Testimony

The Future of Housing in America: Oversight of the Federal Housing Administration, Part II

DOUGLAS HOLTZ-EAKIN | FEBRUARY 26, 2015

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Chairman Luetkemeyer, Ranking Member Cleaver, and members of the committee, thank you for the opportunity to appear today and share my views on the financial status of the Federal Housing Administration (FHA). It is vitally important to reassess the health of FHA's Mutual Mortgage Insurance Fund (MMIF) in light of recent reductions in premiums. In this testimony, I wish make three basic points:

- FHA's annual mortgage insurance premium reduction stands to seriously affect the trajectory of the MMIF and ongoing efforts to limit the government's footprint in housing finance. I applaud the committee for taking a critical look at the implications of this decision,
- HUD and FHA officials have prioritized borrower savings over statutory requirements and the MMIF's financial integrity. Their actions ignore recent history and jeopardize FHA's ability to fulfill its mission going forward,
- Finally, the decision to prematurely reduce premiums only underscores the long overdue need to simultaneously reform FHA and address damaging weaknesses in the U.S. housing finance system.

Let me provide additional detail on each in turn.

FHA's Fiscal Outlook

Background

After the housing bubble burst, FHA expanded the scope of its mortgage insurance program in response to the massive loss of private liquidity. In this effort, FHA depleted its capital reserves and required $1.7 billion from the Treasury Department in 2013 to bolster its finances.

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The capital ratio represents the economic value of the MMIF (essentially assets less liabilities plus the projected cash flow of current books) as a percentage of FHA's total insurance-in-force. FHA reported its capital ratio in FY 2014 to be 0.41 percent, lower than the 1.22 percent that was previously estimated.[1] The projected return to FHA's congressionally mandated minimum has therefore been pushed back another year to 2016 as shown in Figure 1.

Effects of Premium Reduction

Announced in advance of President Obama's state of the union address and effective January 26, 2015, FHA lowered annual mortgage insurance premiums by 50 basis points (bp) or 0.50 percent, the latest in a concerted effort to expand credit availability.[2] This decision directly affects FHA's fiscal outlook in these ways:

- ***Lower prices mean less revenue***. Cutting annual premiums by nearly 40 percent will expectedly reduce incoming cash flow. It would be difficult for FHA to pull in enough new volume above prior projections to make up that loss in revenues. Furthermore, those new volumes would have to come from borrowers previously priced out or borrowers that would have chosen private mortgage insurance. And both options come with caveats. Buyers who found FHA cost-prohibitive previously and were therefore unable to purchase a home are likely to have high loan-to-value ratios (LTVs) and/or low FICO scores that private mortgage insurers would not serve without higher pricing to compensate for the risks. These borrowers are more likely to become delinquent and therefore result in losses for FHA, which could easily turn to taxpayer losses without a restored capital buffer. The second option, pulling borrowers away from private companies, runs firmly against the bipartisan policy objective of limiting the government's involvement in mortgage markets following years of unprecedented and risky government support.
- ***Delay reaching congressional mandate.*** In its last actuarial report, FHA's capital ratio was projected to reach exactly 2.0 percent in 2016. Even a small reduction in incoming cash flow will easily push FHA short of reaching that projected capital ratio, all else staying equal. Regardless of the premium reduction impact, the MMIF's economic value has come in consistently lower than estimated for the past 12 fiscal years. In FY 2012 alone, actual economic value was $22.8 billion less than projected.
- ***More refinancing***. When coupled with interest rates near their lowest level since mid-2013, the reduction in premiums may also encourage a number of FHA borrowers to refinance into lower payments. The Urban Institute estimated that 2.4 million current borrowers could stand to benefit from refinancing.[3] Satish Manusukhani of BofA Merrill Lynch similarly estimated three million borrowers could save money by refinancing, though many would not.[4] Increased refinancing could further reduce expected revenue by encouraging prepayment.
- ***Added risk***. As mentioned previously, in lowering premiums FHA is attracting two kinds of borrowers—those that would have otherwise chosen private mortgage insurance or borrowers with high LTVs and/or low FICO scores that had been priced out of the market. The 50-bp reduction in premiums allows FHA to undercut conventional pricing for many mortgages with very low down payments and those for borrowers with low FICO scores, loan characteristics generally acknowledged to have greater inherent risk.[5]
- ***Pushes out private capital***. Discussed in further detail below, FHA stands to undercut private mortgage insurers by reducing prices, which may increase FHA's market share at a time when the government should be reducing its footprint in housing finance.

Documented History of Missed Projections

Adding to concern surrounding premium reductions, FHA's recent history has been plagued by missed projections. These missed projections enhance the perception that FHA downplays risks borne by taxpayers and cast doubt on the assumption that FHA will continually improve as projected despite cutting annual premiums.

Since FY 2009, FHA's capital ratio has been below the 2 percent minimum mandated by Congress. FHA has repeatedly projected marked improvement only to miss its targets (see Figure 1).

In every actuarial review since 2003, the economic value of FHA's MMIF has come in lower than what was projected the previous year (see Table 1). While FHA has in the past pointed to programs like home equity conversion mortgages (HECM) or the prevalence of seller-funded down payment assistance for losses greater than anticipated, erroneous economic assumptions and volume forecasts are more frequently to blame.

TABLE 1. MMIF ECONOMIC VALUE ($ BILLIONS)

	PROJECTION	ACTUAL	DIFFERENCE
2000	$16.64	$16.96	$0.32
2001	$20.23	$18.51	-$1.72
2002	$22.54	$22.64	$0.10
2003	$27.27	$22.74	-$4.53
2004	$27.70	$21.98	-$5.72
2005	$24.43	$21.62	-$2.81
2006	$22.70	$22.02	-$0.68
2007	$23.13	$21.28	-$1.85
2008	$22.75	$12.91	-$9.84
2009	$15.82	$2.73	-$13.09
2010	$7.88	$5.16	-$2.72
2011	$10.97	$1.19	-$9.78
2012	$9.35	-$13.48	-$22.83

2013	-$2.59	-$7.87	-$5.29
2014	$7.84	$5.93	-$1.91
SOURCE: FHA ACTUARIAL REPORTS, FY 2000 – FY 2014			

Following the dramatic fall in FHA's economic value shown in Table 1, legislative attempts to reform FHA in the last Congress would have raised its mandated capital ratio even higher. Reform proposals have included a new capital ratio of either 3 percent or 4 percent, levels FHA's MMIF is not expected to reach until 2018 and 2019 respectively before factoring in the effects of premium reductions.[6] FHA's capital buffer is meant to protect taxpayers in an economic downturn while preserving FHA's ability to fulfill its mission; its restoration is critical. Furthermore, many rightly worry that FHA's current economic value is overstated due to the influx of money from major mortgage-related legal settlements and the one-time appropriation of $1.7 billion from the Treasury Department (see Table 2).

TABLE 2. MAJOR SETTLEMENTS			
	SETTLEMENT PAYMENT TO FHA	AUDIT REPORT	DATE
BANK OF AMERICA/COUNTRYWIDE	$471,000,000	2012-CF-1809	JUNE 2012
DEUTSCHE BANK/MORTGAGEIT	$196,000,000	2012-CF-1811	JULY 2012
CITI	$122,800,000	2012-CF-1814	SEPTEMBER 2012
ALLY FINANCIAL, BANK OF AMERIC	$315,200,000	2012-CH-1803	SEPTEMBER 2012
JP MORGAN CHASE	$336,000,000	2014-CF-1807	SEPTEMBER 2014
REUNION	$1,040,000	2014-CF-1810	SEPTEMBER 2014
BANK OF AMERICA	$437,600,000	2014-FW-1808	SEPTEMBER 2014
US BANK	$144,199,970	2014-CH-1801	SEPTEMBER 2014
SUNTRUST	$300,000,000	2015-PH-1802	DECEMBER 2014
TOTAL	$2,323,839,970		
SOURCE: HUD OFFICE OF INSPECTOR GENERAL (HUDOIG) AUDIT REPORTS			

Since 2012, the MMIF has been bolstered by at least $4 billion in funds from legal settlement money and the one-time Treasury infusion. Despite that, the MMIF’s capital ratio is still below its mandate.

Market-Shifting Implications

TABLE 3. FHA VS. CONVENTIONAL MORTGAGE MONTHLY PAYMENTS BY LTV

			CONVENTIONAL (BY FICO)									
		FHA	620-639	640-659	660-679	680-699	700-719	720-739	740-759	760-779	780-799	800+
BEFORE	85 LTV	$1,262	$1,219	$1,219	$1,206	$1,163	$1,150	$1,127	$1,121	$1,114	$1,114	$1,114
	90 LTV	$1,337	$1,351	$1,337	$1,323	$1,270	$1,263	$1,225	$1,219	$1,209	$1,209	$1,209
	95 LTV	$1,411	$1,513	$1,498	$1,484	$1,404	$1,397	$1,329	$1,322	$1,306	$1,306	$1,306
	97 LTV	$1,443	$1,619	$1,596	$1,582	$1,525	$1,525	$1,468	$1,461	$1,451	$1,451	$1,451
AFTER	85 LTV	$1,174	$1,219	$1,219	$1,206	$1,163	$1,150	$1,127	$1,121	$1,114	$1,114	$1,114
	90 LTV	$1,243	$1,351	$1,337	$1,323	$1,270	$1,263	$1,225	$1,219	$1,209	$1,209	$1,209
	95 LTV	$1,312	$1,513	$1,498	$1,484	$1,404	$1,397	$1,329	$1,322	$1,306	$1,306	$1,306
	97 LTV	$1,343	$1,619	$1,596	$1,582	$1,525	$1,525	$1,468	$1,461	$1,451	$1,451	$1,451

NOTE: ASSUMES $250,000 HOME PRICE, 4% FHA & 4.5-5% CONVENTIONAL MORTGAGE RATE
SOURCE: DATA FROM GENWORTH & AUTHOR’S CALCULATIONS

The outsized role the government plays in housing continues to be a primary bipartisan concern, yet lowering FHA premiums will exacerbate that problem. The effort will likely preserve or even expand FHA’s market share by making its mortgage insurance cheaper for prospective borrowers than what is offered by private companies. In Table 3, boxes are shaded red if FHA-insured mortgages elicit cheaper monthly payments than conventional mortgages (private mortgage insurance with a GSE guarantee). Conversely, they are shaded green if conventional mortgages would have lower monthly payments than FHA.

With the reduction, FHA is more competitive amongst FICOs below 680 and narrows the gap for FICOs between 680 and 720, regardless of LTV. Though other factors play into choosing whether to opt for private mortgage insurance or FHA, pricing premiums lower across the board makes FHA a cost effective choice for many more borrowers.

Adding to the likelihood that FHA captures business that might otherwise go to private mortgage insurers, the implementation window for the premium reduction was made curiously short when compared to prior premium changes, giving companies little time to adjust. Shown in Table 4, the announced 50 bp decrease in annual premiums became effective January 26, only nine business days after FHA released a mortgagee letter instructing lenders on the change. Earlier premium changes gave mortgage market participants anywhere from 22 to 82 business days between announcement and effective dates.

TABLE 4. FHA PREMIUM CHANGES SINCE 2010

	MORTGAGEE LETTER	ANNOUNCEMENT DATE	EFFECTIVE DATE	DAYS TO IMPLEMENT*
50 BP UFMIP INCREASE	2010-02	JANUARY 21, 2010	APRIL 5, 2010	50
125 BP UPMIP DECREASE & 35 BP ANNUAL MIP INCREASE	2010-28	SEPTEMBER 1, 2010	OCTOBER 4, 2010	22
25 BP ANNUAL MIP INCREASE	2011-10	FEBRUARY 14, 2011	APRIL 18, 2011	43
10 BP ANNUAL MIP INCREASE & 75 BP UFMIP INCREASE	2012-04	MARCH 6, 2012	APRIL 9, 2012	23
25 BP ANNUAL MIP INCREASE**	2012-04	MARCH 6, 2012	JUNE 11, 2012	67
10 BP ANNUAL MIP INCREASE	2013-04	JANUARY 31, 2013	APRIL 1, 2013	40
45 BP ANNUAL MIP INCREASE***	2013-04	JANUARY 31, 2013	JUNE 3, 2013	82
50 BP ANNUAL MIP DECREASE	2015-01	JANUARY 9, 2015	JANUARY 26, 2015	9

* BUSINESS DAYS ONLY—EXCLUDES WEEKENDS AND FEDERAL HOLIDAYS
**FOR LOANS EXCEEDING $625,500

*** FOR LOANS WITH LTV < 78 PERCENT

NOTE: FHA CHARGES TWO FEES – AN UPFRONT MORTGAGE INSURANCE PREMIUM (UFMIP) AND ANNUAL MORTGAGE INSURANCE PREMIUM (ANNUAL MIP). THE RECENT PREMIUM ANNOUNCEMENT IS A 50 BP REDUCTION IN THE ANNUAL MIP, WHICH IS PAID OVER THE LIFE OF THE LOAN WHEREAS THE UPFMIP IS DUE WHEN THE LOAN IS INITIALLY MADE.

Need for Reform

FHA gained significant market share at a time when lending seized up and home prices were still falling. For the past several years, the critical question has become how to rebuild FHA's solvency, return it to its original mission, and return private capital to the market. Normally self-funded through premiums, the FHA required $1.7 billion from the Treasury Department to bolster its finances to cover losses, largely from books of business after the housing bust and the FHA's reverse mortgage program. Most legislative proposals to overhaul the FHA have failed to pass both houses despite consistent bipartisan support for reform. There are three critical goals to FHA reform:

- Limit mortgage insurance to a defined and qualified target group,
- Return the FHA to its mandated capital requirement and limit future taxpayer losses, and
- Coordinate reform of the larger housing finance system and the return of private capital with changes to the FHA.

With the passage of the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) and the accompanying

Federal Credit Reform Act of 1990 (FCRA), Congress required FHA to operate on an actuarially sound basis, with a capital ratio of 2 percent of insurance-in-force and an annual actuarial review conducted by an independent contractor. Yet these safeguards have been insufficient as there are few to no consequences for FHA when its capital ratio falls below the mandated level.

The PATH Act passed by the House Financial Services Committee last Congress would have made significant changes to both the structure and operations of the FHA. When evaluated on the basis of the three goals of FHA reform, the bill would have clearly limited mortgage insurance to a defined group, first-time homebuyers and low- and moderate-income homebuyers, increased FHA's capital buffer and enhanced the role of the private market. Notably, by addressing FHA in conjunction with a wind down of the GSEs, the bill was also cognizant of how misaligned pricing limits and standards can shift market share between government-backed entities instead of drawing in private capital. With FHA lowering premiums and recent actions at FHFA to encourage high LTV lending, now is the time for both houses of Congress to revisit efforts to reform both FHA and the GSEs.

[1] The capital ratio can be calculated by combining the economic values of MMIF and HECM Fund divided by the total amortized insurance-in-force found here: http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts/actr/actrmenu