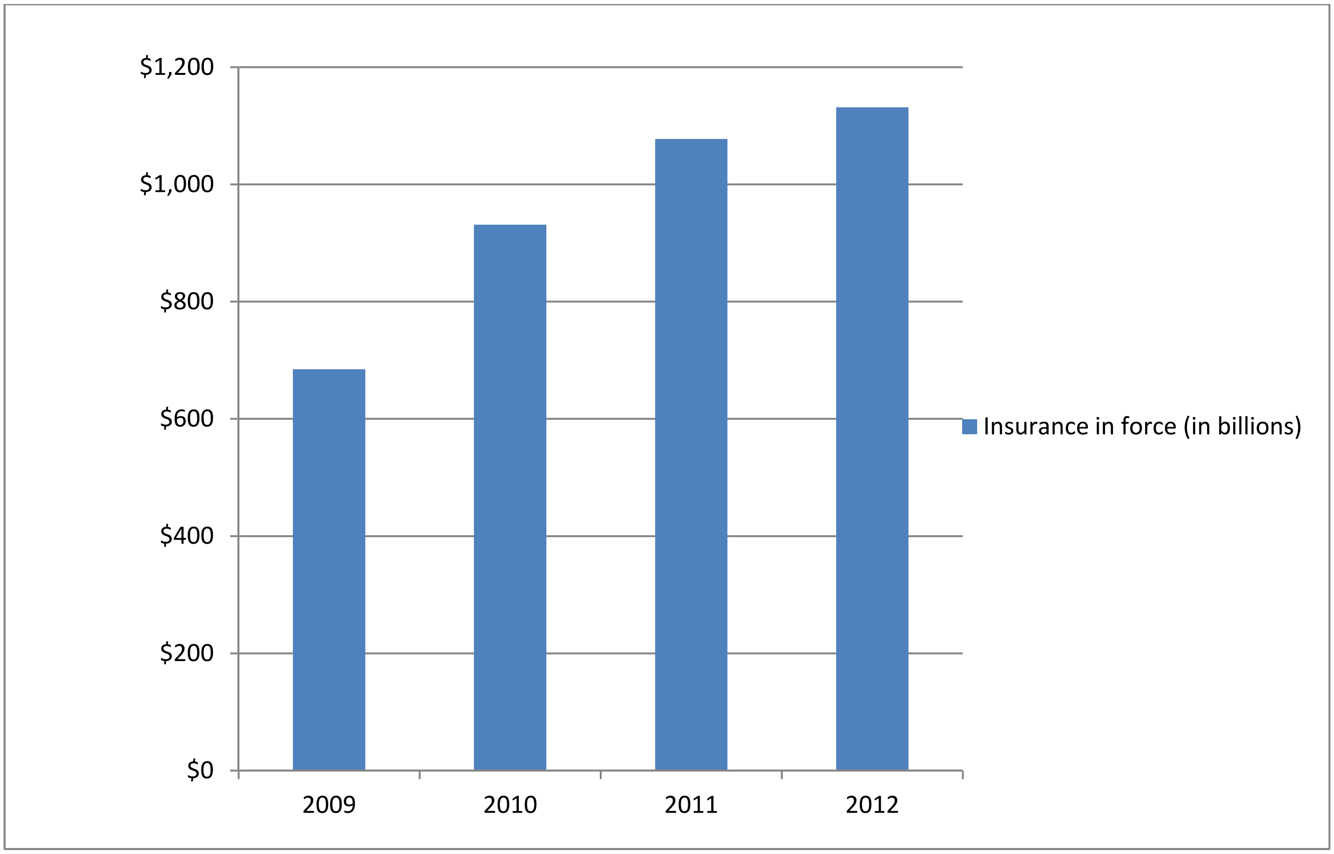
The FHA's recently released FY 2012 Actuarial Study confirmed the decline in financial condition that *FHA Watch* has been tracking over the past year. While HUD attempted to downplay the report by highlighting the base case, which shows an economic value of −$16.3 billion,[1] the FHA's economic value is currently −$34 billion, given today's low interest rate environment.[2]

The lower estimate of −$13.5 billion economic value is based on Moody's July 2012 forecast projecting 10-year treasuries in calendar year Q3:12 to be over about 2.2 percent and climbing to 4.59 percent by 2014.[3] Today, the 10-year rate is at 1.61 percent. Under that same forecast, mortgage rates are projected to double to 6.58 percent by CY Q3:14.[4] As was the case in 2011, when the home price forecast was obsolete by the time the actuary's report was released in November, the FHA is ignoring the Federal Reserve's September interest rate intervention, which dramatically impacted the base case findings. The Securities and Exchange Commission (SEC) would be all over a public company that made similar material misstatements and omissions causing the company's disclosure to be misleading.

The FHA compounded its omission by attempting to downplay the significance of its fiscal plight. It cherry-picked a piece of "good news"—the study projects that FHA will generate $11 billion in new economic value in FY 2013—to proclaim that the 2012 deficit will be largely wiped out by next year. This ignores the reality of the FHA's true −$35 billion economic value today.

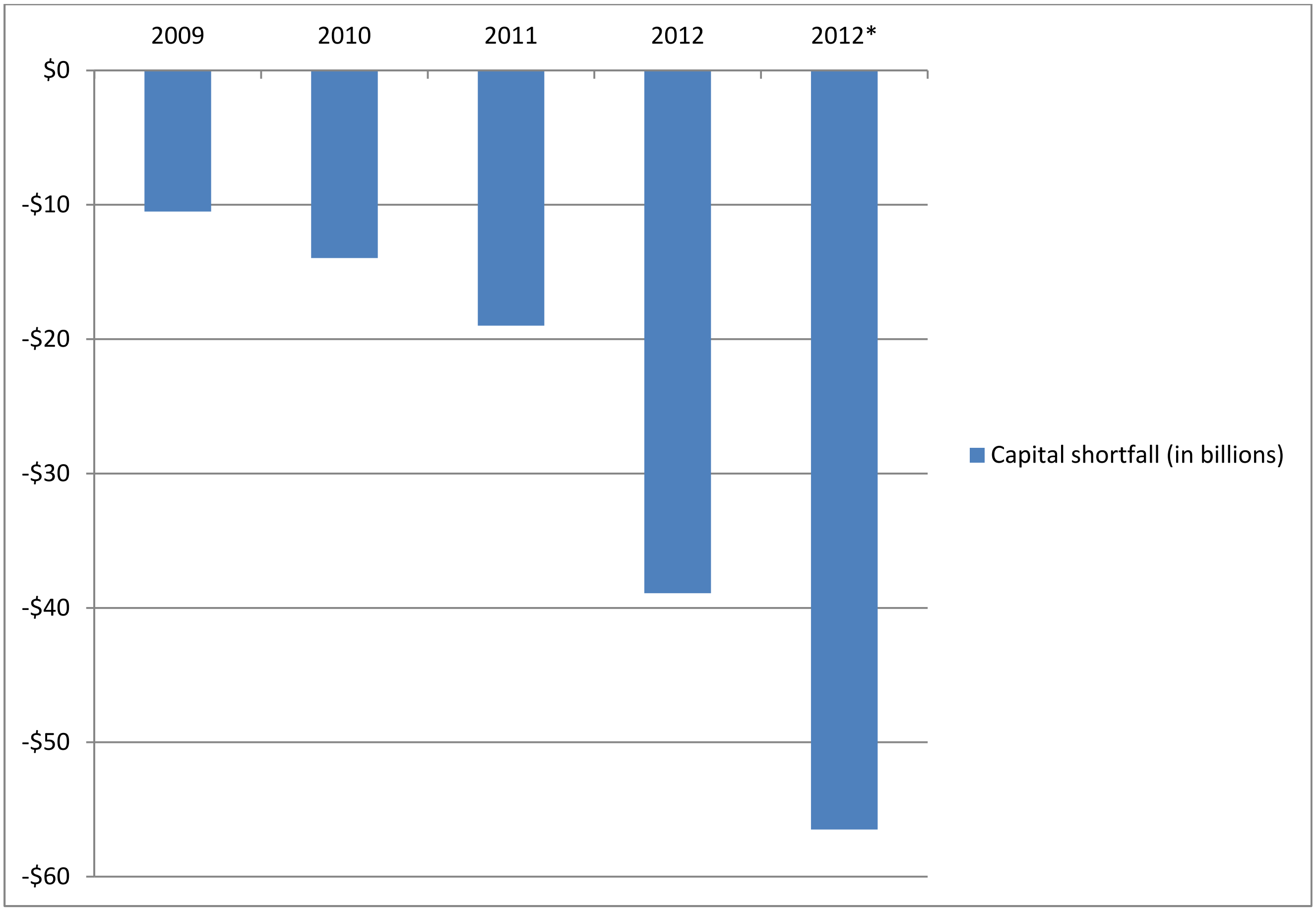
Figure 1 shows the FHA's strategy has been to "grow" its way out of its fiscal problems.

Figure 1. Growth of Total Insurance in Force



However, its capital shortfall has grown even larger, as we see in figure 2.

Figure 2. Mutual Mortgage Insurance Fund Capital Shortfall



Note: *Shortfall under current low interest rates.

These trends and the FHA's poor financial condition are cause for significant concern for Congress and taxpayers.

- Each year, the FHA gives Congress a report saying, "don't worry; next year will be better." But each year is worse.
- For the fourth consecutive year, the FHA has missed its 2 percent statutory capital requirement. It is now out of compliance relative to this requirement by **$56 billion**.
- The FHA's −$34 billion economic value for 2012 represents a deterioration of **$45 billion** from last year's projection for FY 2012.
- The FHA's own numbers indicates that it faces at least another five years of continued violation of its capital standard.
- The hole keeps getting bigger while the FHA's cash reserves dwindle.

What do we know for sure about the FHA's fiscal condition?

1. Under generally accepted accounting principles (GAAP) the FHA's forward mortgage program has a current net worth estimated at −$25 billion, meaning it has a total current capital shortfall of $47 billion based on its 2 percent capital requirement.
2. Its available cash is dwindling fast and may be exhausted within the next 12 to 18 months.
3. One in six FHA loans is delinquent by 30 days or more.

The longer it takes the FHA to return to a sound fiscal footing, the greater the risk to the taxpayers.

Spotlight on Insolvency

FHA's Estimated GAAP Net Worth Equals –$25.38 Billion, with a Capital Shortfall of $45–67 Billion

The estimate for October of the FHA's GAAP net worth is –$25.38 billion, down from –$16.3 billion and –$25.03 billion (adjusted)[5] in September 2011 and September 2012, respectively. The capital shortfall stands at $45 billion (using a 2 percent capital ratio) and $64 billion (using a 4 percent capital ratio). The Denial Dial was reset to −2.33 percent. The FHA's estimated net worth on a GAAP basis has declined by $10 billion and $0.5 billion since the end of FY 2011 and FY 2012, respectively. Note: all of these calculations are for the forward mortgage program and exclude consideration of FHA's reverse mortgage or Home Equity Conversion Mortgage (HECM) program,

FHA Watch's GAAP analysis of the FHA over the past year has shown its fiscal position to be much worse than as set forth in the FY 2011 Actuarial Report:

- The 2011 report found that the FHA's forward mortgage program had an economic value of $1.2 billion on September 30, 2011.

- *FHA Watch*, using GAAP analysis, found the FHA to have a net worth of −$16.3 billion on September 30, 2011.

The FHA's FY 2012 Actuarial Report was released on November 16 and shows a dramatic decline in the FHA's financial condition.

- The 2012 report found that under today's low interest rates, the FHA's forward mortgage program had an economic value of −$31 billion on September 30, 2011.

- *FHA Watch*, using GAAP analysis, found the FHA to have a net worth of −$25 billion on September 30, 2011.

FHA Watch will continue tracking the FHA's financial condition over the coming months. For the monthly data tabulation, see table A1 in the appendix.

Spotlight on Delinquency

Delinquency Rates Decline

In October, 16.57 percent of all FHA loans were delinquent, down from 17.3 percent in September 2012 and 16.78 percent in September 2011. Total delinquencies decreased by 52,000 over September 2012 and increased by 57,000 from September 2011.

Most of the decline since September 2012 (41,000) was registered in the 30 days category. The serious delinquency rate declined slightly to 9.54 percent from 9.62 percent in September 2012, but remains substantially elevated from the September 2011 rate of 8.77 percent.

For the monthly data tabulation, see table A2 in the appendix.

Spotlight on Best Price Execution

FHA's Pricing Dominance Eases as the FHA Announces Premium Changes

Table 1 demonstrates the pricing advantages the Ginnie/FHA, Ginnie/US Department of Agriculture (USDA), and Ginnie/US Department of Veterans Affairs (VA) divisions have over Fannie Mae.

The FHA announced two changes to its premium polices as part of its report to Congress on its FY 2012 Actuarial Study. Both of these changes should reduce the FHA's crowding out of private mortgage insurers:

1. The annual mortgage insurance premium will be raised by 10 basis points across the board. This will decrease the FHA's competitiveness by about $450 on loans A–F and increase Fannie's advantage on medium-risk loans D–F.
2. The FHA will begin charging mortgage insurance premiums once scheduled loan amortization reached 78 percent. As a result, it is no longer competitive with respect to low-risk loans G, H, I, and J. This change will have an effect on new production with an initial loan-to-value (LTV) ratio of 80 percent or less; these loans constituted 6 percent of 2012 business.

Table 1. Best Price Execution (Ginnie pricing advantages in bold)

Feature	**Loan A**	**Loan B**	**Loan C**	**Loan D**	**Loan E**	**Loan F**	**Loan G**	**Loan H**	**Loan I**	**Loan J**
MBS coupon	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	2.50%
Term	30-yr	30-yr	30-yr	30-yr	30-yr	30-yr	30-yr	30-yr	30-yr	15-yr
LTV	95.00%	96.50%	95%	90%	95%	90%	78%	78%	75%	78%
FICO	620	680	700	700	720	740	720	740	740	740
Risk level	Very high	High	Medium	Medium	Medium	Medium-low	Low	Low	Low	Very low
Ginnie/FHA Execution	98.96	98.74	98.96	98.96	98.96	98.96	98.96	98.96	98.96	101.70
Ginnie/USDA Execution	103.21	103.21	103.21	103.21	103.21	103.21	104.56	104.56	104.56	103.25
Ginnie/VA Execution	105.06	104.41	105.06	105.31	105.06	105.31	105.31	105.31	105.31	104.00
Fannie Execution	94.90	97.37	98.32	99.76	100.03	101.09	103.05	103.30	103.55	103.29
Ginnie/FHA advantage on a $150,000 loan compared to Fannie	**$6,098**	**$2,047**	**$968**	-$1,192	-$1,605	-$3,195	-$6,127	-$6,502	-$6,877	-$2,389
Ginnie/USDA advantage on a $150,000 loan compared to Fannie	**$12,473**	**$8,760**	**$7,343**	**$5,183**	**$4,770**	**$3,180**	**$2,273**	**$1,898**	**$1,523**	-$64
Ginnie/VA advantage on a $150,000 loan compared to Fannie	**$15,248**	**$10,560**	**$10,118**	**$8,333**	**$7,545**	**$6,330**	**$3,398**	**$3,023**	**$2,648**	**$1,061**

Source: Adapted from JPMorgan's *2012 Securitized Products Outlook*, November 23, 2011, 18.
Note: Mortgage-backed security (MBS) pricing from *MBS Live*, published by Mortgage News Daily. Comparison based on MBS pricing as of November 16, 2012. On that date a Ginnie 30-year MBS with a coupon of 3.0 percent had a price of 106.56, and a Fannie 30-year MBS with the same 3.0 percent coupon had a price of 105.06. These prices were then adjusted based on the present value (where necessary) of applicable borrower-paid credit fees, mortgage insurance premiums, and the value of the base servicing fee. Fannie's guarantee fee was increased by 10 basis points effective April 2012, as mandated by Congress, and by a 10 basis points again

as announced on August 31, 2012, by the Federal Housing Finance Agency. All publicly announced FHA premium increases are included. USDA and VA premiums are unchanged.

Each of the Government Mortgage Complex's five divisions (Freddie Mac is the fifth) has substantial pricing advantages over the private sector. The result is that the Government Mortgage Complex's share of the entire first-mortgage market continues to remain at around 90 percent.

The Road Map to FHA Reform

Immediate Action Needed to Address the FHA's Fiscal Crisis

Perform a safety and soundness review now. The House of Representatives, by a vote of 402 to 7, passed an FHA reform bill in September that, among other provisions, required the Government Accountability Office to have an independent third party conduct a safety and soundness review of FHA under GAAP applicable to the private sector. This is critical, since the FHA likely has a current net worth under GAAP in excess of −$25 billion, meaning it has a total capital shortfall today of $47 billion. We must know what the FHA's true financial condition is. Congress must not continue allowing an agency with $1.1 trillion in obligations to operate on rosy scenarios.

Apply an SEC-style disclosure standard to FHA now. The House-passed bill also had a provision to hold HUD to the equivalent of an SEC disclosure standard—no public company could issue a report in November and omit the material impact of the Federal Reserve's interest rate action in September.

The FHA must bring a *credible* plan to Congress for how to deal with its insolvency. To start, the FHA must reduce its tolerance for failure and return to its traditional mission.

The FHA is financing failure for too many families, most of whom live in low- and moderate-income communities. This is a disservice to these families and communities whom its mission is to serve. The best way to do that is to reduce the combination of risk layering (low FICO, low down payment, high debt ratios, and/or slowly amortizing 30-year term) on its high-risk mortgages.

- The secretary of HUD should immediately announce that to protect families and communities from abusive lending practices, it will not knowingly insure a loan for any family for which the expected foreclosure rate, based on that family's credit attributes, is 10 percent or more.
- Borrowers taking out high-risk loans should be offered either a loan with a minimal down payment or a slowly amortizing 30-year term, but not both. This only makes sense with home prices at their lowest in 10 years and interest rates at their lowest in generations.
- Seller concessions should be limited to 3 percent of a home's value.

The FHA continues to finance loans with balances of up to $729,000. In FY 2011, 38 percent of the loans it guaranteed were in excess of 150 percent of the current area median home price. Traditionally, fewer than 10 percent of FHA-financed homes were in excess of even 125 percent of the area median. To begin returning the FHA to its traditional mission, loan limits should immediately be reduced to 150 percent of county median home price. Gradually, they should be reduced to 100 percent of the county median home price.

These steps would put the FHA on the road to replacing irresponsible lending with responsible lending.

Below is a compendium of all of *FHA Watch's* suggested reforms. Each month, the "Road Map to Reform" will chronicle progress made in putting the FHA on a sustainable road to reform. There have been no status changes over the last month.

Table 2. Road Map to Program Reform

Principles for Program Reform:

1. Step back from markets that can be served by the private sector by taking steps to return to a traditional 10 percent home purchase market share.
2. Stop knowingly lending to people who cannot afford to repay their loans.
3. Help homeowners establish meaningful equity in their homes.
4. Concentrate on homebuyers who truly need help purchasing their first home.

Suggested Reforms to Implement Program Reform Principles 1–4	**Status (green denotes progress toward adoption, red denotes a step backward)**
Set loan limits equal to the county's current median house price.	In November 2011, Congress set higher limits.
Serve first-time homebuyers with incomes below the area median.	No action
Serve repeat homebuyers below 80 percent of area median.	No action
Set maximum FICO score at 675.	No action
Limit rate-reduction refinances to term reduction only; payment remains the same.	No action
Eliminate cash-out refinances.	No action
Eliminate specific risks that are difficult to offset with lower-risk features: 1. FICO scores below 580. 2. Adjustable rate mortgages. 3. Seller concessions greater than 3 percent.	1. Needs further action. In 2010, minimum down payment increased to 10 percent. 2. No action 3. Needs further action. In February 2012, the FHA issued a proposed rule that limits seller concessions to the greater of 3 percent or $6,000. This layering of risk leaves borrowers central to the FHA's low- and moderate-income mission prey to excessive default rates. The most common concession levels of 3, 4, and 5 percent experience 43, 64, and 96 percent higher failure rates,

	respectively, than loans with no seller concessions.
Limit/adjust risk layering to meet target projected average claim rates of 5 per 100 insured loans under normal circumstances and 10 per 100 insured loans under stress circumstances.	No action
Immediately reduce maximum claim coverage to 80 percent from the current 100 percent, with an ultimate goal of 50 percent.	No action
Require lenders to buy back any loan that defaults within six months of origination.	No action
Reinstate the use of an appraisal board. This would replace the current system where the lender chooses the appraiser.	No action
Require the FHA to make its data and actuarial analysis programs available publicly.	No action
Until the above reforms are implemented, levy a 0.25 percent, 0.50 percent, and 0.75 percent per-year government subsidy reduction fee on any Ginnie/FHA or Ginnie/USDA insured loan with an initial LTV of > 90 percent and <= 95 percent, with an initial LTV of > 80 percent and <= 90 percent, and with an initial LTV of <= 80 percent, respectively. Revenue would be paid directly to the Treasury and not benefit Ginnie, the FHA, or the USDA.	No action
Until the above reforms are implemented, the HUD Secretary shall require FHA mortgagees to disclose to applicants for a forward FHA single-family loan with a clear and conspicuous notice both within 72 hours of application and at closing setting forth the applicant's LTV, FICO score, and total debt-to-income ratio, all as used in underwriting applicant's FHA loan. This disclosure shall also include the estimated cumulative claim rate for loans insured by the secretary with similar risk characteristics to the applicant's and the average estimated cumulative claim rate for the most recent fiscal year as determined in the FHA's annual actuarial study. The secretary shall calculate such estimates in a manner similar to that used in the FHA's annual actuarial study and provide it to the mortgagee.	No action

Table 3. Road Map to Fiscal Reform

Principles for Fiscal Reform:

1. Utilize generally accepted accounting principles, and set rigorous disclosure standards.
2. Establish and maintain loan loss and unearned premium reserves.
3. Establish and maintain a minimum capital requirement of 4 percent of amortized risk in force.
4. Fund a countercyclical premium reserve.

Suggested Reforms to Implement Fiscal Reform Principles 1, 2, 3, and 4	**Status (green denotes progress toward adoption, red denotes a step backward)**
Require use of generally accepted accounting standards applicable for private mortgage insurers with respect to quarterly examinations of the FHA's financial condition.	No action
Require application of US Securities and Exchange Commission disclosure standards to information disclosed regarding the FHA's insurance programs and funds.	This provision contained in the FHA Emergency Solvency Act of 2012, which passed the full House on September 11, 2012.
Require the GAO to retain an independent third party to conduct a safety and soundness review under applicable generally accepted accounting principles applicable to the private sector and report within 60 days.	This provision contained in the FHA Emergency Solvency Act of 2012.
Require the FHA to establish an emergency capital plan with biweekly updates to Congress.	This provision contained in the FHA Emergency Solvency Act of 2012.
Require the FHA to establish and maintain loan loss and unearned premium reserves on a similar basis as applied to private mortgage insurers.	No action
Hold oversight hearings to determine the FHA's current and ongoing fiscal condition based on emergency capital plan reports.	No action
Require the maintenance of a minimum capital level of 4 percent calculated in accordance with generally accepted accounting principles as applied to private mortgage insurers.	No action
The FHA's premium structure should be set where 50 percent of the premium is sufficient to meet normal claim expectations on insured loans. Unused portions of this premium would accumulate in the capital reserve account. The remaining 50 percent of	No action

the premium would accumulate in a separate countercyclical catastrophic premium reserve account for a 10-year period and would be available to pay catastrophic losses from periodic but unpredictable general economic risks.	

Appendix: Historical Data Tables

Table A1. Insolvency Watch ($ Billions)

Date	FHA's "Capital Resources" (Assets)	Cash Flow since end of fiscal year*	Estimated Loss Reserve (Liabilities on PMI Basis)**	Estimated Liability for Excess Upfront Premiums beyond GAAP Allowance	Current Net Worth (PMI Basis)	Required Capital Ratio	Required Capital Under Applicable Ratio***	Capital Shortfall (PMI Basis)
Sept. 30, 2011	$28.18	---	$36.49	$8.00	($16.31)	2%	$18.14	($34.46)
Sept. 30, 2011	$28.18	---	$36.49	$8.00	($16.31)	4%	$36.29	($52.60)
Sept. 30, 2012	$25.57	---	$41.50	$9.10	($25.03)	2%	$19.43	($44.45)
Sept. 30, 2012	$25.57	---	$41.50	$9.10	($25.03)	4%	$38.85	($63.88)
Oct. 31, 2012	$25.57	($0.60)	$41.01	$9.35	($25.38)	2%	$19.51	($44.89)
Oct. 31, 2012	$25.57	($0.60)	$41.01	$9.35	($25.38)	4%	$39.02	($64.41)

Notes: Table A1 estimates FHA's current net worth and capital shortfall under accounting rules applicable to a private mortgage insurer (PMI) such as Genworth. Estimates are based on Genworth having the FHA's delinquent loans, risk exposure, capital resources, and capital ratio (under both the 2 percent statutory requirement for the FHA and the 4 percent of risk-in-force requirement applicable to a PMI). In quarter 3 of 2012, Genworth had loss reserves equaling 59 percent of its risk-in-force on sixty-days-plus delinquent loans. This was down from 60 percent in quarter 2 of 2012. Genworth, Quarterly Financial Supplements, Delinquency Metrics-US Mortgage Insurance Segment, 52, http://phx.corporate-ir.net/phoenix.zhtml?c=175970&p=irol-quarterlyreports (accessed November 17, 2012).

*The FHA's negative cash flow was $596 million per month during Q3 of FY 2012. See exhibit 10, US Department of Housing and Urban Development, *FHA Single-Family Mutual Mortgage Insurance Fund Programs, Quarterly Report to Congress*, 12. The FHA raised its upfront premium from 1 to 1.75 percent (excluding streamline refinances) effective for case numbers assigned on or after April 9, 2012. Since under GAAP accounting this amount would not be taken into income immediately, it will be accounted for in the "Estimated liability for excess upfront premiums beyond GAAP allowance." The amount of this liability was estimated at $9.35 billion as of October 31, 2012.

** Outstanding balance of loans sixty-days-plus delinquent based on loan counts on applicable date times average loan balance for loans going to claim of $126,524.

***Total based on the FHA's total amortized risk in force net of loans covered by loan loss reserve.

Table A2. National Delinquency Watch

End Date	Thirty-Days Delinquency Rate and Number of Loans	Sixty-Days-Plus Delinquency Rate and Number of Loans	Thirty-Days-Plus Delinquency Rate and Number of Loans	Serious Delinquency Rate and Number of Loans	Total Loans
Jan. 2011	N/A	N/A	N/A	8.9% / 612,443	6,882,984

Feb. 2011	N/A	N/A	N/A	8.9% / 619,712	6,932,510
Mar. 2011	N/A	N/A	N/A	8.3% / 580,480	6,983,893
Apr. 2011	N/A	N/A	N/A	8.2% / 575,950	7,035,016
May 2011	N/A	N/A	N/A	8.2% / 578,933	7,090,489
June 2011	5.79% / 411,258	10.55% / 749,204	16.62% / 1,160,462	8.34% / 592,366	7,103,531
Aug. 2011	N/A	N/A	N/A	8.4% / 611,822	7,259,736
Sept. 2011	5.70% / 413,834	11.08% / 803,899	16.78% / 1,217,733	8.77% / 636,778	7,258,328
Oct. 2011	5.55% / 404,773	11.47% / 836,789	17.02% / 1,241,562	9.05% / 660,499	7,296,639
Nov. 2011	5.61% / 411.663	11.81% / 865,658	17.42% / 1,277,321	9.46% / 693,314	7,331,525
Dec. 2011	5.72% / 421,404	12.07% / 889,602	17.79% / 1,311,006	9.73% / 716,786	7,370,426
Jan. 2012	5.35% / 397,018	12.18% / 903,748	17.53% / 1,300,766	9.92% / 735,760	7,418,830
Feb. 2012	4.78% / 355,092	11.70% / 871.870	16.47% / 1,226,962	9.73% / 725,002	7,450,480
Mar. 2012	4.57% / 341,213	11.21% / 837,472	15.78% / 1,178,685	9.47% / 707,930	7,471,708
Apr. 2012	4.77% / 358,174	11.20% / 840,803	15.97% / 1,198,977	9.42% / 707,222	7,507,031
May 2012	4.93% / 372,514	11.29% / 852,608	16.23% / 1,225,222	9.43% / 711,612	7,549,730
June 2012	5.19% / 393,894	11.43% / 867,959	16.61% / 1,261,853	9.48% / 719,984	7,594,689
July 2012	5.04% / 384,349	11.48% / 874,802	16.52% / 1,259,151	9.51% / 725,074	7,622,873
Aug. 2012	4.91% / 375,464	11.44% / 874,656	16.35% / 1,250,120	9.49% / 725,692	7,645,912
Sept. 2012	5.58% / 428,351	11.70% / 898,590	17.30% / 1,326,931	9.62% / 738,303	7,671,677
Oct. 2012	5.02% / 387,000	11.54% / 887,959	16.57% / 1,274,959	9.54% / 734,431	7.693,992

Source: US Department of Housing and Urban Development, "Neighborhood Watch," https://entp.hud.gov/sfnw/public (Servicing download, Excel; accessed November 17, 2012) and US Department of Housing and Urban Development, "FHA Outlook," http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts/ooe/olmenu (accessed October 21, 2012). Rates not seasonally adjusted. Serious delinquency includes ninety-days-plus delinquency and loans in bankruptcy or foreclosure.

Notes

[1] This is the total for the Mutual Mortgage Insurance Fund which has programs: the forward mortgage program and the reverse or HECM program. Sources: US Department of Housing and Urban Development, *Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year 2012*, November 5, 2012, 9; and US Department of Housing and Urban Development, *Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund HECM Loans for Fiscal Year 2012*, October 12, 2012, iv.
[2] Ibid., 63. The −$2.8 billion economic value for the HECM program is included.
[3] Ibid., 8.
[4] Ibid., 8.
[5] Adjusted to reflect $2.3 billion in investment income as reported in the Actuarial Study.