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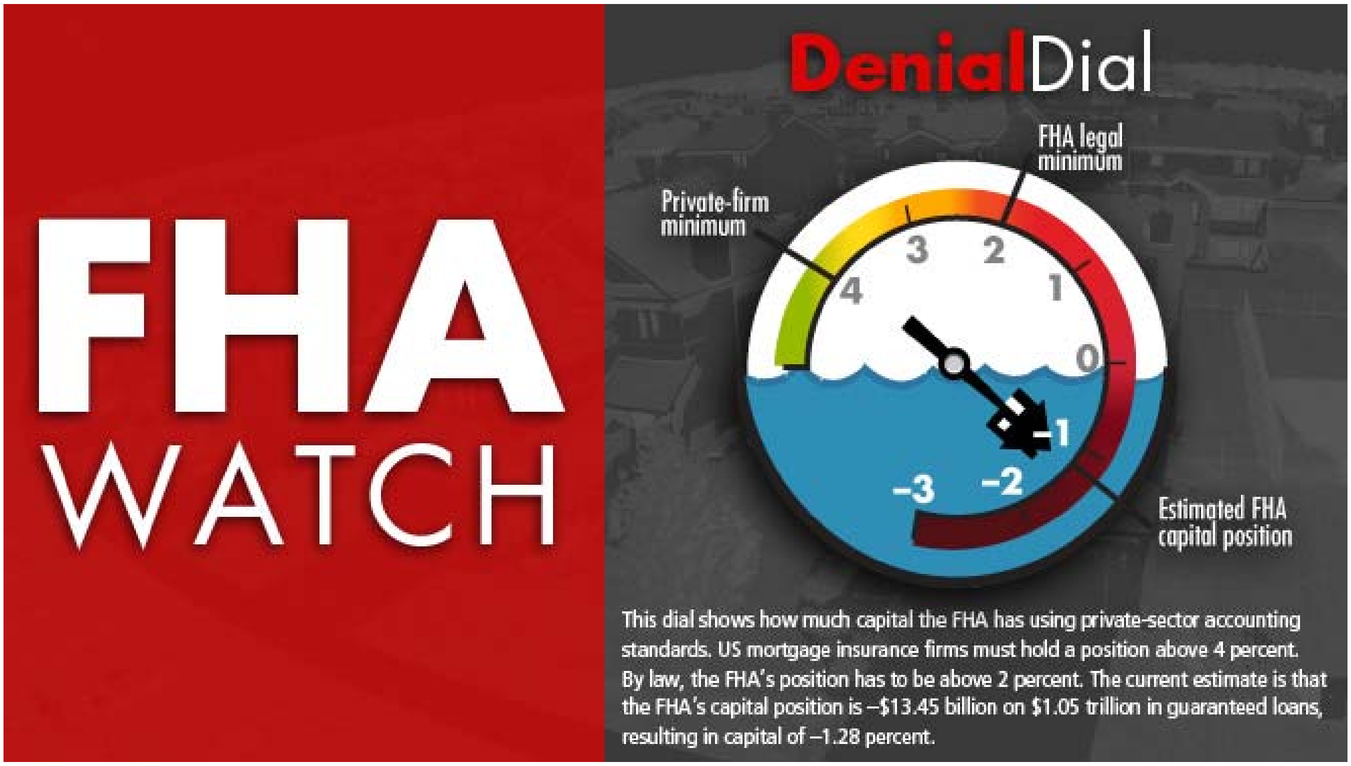

This Issue's Highlight

Spotlight on Best Price Execution: It was a clean sweep for the two Ginnie siblings over Fannie in the best price execution loan analysis. Ginnie/USDA was the best execution for six of the loans and Ginnie/FHA the best execution for the remaining four. For the riskiest loan (a $150,000 loan with a 95 percent LTV ratio and a 620 FICO score), Ginnie/USDA had a whopping $11,205 price advantage over Fannie. Although the Ginnie/VA division was excluded from the analysis (it is available only to veterans) because it charges no mortgage insurance premium, its pricing advantage would be more than $16,000 on the same $150,000 loan.

This presents a challenge to policymakers. With the Government Mortgage Complex's five divisions, the opportunities for market distortions are endless. In FY 2011, the Ginnie/VA division had an 18 percent share of the mortgage insurance market compared to 62 percent for the Ginnie/FHA division and 20 percent for all private mortgage insurers (the Ginnie/USDA share was not included in this report). In FY 2012 (October–December) the Ginnie/VA division increased its share to 30 percent of the mortgage insurance market while Ginnie/FHA's share declined to 51 percent and the share for all private mortgage insurers also declined, to 19 percent.

This Month's Features

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Spotlight on Insolvency

FHA Is Estimated to Have a Current Net Worth of –$13.45 Billion and an Estimated Capital Shortfall of $32–51 Billion

The current estimate for the FHA's net worth is –$13.45 billion. This represents a modest improvement over last month as the result of a decline in the number of sixty-days-plus delinquent loans. The number (871,870) and rate (11.7 percent) remain substantially elevated from June 2011 levels (749,204 loans and 10.55 percent). The FHA's capital shortfall showed minimal improvement and stands at $32 billion (using a 2 percent capital ratio) and $51 billion (using a 4 percent capital ratio).

Table 1. Insolvency Watch ($ Billions)

Date	FHA's "Capital Resources" Assets	Cash Flow since Sept. 30, 2011*	Estimated Loss Reserve (Liabilities on PMI Basis)	Current Net Worth (PMI Basis)	Required Capital Ratio	Required Capital Under Applicable Ratio**	Capital Shortfall (PMI Basis)
Sept. 30, 2011	$28.18	---	$37.95	($9.77)	2%	$18.14	($27.91)
Sept. 30, 2011	$28.18	---	$37.95	($9.77)	4%	$36.29	($46.06)
Dec. 31, 2011	$28.18	($0.65)	$41.99	($14.46)	2%	$18.47	($32.93)
Dec. 31, 2011	$28.18	($0.65)	$41.99	($14.46)	4%	$36.94	($51.40)
Jan. 31, 2012	$28.18	($0.26)	$42.66	($14.74)	2%	$18.59	($33.34)
Jan. 31, 2012	$28.18	($0.26)	$42.66	($14.74)	4%	$37.18	($51.93)
Feb. 29, 2012	$28.18	($0.48)	$41.15	($13.45)	2%	$18.79	($32.25)
Feb. 29, 2012	$28.18	($0.48)	$41.15	($13.45)	4%	$37.59	($51.04)

Notes: Table 1 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). Reserves as a percentage of risk-in-force from Genworth, Quarterly Financial Supplements, Delinquency Metrics-US Mortgage Insurance Segment, http://phx.corporate-ir.net/phoenix.zhtml?c=175970&p=irol-quarterlyreports (accessed February 8, 2012).

*The FHA's negative cash flow was $216 million per month during FY 2011. See exhibit II-2, US Department of Housing and Urban Development, *Actuarial Review of the Federal Housing Administration*, 14. The FHA's forward single-family Mutual Mortgage Insurance Fund (MMIF) is expected to receive approximately $600 million from three settlements with lenders, which was added to January's cash flow.

**Total based on the FHA's total amortized risk in force net of loans covered by loan loss reserve of $907.2 billion ($1.009 trillion − $101.8 billion) and $938.6 billion ($1.05 trillion − $111.4 billion) as of September 30, 2011, and February 29, 2011 (estimated), respectively. See exhibit II-2 in US Department of Housing and Urban Development, *Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year 2011* (excludes HECM) (Washington, DC: Author, October 12, 2011), 14; and US Department of Housing and Urban Development, *Monthly Report to the FHA Commissioner*, January 2012, http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts/com/commenu (accessed March 17, 2012). Outstanding balance of loans sixty-days-plus delinquent at February 29, 2012, and September 30, 2011, based on loan counts of 871,870 and 803,899, respectively, and an average loan balance for loans going to claim of $127,821.

Spotlight on Delinquency

Total Delinquency Rate in February Declines to 16.47 Percent; Serious Delinquency Rate Eases to 9.73 Percent

The FHA's total delinquency in February declined to 16.47 percent from 17.53 percent in January 2011, representing the lowest rate since at least June 2011. The FHA's serious delinquency situation eased to 9.73 percent, but remains at a near-record level and is substantially higher than February 2011, when it stood at 8.9 percent.

Table 2. 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	Total Loans
Feb. 2012	4.78%/355,092	11.70%/871.870	16.47%/1,226,962	9.73%/725,002	7,450,480
Jan. 2012	5.35%/397,018	12.18%/903,748	17.53%/1,300,766	9.92%/735,760	7,418,830
Dec. 2011	5.72%/421,404	12.07%/889,602	17.79%/1,311,006	9.73%/716,786	7,370,426
Nov. 2011	5.61%/411.663	11.81%/865,658	17.42%/1,277,321	9.46%/693,314	7,331,525
Oct. 2011	5.55%/404,773	11.47%/836,789	17.02%/1,241,562	9.05%/660,499	7,296,639
Sept. 2011	5.70%/413,834	11.08%/803,899	16.78%/1,217,733	8.77%/636,778	7,258,328
June 2011	5.79%/411,258	10.55%/749,204	16.62%/1,160,462	8.34%/592,366	7,103,531
Apr. 2011	N/A	N/A	N/A	8.2%/575,950	7,035,016
Mar. 2011	N/A	N/A	N/A	8.3%/580,480	6,983,893
Feb. 2011	N/A	N/A	N/A	8.9%/619,712	6,932,510
Jan. 2011	N/A	N/A	N/A	8.9%/612,443	6,882,984

Source: US Department of Housing and Urban Development, "Neighborhood Watch," https://entp.hud.gov/sfnw/public (Servicing download, Excel; accessed March 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 March 17, 2012). Rates not seasonally adjusted. Serious delinquency includes ninety-days-plus delinquency and loans in bankruptcy or foreclosure.

Spotlight on Ginnie/USDA

Meet the FHA's Country Cousin, the USDA Guaranteed Rural Housing Loan Program: Its Default Rate Exceeds the FHA's

The Ginnie/US Department of Agriculture (USDA) division of the government-owned mortgage lending conglomeration I am calling the Government Mortgage Complex[1] trumps its older sibling, the Ginnie/FHA division, in many respects. The USDA Rural Housing Loan Program offers higher maximum loan-to-value (LTV) ratios (100 percent versus 96.5 percent) and lower mortgage insurance premiums, to name just two. See table 3 for a full comparison.

This explains why, among the USDA, FHA, and Veterans Affairs (VA), the USDA has had the most explosive growth, with a nearly tenfold increase in home purchase loan market share from 2005 to 2010. This compares to a sevenfold increase for the FHA and threefold increase for the VA.[2]

Yet the Ginnie/USDA division of the Government Mortgage Complex operates in an even more opaque manner than the Ginnie/FHA division, with minimal loan metric and performance data published regarding its $80 billion guarantee program:

1. As of July 31, 2011 (most recent data published), the delinquency rate for the USDA Single Family Guaranteed Program was 18.7 percent.[3] This was higher than the FHA's rate of slightly less than 17 percent as of the same date.
2. When I asked the USDA for more recent delinquency information, the response was that it does not release delinquency information and was referred to the most recent official program assessment, which was performed in 2007.

As policymakers undertake efforts to shrink the Government Mortgage Complex, they must consider the USDA's explosive growth and poor loan performance and threats posed to the taxpayer, borrowers, neighborhoods and rural areas.

Table 3. Ginnie/USDA Highlights and Comparison to Ginnie/FHA

Program Attribute	**Ginnie/USDA**	**Ginnie/FHA**
Geography	Includes 34% of U.S population.[*] This is much higher than in other definitions of "rural." 1. About 16% of the population live outside of metro areas. 2. About 23% of the population is classified as rural by the US Census Bureau.	Entire country
Maximum LTV ratio	100% (102% with financed upfront premium)	96.5% (98.25% with financed upfront premium)
Income limit	The law provides a limit of 115% of median area income. In practice, the USDA income limit well exceeds 115% of median area income.	None
Debt limit	Principal, interest, taxes, and insurance: 29% of gross monthly income Total of all monthly debts: 41% of gross monthly income Both limits have some flexibility.	Median for total-debt-to-income ratio is about 42%, with about 17% being greater than 50%.
Mortgage limit	None (income limit and debt formulas create an effective mortgage limit).	Ranges from a floor of $271,050 for one-unit properties to a ceiling of $729,750 for one-unit properties

		in higher-cost areas.
Mortgage insurance premium	2% upfront and 0.30% annually on loan balance. Present value estimated at 3.35%.	1.75% and 1.2% or 1.25% annually on loan balance. Present value estimated at 7.15% or 7.38%.
Credit history	No minimum FICO credit score. Applicants must have reasonable credit histories.	While no minimum FICO score, program requirements effectively limit to a minimum 580 score.
Limit on seller concessions	None	Current: Less than or equal to 6%. Proposed: Greater of 3% or $6,000.

*Housing Assistance Council, *Estimating Potential Changes to USDA-RD's Eligible Area Designations* (Washington, DC: Author, September 11, 2011), www.ruralhome.org/storage/documents/usdaeligibilityreport.pdf (March 5, 2012).

As noted above in table 3, the law provides a limit of 115 percent of median area income. In practice, the USDA income limit well exceeds 115 percent of median area income and as the example below demonstrates can be in excess of 150 percent of median area income.

1. The US Department of Housing and Urban Development (HUD) is responsible for providing median area income data.
2. It starts with a calculation of 50 percent of median income for a family of four (50 percent area limit) based on actual data.
3. HUD substitutes 50 percent of the statewide median if greater than the 50 percent area limit, creating an upward bias in the result.
4. The 50 percent area limit is doubled to convert to 100 percent of area median income for a family of four.
5. USDA multiplies the HUD result by 115 percent to yield 115 percent of area median income for a family of four.
6. USDA applies this unadjusted figure to families of one, two, or three, making a separate calculation for families of five or greater. This creates an upward bias for these families.

Example: In Florida, the USDA has set "115 percent of median income" limits for families of one to four that range from a low of $74,750 in most nonmetro areas to a high of $95,100 in the most expensive metro areas. But the HUD nonmetro median income ranges from $47,200 to $47,400. Thus most nonmetro limits are closer to 160% of median family income and heavily favor one- or two-person families.

Spotlight on Best Price Execution

A Clean Sweep by the Ginnie/USDA and Ginnie/FHA Divisions

As reported in issue 2, while all of the Government Mortgage Complex's five divisions (Fannie, Freddie, Ginnie/FHA, Ginnie/USDA, and Ginnie/VA) benefit from a plethora of subsidies compared to the private sector, some benefit more than others. This provides innumerable opportunities for creating market distortions.

Since the last issue, the FHA announced an increase in its upfront premium from 1 to 1.75 percent. Table 5 reflects this increase.

- This increase will immediately be used by the FHA to bolster the MMIF. This accounting gimmick continues the unsound practice of counting upfront premiums as current income rather than placing them in an unearned premium account where they would be brought into income over the life of the related loans. The FHA's practice makes it appear the MMIF is more solvent than it actually is.
- This increase does reduce Ginnie/FHA's net price by $1,100 and thus helps reduce the pricing advantage it has on certain low-risk loans. However, as table 5 demonstrates, more must be done to reduce Ginnie/FHA's advantage on low-LTV businesses that most certainly do not need the Government Mortgage Complex's subsidies.

This month, the Ginnie/USDA division was added to the best price execution analysis covering ten representative loans. As table 4 indicates, Ginnie/USDA was the best execution for six of the loans and Ginnie/FHA the best execution for the remaining four.[4]

Table 4. Best Price Execution (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	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.00%
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	96.57	96.35	96.57	96.57	96.57	96.57	**101.97**	**101.97**	**101.97**	**103.53**
Ginnie/USDA Execution	**100.37**	**100.37**	**100.37**	**100.37**	**100.37**	**100.37**	101.72	101.72	101.72	102.78
Fannie Execution	92.90	95.38	96.32	97.76	98.04	99.10	101.05	101.30	101.55	102.56
Ginnie/FHA advantage on a $150,000 loan compared to Fannie	$5,505	$1,455	$375	-$1,785	-$2,198	-$3,788	$1,380	$1,005	$630	$1,455
Ginnie/USDA advantage on a $150,000 loan compared to Fannie	$11,205	$7,493	$6,075	$3,915	$3,503	$1,913	$1,005	$630	$255	$330

Source: Adapted from J.P. Morgan's *2012 Securitized Products Outlook*, 18. MBS pricing from *MBS Live* published by Mortgage News Daily.
Note: Based on actual MBS pricing as of March 15, 2012. For example, on that date a Ginnie thirty-year MBS with a coupon of 3.5 percent had a price of 103.72, and a Fannie thirty-year MBS with the same 3.5 percent coupon had a price of 102.25. These prices were then adjusted for applicable borrower-paid credit fees and mortgage insurance premiums and assumes the

FHA's annual mortgage insurance premium and Fannie's guarantee fee increases by ten basis points on April 1, 2012, and FHA's upfront premium increases by 0.75 percent on April 1, 2012. USDA premiums were unchanged.

For loan A, the riskiest loan listed in table 4 (a $150,000 loan with a 95 percent LTV ratio and a 620 FICO score), Ginnie/USDA had a whopping $11,205 price advantage over Fannie. Although the Ginnie/VA division was excluded because it is only available to veterans, it charges no mortgage insurance premium, giving it a pricing advantage of more than $16,000 on the same $150,000 loan.

As noted above, the Ginnie/USDA division has had substantial mission creep. Congress and regulators should limit Ginnie/USDA to its core mission and implement pricing increases so as to deter lending outside of the Ginnie/USDA division's core mission. This is necessary to limit the opportunity for the Ginnie/FHA division's business to merely shift to Ginnie/USDA division as policymakers move forward with the goal of reducing Ginnie/FHA's market share.

Such a market share shift is a real possibility. In FY 2011, the Ginnie/VA division had an 18 percent share of the mortgage insurance market, compared to 62 percent for the Ginnie/FHA division and 20 percent for all private mortgage insurers (the Ginnie/USDA share was not compiled in this report). In FY2012 (October–December) the Ginnie/VA division increased its share to 30 percent of the mortgage insurance market while the Ginnie/FHA division's share declined to 51 percent and the share for all private mortgage insurers declined also to 19 percent.[5] In mid-FY 2011 (April 18, 2011) FHA implemented a sizable 0.25 percent increase in its annual premium rate. The VA charges no premium and has also benefited from Ginnie's pricing execution improvement compared to Fannie and Freddie. Thus, it is no surprise that the big market share winner was the Ginnie/VA division of the Government Mortgage Complex.

The FHA has two more premium increases scheduled for next month—a 0.10 percent increase in its annual premium rate and a 0.75 percent increase in its upfront premium. Fannie and Freddie also have an increase of at least 0.10 percent in their guaranty fees slated for implementation in the next few months. As these increases and more on the horizon occur, the Ginnie/USDA division has no increases planned, and the Ginnie/VA division will presumably continue providing its mortgage insurance benefit at no cost.

FHA Watch will continue monitoring this fluid situation.

Spotlight on the Road to FHA Program Reform

Principles to Guide FHA Reform to Achieve Sustainable Homeownership Consistent with the FHA's Low- and Moderate-Income Mission

In this issue, *FHA Watch* will spotlight policy changes needed to implement program reform principles 2, 3, and 4:

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.**

Program reform principles 2 and 3 are complementary. By ending lending to people who cannot afford to repay their loans, the FHA will be helping homeowners establish meaningful equity in their homes.

Principle 2: Stop knowingly lending to people who cannot afford to repay their loans.

> "Given FHA's mission, allowing the continuation of practices that result in . . . a high proportion of families losing their homes represents a disservice to American families and communities.[6]

As I described in issues 1 and 2, the FHA's underwriting standards continue to result in an expected claim rate of 15 or more per 100 loans for a substantial subset of borrowers. This is the result of allowing excessive risk layering on individual loans at underwriting. These risks include:

1. Minimal earned equity[7] during a loan's first four years.[8] The average FHA borrower accumulates 7 percent in earned equity during a loan's first four years, an amount insufficient to pay a seller's normal closing costs.[9] This results from a combination of
    a. Small down payments (the median down payment is 4 percent);
    b. Slow scheduled principal amortization (almost all FHA loans have thirty-year terms);
    c. An already-high LTV ratio increased by allowing the upfront mortgage insurance premium of 1.75 percent to be financed and repaid over thirty years, raising the maximum LTV to 98.25 percent;
    d. Allowing excessive seller concessions that distort property values and increase the effective LTV to over 100 percent in many cases. Twenty percent of FHA loans have seller concessions in excess of 3 percent of sales price, rising to 33 percent on loan amounts below $180,000.
2. Borrowers with impaired credit. Twenty-five percent of recent FHA borrowers have a FICO score below 660, with the FHA's an announced goal being an increase to 40 percent;
3. Overstretched borrowers at origination. The median total-debt-to-income ratio is 42 percent.

To stop knowingly lending to people who cannot afford to repay their loans, the FHA should

1. Target projected average claim rates of 5 per 100 insured loans under normal circumstances and 10 per 100 insured loans under stress circumstances.
    a. This rate is about five times the normal default level for prime loans;
    b. This rate is about half the FHA's normal default level.

2. Eliminate specific risks that are difficult to offset with lower-risk features.
    a. FICO scores below 580. With this level of impaired credit, even when other risk factors are minimized, it would be difficult for FHA to make "a reasonable and good faith determination" that "the consumer has a reasonable ability to repay the loan."[10]
    b. Adjustable-rate mortgages (ARMs). For 2006 to 2009, ARM loans exhibited cumulative claim rates 25–35 percent higher than those for thirty-year fixed-rate loans.
    c. Loans with a seller concession greater than 3 percent. These loans exhibit failure rates about 80 percent higher than for loans with no seller concession. Loans with seller concessions of 1–3 percent have failure rates about 40 percent higher than those with no concession.[11]

i. In its second attempt at a proposed rule on seller concessions,[12] the FHA partially addressed this excessive risk. However, rather than setting a flat 3 percent limit as it originally suggested in 2010, it now proposes a limit of the greater of 3 percent of sales price or $6,000.
ii. The good news is that this formula largely protects borrowers with loan amounts greater than $180,000 from the destructive impact of seller concessions exceeding 3 percent.
iii. The bad news is that this formula leaves borrowers with loans amounts less than $180,000 exposed to the destructive impact of seller concessions exceeding 3 percent. About one in three borrowers in this loan-size group will still see the sales price of their home inflated because of seller concessions of greater than 3 percent. With 64–100 percent higher failure rates than loans with no seller concessions, these borrowers will still bear the full brunt of this form of destructive lending.
iv. This is all the more troubling since many of these borrowers are part of the FHA's low- and moderate-income mission. As the FHA's market share shrinks to better meet this mission, a growing percentage of borrowers will be condemned to this form of destructive lending.

3. Limit risk layering applicable on any given loan application so as to yield a projected claim rate of 5 per 100 insured loans under normal circumstances.[13]

Principle 3: Help homeowners establish meaningful equity in their homes.

Under principle 2 above, I proposed a projected claim rate of 5 per 100 insured loans under normal circumstances. Accomplishing this is directly related to the level of earned equity a homeowner establishes. As noted above, the FHA's traditional underwriting standards lead to the accumulation of only 7 percent in earned equity during a loan's first four years,

A projected claim rate of 5 per 100 is accomplished by balancing the layering of key risk factors, such as loan term, LTV ratio, FICO score, and total debt-to-income (DTI) ratio.

Table 5. Underwriting Standards That Help Homeowners Establish Meaningful Equity in Their Homes

FICO Score	Maximum LTV Limit*	Maximum Loan Term	Maximum Total DTI Ratio	Equity after Four Years**	Estimated Claim Rate
660–675	95.75%***	30 years	<50%	11%	5

620–659	95.75%/ 89.75%***	20/30 years	<50%/40%	17%	5
580–619	91.75%/ 83.75%***	15/20 years	<45%/40%	27%	5

* FHA annual premium payable until (1) the amortized loan balance is equal to 70 percent of the lesser of original sales price or original appraised value or (2) the sum of upfront premium plus annual premium of 0.50 percent exceeds a cumulative 4.5 percent.
** Earned equity is the sum of initial equity plus scheduled amortization based on an interest rate of 4.5 percent.
*** Maximum LTV Limit inclusive of financing up to a 1.75 percent upfront mortgage insurance premium. Where two limits are noted, the first is for the lower term listed under Maximum Loan Term and the second is for the higher term.

Two additional steps should be taken by the FHA to advance the goal of wealth building:

1. Use rate-reduction refinances as an opportunity to build additional earned equity. By keeping the monthly payment constant, a lower interest rate is used to speed up scheduled loan amortization.
2. The FHA should not enable cash-out refinances, as they work against wealth building.

These common-sense underwriting standards would help assure homebuyers assisted by the FHA that they have reasonable ability to succeed in building wealth through home ownership.

Principle 4: Concentrate on homebuyers who truly need help purchasing their first home.

Program reform principle 4 is complementary to principle 1. Once the FHA steps back from markets the private sector can serve, it will be able to concentrate on its mission to help low- and moderate-income homebuyers truly needing help. It should

1. Limit first-time homebuyers to less than 100 percent of median income and repeat buyers to less than 80 percent of area median income. Congress has set 80 percent of median income to define low- and moderate-income borrowers for Community Reinvestment Act lending and Fannie/Freddie affordable housing goals.
2. Limit FHA loans to 100 percent of the applicable county's current median house price.
3. Set a maximum FICO credit score of 675.

Spotlight on the Road to FHA Fiscal Reform

Policy Changes Needed to Implement Fiscal Reform Principle 2

In this issue, *FHA Watch* will spotlight policy changes needed to implement fiscal reform principle 2:

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.

As *FHA Watch* has documented, FHA is a seriously troubled and deeply insolvent government agency. It is not held to basic loan loss reserving principles applicable to financial guarantors such as private mortgage insurers.

- Its estimated losses on loans currently sixty days or more delinquent exceed its liquid capital leaving it with an estimated current net worth of -$13 billion.
- Much of its premium income consists of upfront payments usually financed into the original loan balance. Rather than placing these funds in an unearned premium reserve to cover losses on the guarantees they relate to, it uses them to pay current claims.

The FHA should be required to establish and maintain loan loss and unearned premium reserves on a similar basis as applied to private mortgage insurers.

The Road Map to FHA Reform

Specific Steps to Reform and the Status of Each

Each month, *FHA Watch*'s "Road Map to Reform" will chronicle progress made in putting the FHA on a sustainable road to reform.

Table 6. Road Map to Program Reform

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, compared to 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
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 provide applicants for a forward FHA single-family loan with a clear and conspicuous notice within 72 hours of application and at closing setting forth the applicant's proposed loan-to-value, FICO score, and total debt-to-income ratio, all as used in underwriting applicant's FHA loan. The notice shall also provide the estimated cumulative claim rate for loans insured by the secretary and having similar risk characteristics to the applicant. The secretary shall make such estimate in a manner similar to that used in the FHA's annual actuarial study. The secretary shall also cause to be disclosed the average estimated cumulative claim rate for the most recent fiscal year as determined in the FHA's annual actuarial study.	No action

Table 7. Road Map to Fiscal Reform

Suggested Reforms to Implement Fiscal Reform Principles 1 and 2	**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.	Contained in Rep. Scott Garrett's amendment to Rep. Judy Biggert's *FHA Emergency Solvency Act of 2012* approved by the Insurance, Housing and Community Opportunity Subcommittee of the House Financial Services Committee on February 7, 2012.
Require the US Treasury 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 sixty days.	Contained in Garrett amendment to Biggert bill. Subcommittee approval on February 7, 2012.
Require the FHA to establish an emergency capital plan with biweekly updates to Congress.	Contained in Garrett amendment to Biggert bill. Subcommittee approval on February 7, 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

Notes

[1] The Government Mortgage Complex has five divisions: Fannie Mae, Freddie Mac, Ginnie/FHA, Ginnie/USDA, and Ginnie/VA. The Government Mortgage Complex currently guarantees ninety percent of all newly originated home mortgages.

[2] Mortgage Bankers Association, "2004-2010 HMDA Home Purchase Owner-Occupied by Borrower Race," January 13, 2012 (draft).

[3] Tammye Trevino, "Passback: Rural Development," Statement before the House Financial Services Subcommittee on Insurance, Housing and Community Opportunity, September 8, 2011, www.financialservices.house.gov/UploadedFiles/090811trevino.pdf (accessed March 5, 2012).

[4] Ginnie/VA is excluded, as it operates as a veteran benefits program.

[5] US Department of Housing and Urban Development, *Monthly Report to the FHA Commissioner*, January 2012, http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts/com/commenu (accessed March 17, 2012).

[6] US Housing and Urban Development Department, "Federal Housing Administration Risk Management Initiatives: Reduction of Seller Concessions and New Loan-to-Value and Credit Score Requirements" (notice of proposed rulemaking), July 15, 2010, www.federalregister.gov/articles/2010/07/15/2010-17326/federal-housing-administration-risk-management-initiatives-reduction-of-seller-concessions-and-new#p-31 (accessed January 18, 2012).

[7] Earned equity consists of initial down payment net of additional amounts financed in the loan plus scheduled and unscheduled principal amortization. It excludes house price inflation.

[8] A properly underwritten loan should have minimal default propensity in its first three years, with the peak default period consisting of years four–eight.

[9] Such as real estate agent commission, real estate transaction fees and taxes, title work, and other fees and charges

[10] *Dodd-Frank Wall Street Reform and Consumer Protection Act*, H.R. 4173, 111th Cong., 2d sess. (January 5, 2010), Section 1411.

[11] For loans less than or equal to $180,000, about one-third have no seller concession, one-third have a concession greater than zero and less than or equal to 3 percent, and one-third have a concession greater than 3 percent. Department of Housing and Urban Development, "FHA Risk Management Initiatives: Revised Seller Concessions," *Federal Register* 77, no. 36 (February 23, 2012), www.gpo.gov/fdsys/pkg/FR-2012-02-23/pdf/2012-3934.pdf (accessed March 15, 2012).

[12] Ibid.

[13] See Board of Governors of the Federal Reserve System, *Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit* (Washington, DC, August 2007), www.federalreserve.gov/boarddocs/RptCongress/creditscore/creditscore.pdf (accessed March 15, 2012). The report says (emphasis added), "When the interest rate charged by a lender is appropriate for the average risk pool of prospective borrowers but is either to low or too high for some of the individual borrowers, the pool can suffer adverse selection, that is, a rise in the relative number of high risk borrowers. **High risk borrowers—those for whom the correct *individual* interest rate would be higher than the *average* rate—will perceive the single-rate offer as a good deal and accept the terms, perhaps borrowing more than they would if charged a rate more consistent with their risk profile**" (38).