If You Are In A Hole…

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First stop digging — or so goes the old saying. In January 2015 the Secretary of Housing and Urban Development (HUD) lowered mortgage insurance premiums for Federal Housing Administration (FHA)-backed mortgages by 50 basis points (bps). This was troubling from two perspectives. First, it was reminiscent of the behavior leading up to the recent financial crisis, as FHA, Fannie Mae, and Freddie Mac had lowered standards and expanded their lending to the least qualified borrowers. Second, it reduced resources available in the Mutual Mortgage Insurance Fund (MMIF), the already-undercapitalized backstop for mortgage lending losses. The MMIF capital ratio hovers around 2 percent, while, for comparison's sake, the minimum capital requirements set by the Federal Reserve for banks is 4.5 percent. Losing revenue while maintaining risk is simply digging a deeper financial hole for the taxpayer.

Predictably, by August of that year, FHA was seeing a 173 percent increase in refinanced single family mortgages as a result of the mortgagees' refinancing to take advantage of the lower premium. This is unambiguously bad news for the financial condition of the FHA: the same risk remains on the books, but less revenue is available to cover losses. So it was a bit shocking in January when HUD Secretary Julian Castro announced another 25 basis point (bp) reduction in FHA mortgage insurance premiums.

AAF research found that a 25 bp reduction in FHA mortgage insurance premiums would have resulted in the MMIF losing $33 million annually in premium revenue. The tangible costs would be accompanied by exacerbating the outsized role the government plays in housing finance. The effort would have expanded FHA's market share by making its mortgage insurance cheaper for borrowers than what is offered by private insurers. A 25 bp reduction would have allowed FHA to undercut conventional pricing for most mortgages with low down payments (i.e. high loan-to-value mortgages) and those for borrowers with lower credit scores — loan characteristics generally recognized as having greater inherent risk.

Thankfully, one of the first steps taken by the incoming Trump Administration was to reverse the 25 bp reduction in FHA mortgage insurance premiums. In FHA's most recent actuarial review of the MMIF, there are clear results from the Administration's policy reversal. Specifically, the capital ratio for the program increased from 3.1 to 3.3 percent. Had the 25 bp reduction been allowed to take effect, the MMIF would have seen its capital ratio fall below 2 percent — a dangerous level for both the homeowners who rely on the program and the taxpayers who back it.

Having stopped digging a deeper hole, the time has come for Congress to follow in turn with real reforms to the FHA as one part of housing finance reform.