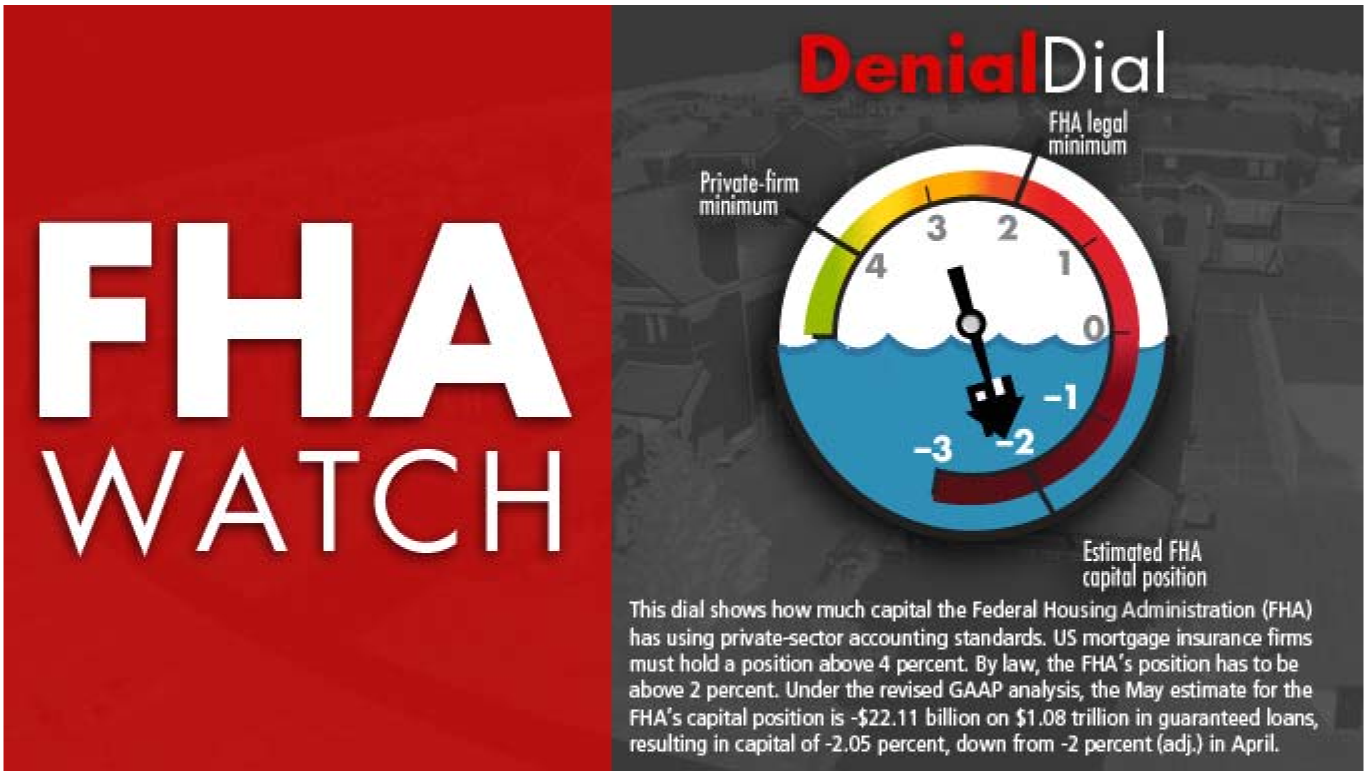
FHA Watch
June 2012
Volume 1, No. 6

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, email edward.pinto@aei.org.



This Issue's Highlight

FHA Is Responsible for 1.5 Million New Underwater Loans

The Federal Reserve estimates that about one-third of the 11.1 million underwater home loans in the United States are insured by the Federal Housing Administration (FHA). These 3.6 million underwater FHA loans account for nearly half of the FHA's 7.4 million outstanding loans. Since about 72 percent of all outstanding FHA loans date from 2009 or later, a reasonable estimate would be that about 1.5 million of recent FHA borrowers are underwater.

This comes as no surprise since the FHA continues to combine minimal down payments (average of 4 percent) with slowly amortizing thirty-year loan terms. As a result, earned homeowner equity (the combination of down payment and scheduled loan amortization) amounts to less than 10 percent after four years, or about enough to sell a home at the break-even point if home prices stay steady. However, prices have declined nationally about 7 percent since mid-2009, with lower-priced homes declining even more. When combined with borrowers' low

FICO scores and high debt-to-income (DTI) ratios, the result is a continuation of the FHA's destructive lending—lending that has resulted in 20–25 percent of recent borrowers facing a 10 percent or greater likelihood of foreclosure.

This Month's Features

Spotlight on Insolvency

FHA's Position Worsened in May, with an Estimated Current Net Worth of –$22.11 Billion and a Capital Shortfall of $41–61 Billion

Spotlight on Delinquency

Total Delinquency Rate Increased in May to 16.23 Percent Because of Increase in Both Thirty- and Sixty-Day Delinquencies; Serious Delinquency Rate Ticked Up to 9.43 Percent

Spotlight on Underwater Loans

FHA Is Responsible for 1.5 Million New Underwater Loans

Spotlight on Best Price Execution

The Government Mortgage Complex's Ginnie Brands Demonstrate Continued Pricing Dominance over Fannie Mae

The Road Map to FHA Reform

Specific Steps to Reform and the Status of Each

Spotlight on Insolvency

FHA's Position Worsened in May, with an Estimated Current Net Worth of –$22.11 Billion and a Capital Shortfall of $41–61 Billion

The current estimate for the FHA's net worth is –$22.11 billion, down from –$16.95 (adjusted) billion and –$21.36 (adj.) billion in September 2011 and April 2012, respectively. This is the result of an increase in the number of sixty-days-plus delinquent loans and continued monthly losses in excess of monthly cash flow. The number (852,608) and rate (11.29 percent) of sixty-days-plus delinquents remain substantially elevated from June 2011 levels (749,204 loans and 10.55 percent). The FHA's capital shortfall also increased by about $900 million from April 2012 as a result of growing delinquencies, along with a growing book of risk-in-force. The capital shortfall (adj.) stands at $41 billion (using a 2 percent capital ratio) and $61 billion (using a 4 percent capital ratio).

Since September 30, 2011, *FHA Watch's* estimate of the FHA's current net worth, based on generally accepted accounting principles (GAAP), has decreased from –$17 billion to –$21 billion. Thus, with two-thirds of FY

2012 over, the FHA has lost $4 billion in net worth. This compares with the FHA's projection of an increase in capital of about $8 billion during FY 2012.

Starting with this issue of *FHA Watch*, a second difference between the FHA's government accounting principles and private GAAP has been added to the analysis. Under GAAP, upfront premiums charged on loans are earned over a time frame that matches the expiration of the underlying insured loan. The FHA charges substantial upfront premiums (currently 1.75 percent of the loan balance). Since 2008, it has guaranteed over $650 billion in mortgages, the preponderance with thirty-year terms.

Since 2009, the FHA has charged an upfront fee that has ranged from 1 percent to 2.25 percent and has averaged about 1.6 percent.[i] It currently takes this entire upfront fee immediately into income and, as a result, has recognized $10 billion in income since the beginning of 2009. Under GAAP, upfront premiums on thirty-year loan terms would be brought into income over a period of between twelve and sixteen years.

While access to the FHA's records would be needed to do a precise calculation, a reasonable estimate is that, under GAAP, the FHA would have been permitted to recognize only about $2 billion to date, not the full $10 billion in upfront premiums. The $8 billion balance would be accounted for as a liability relating to unearned upfront premiums. This $8 billion accounts for over 25 percent of the assets claimed by the FHA in its 2011 Actuarial Review. As a result, the FHA's net worth has dropped by $8 billion and its capital shortfalls have increased by the same amount, as compared to previous *FHA Watch* estimates.

For the monthly data tabulation, see table A1 in the appendix. All the months have been updated to take this additional calculation into account.

Spotlight on Delinquency

Total Delinquency Rate Increased in May to 16.23 Percent Because of Increase in Both Thirty- and Sixty-Day Delinquencies; Serious Delinquency Rate Ticked Up to 9.43 Percent

The FHA's total delinquency rate increased in May to 16.23 percent, from 15.97 percent in April 2012. An increase in thirty- and sixty-day delinquencies accounted for almost all the increase. The FHA's serious delinquency rate ticked up to 9.43 percent and remains at a near-record level, substantially higher than May 2011, when it stood at 8.2 percent.

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

Spotlight on Underwater Loans

FHA Is Responsible for 1.5 Million New Underwater Loans

The Federal Reserve estimates that about one-third of the 11.1 million underwater home loans in the United States are FHA-insured. These 3.6 million underwater FHA loans account for nearly half of the FHA's 7.4 million outstanding loans. Since about 72 percent of all outstanding FHA loans date from 2009 or later, a reasonable estimate would be that about 1.5 million of recent FHA borrowers are underwater.

This comes as no surprise since the FHA continues to combine minimal down payments (average of 4 percent) with slowly amortizing thirty-year loan terms. As a result, earned homeowner equity (the combination of down payment and scheduled loan amortization) amounts to less than 10 percent after four years, or about enough to sell a home at the break-even point if home prices stay steady. However, prices have declined nationally about 7 percent since mid-2009, with lower-priced homes declining even more. When combined with borrowers' low FICO scores and high DTI ratios, the result is a continuation of the FHA's destructive lending—lending that has resulted in 20–25 percent of recent borrowers facing a 10 percent or greater likelihood of foreclosure.

The underwriting characteristics of these loans are in **red** in table 1. These represent loans with projected claim termination rates of greater than 10 percent.

Table 1. Projected Foreclosure Rates for FHA's FY 2010 Insurance Book with LTVs over 90 Percent

FICO credit score*	DTI**>35%	DTI <=35%
580–599	**30%**	**20%**
600–619	**24%**	**15%**
620–659	**14%**	9%
660–679	8%	5%
680–719	6%	3%
>=720	3%	1.4%

Note: Eighty percent of FHA loans have an LTV ratio greater than 90 percent. Projected foreclosure rate includes loans that have gone to claim.
*Nationally, the median FICO credit score for all individuals with a score (not just FHA borrowers) is about 720.
**DTI: Total debt-to-income ratio
Source: Derived from the FHA's claim rate projection for 2010 contained in the FHA's 2011 Actuarial Study and data tabulations on FHA's seriously delinquent loans provided upon request by Genworth Financial.

Expected foreclosure rates are much higher in areas like Atlanta, where house prices have declined substantially since the beginning of 2009, particularly homes in the lower price range. Thus, the FHA's destructive lending is disproportionately hurting areas with low wealth—the areas where it is the FHA's mission to help.

Spotlight on Best Price Execution

The Government Mortgage Complex's Ginnie Brands Demonstrate Continued Pricing Dominance over Fannie Mae

Table 2 demonstrates the pricing advantages the Ginnie/FHA, Ginnie/USDA, and Ginnie/VA divisions have over Fannie Mae. The FHA division had a better execution than Fannie on 6 out of 10 representative loans, the USDA 9 out of 10, and the VA on 10 out of 10 loans. And the greater the credit risk, the greater the advantage—Ginnie had an advantage of a $14,000 on the highest-risk loan shown (loan A guaranteed by the VA).

These results are slightly less favorable to the Ginnie brands than last month's. Given the rise in price as a result of the recent drop in yields, this month's best price execution is based on a 3 percent thirty-year coupon and a 2.5 percent fifteen-year coupon, rather than prior months' 3.5 and 3 percent, respectively. This switch to the lower coupons somewhat understates the actual Ginnie advantage in the marketplace, as both sets of coupons are actively used for pricing.

Table 2. 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	3.50%	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	96.26	96.03	96.26	96.26	96.26	96.26	101.66	101.66	101.66	101.91
Ginnie/USDA Execution	100.06	100.06	100.06	100.06	100.06	100.06	101.41	101.41	101.41	101.66
Ginnie/VA Execution	101.91	101.26	101.91	102.16	101.91	102.16	102.16	102.16	102.16	102.41
Fannie Execution	92.68	95.16	96.10	97.54	97.82	98.88	100.83	101.08	101.33	102.18
Ginnie/FHA advantage on a $150,000 loan compared to Fannie	**$5,363**	**$1,313**	**$233**	-$1,927	-$2,340	-$3,930	**$1,238**	**$863**	**$488**	-$413
Ginnie/USDA advantage on a $150,000 loan compared to Fannie	**$11,063**	**$7,350**	**$5,933**	**$3,773**	**$3,360**	**$1,770**	**$863**	**$488**	**$113**	-$788
Ginnie/VA advantage on a $150,000 loan compared to Fannie	**$13,838**	**$9,150**	**$8,708**	**$6,923**	**$6,135**	**$4,920**	**$1,988**	**$1,613**	**$1,238**	**$337**

Source: Adapted from JP Morgan's *2012 Securitized Products Outlook*, November 23, 2011, 18.
Note: Mortgage-backed security (MBS) pricing from *MBS Live*, published by Mortgage News Daily. Based on MBS pricing as of June 12, 2012. On that date a Ginnie thirty-year MBS with a coupon of 3.0 percent had a price of 103.41, and a Fannie thirty-year MBS with the same 3.5 percent coupon had a price of 102.03. These prices were then adjusted for applicable borrower-paid credit fees

and mortgage insurance premiums. Fannie's guarantee fee was increased by ten basis points in April 2012 as mandated by Congress. All publicly announced FHA premium increases are included. USDA and VA premiums are unchanged.

Each of the Government Mortgage Complex's five divisions has substantial pricing advantages over the private sector. The result is that the Government Mortgage Complex's share of the entire first-mortgage market remained at around 90 percent in 2011.

The Road Map to FHA Reform

Specific Steps to Reform and the Status of Each

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 3. 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 should 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	No action

applicant's proposed LTV, FICO score, and total debt-to-income ratio, all as used in underwriting applicant's FHA loan. The notice should also provide the estimated cumulative claim rate for loans insured by the secretary and having similar risk characteristics to the applicant's. The secretary should make such estimate in a manner similar to that used in the FHA's annual actuarial study. The secretary should also disclose the average estimated cumulative claim rate for the most recent fiscal year as determined in the FHA's annual actuarial study.	

Table 4. 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 Financial Services Committee by voice vote on March 27, 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 sixty 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	No action

and unearned premium reserves on a similar basis as applied to private mortgage insurers.	
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 the premium would accumulate in a separate countercyclical catastrophic premium reserve account for a ten-year period and would be available to pay catastrophic losses from periodic but unpredictable general economic risks.	No action

Appendix: Historical Data Tables

Table A1. Insolvency Watch ($ Billions)

Date	FHA's "Capital Resources" (Assets)	Cash Flow since Sept. 30, 2011*	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	---	$37.13	$8.00	($16.95)	2%	$18.14	($35.09)
Sept. 30, 2011	$28.18	---	$37.13	$8.00	($16.95)	4%	$36.29	($53.24)
Dec. 31, 2011	$28.18	($0.43)	$41.09	$8.00	($21.34)	2%	$18.47	($39.81)
Dec. 31, 2011	$28.18	($0.43)	$41.09	$8.00	($21.34)	4%	$36.94	($58.27)
Jan. 31, 2012	$28.18	($0.21)	$41.74	$8.00	($21.78)	2%	$18.59	($40.37)
Jan. 31, 2012	$28.18	($0.21)	$41.74	$8.00	($21.78)	4%	$37.18	($58.96)
Feb. 29, 2012	$28.18	($0.60)	$40.27	$8.00	($20.69)	2%	$18.75	($39.44)
Feb. 29, 2012	$28.18	($0.60)	$40.27	$8.00	($20.69)	4%	$37.51	($58.19)
Mar. 31, 2012	$28.18	($0.98)	$38.68	$8.00	($19.48)	2%	$19.16	($38.64)
Mar. 31, 2012	$28.18	($0.98)	$38.68	$8.00	($19.48)	4%	$38.32	($57.80)
Apr. 30, 2012	$28.18	($1.37)	$40.17	$8.00	($21.36)	2%	$19.25	($40.61)
Apr. 30, 2012	$28.18	($1.37)	$40.17	$8.00	($21.36)	4%	$38.50	($59.87)
May 31, 2012	$28.18	($1.55)	$40.74	$8.00	($22.11)	2%	$19.36	($41.47)
May 31, 2012	$28.18	($1.55)	$40.74	$8.00	($22.11)	4%	$38.72	($60.83)

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 2 of 2012, Genworth had loss reserves equaling 60 percent of its risk-in-force on sixty-days-plus delinquent loans. This was up from 58 percent in quarter 4 of 2011. Genworth, Quarterly Financial Supplements, Delinquency Metrics-US Mortgage Insurance Segment, 50, http://phx.corporate-ir.net/phoenix.zhtml?c=175970&p=irol-quarterlyreports (accessed May 19, 2012).

*The FHA's negative cash flow was $143 million and $385 million per month during Q.1:FY2012 and Q.2:2012 respectively. See exhibit 10, US Department of Housing and Urban Development, *FHA Single-Family Mutual Mortgage Insurance Fund Programs, Quarterly Report to Congress*, 13. 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. The FHA's forward single-family Mutual Mortgage Insurance Fund (MMIF) received approximately $200 million from a settlement made with a lender in May 2012, which was added to May's cash flow. 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 is accounted for in the in the "Estimated liability for excess upfront premiums beyond GAAP."

**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 $968 billion ($1.076 trillion − $108 billion) as of September 30, 2011, and April 30, 2012 (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; US Department of Housing and Urban Development, *Monthly Report to the FHA Commissioner*, February 2012, 6, http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts/com/commenu (accessed May 19, 2012); and US Department of Housing and Urban Development, *FHA Outlook*, March 2012, http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts/ooe/olmenu (accessed May 19, 2012). Outstanding balance of loans sixty-days-plus delinquent at May 31, 2012, and September 30, 2011, based on loan counts of 852,608 and 803,899, respectively, and an average loan balance for loans going to claim of $126,524.

******* All months have been updated to take this additional feature into account.

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
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

Source: US Department of Housing and Urban Development, "Neighborhood Watch," https://entp.hud.gov/sfnw/public (Servicing download, Excel; accessed May 19, 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 April 14, 2012). Rates not seasonally adjusted. Serious delinquency includes ninety-days-plus delinquency and loans in bankruptcy or foreclosure.

Note

[i] See exhibit B-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).