Guidelines for Federal Housing Administration Reform

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After the housing bubble burst, the Federal Housing Administration (FHA) rapidly expanded the scope of its mortgage insurance well beyond its traditional mission of helping low-to-moderate income, first-time home buyers. Instead of lending directly to borrowers, the FHA insures mortgages in exchange for a premium, and only pays out the cost of those mortgages when borrowers stop making payments. In response to the massive loss of private liquidity, the FHA gained significant market share at a time when banks stopped lending and home prices were still falling. Congress also raised the FHA's loan limits in order to provide more liquidity, pushing its lending higher up the income scale. The FHA's intervention resulted in the most severe delinquency and default rates in the agency's history. Normally self-funded, FHA is facing the possibility of a first-ever bailout, with some estimates as high as $16.3 billion. Now, as home prices have finally started to rebound, pressure is mounting to resolve the FHA's fate and limit financial losses.

Unsurprisingly, the debate over reforming the FHA has been polarized. Liberals maintain that home prices would have fallen dramatically had the FHA not stepped in when private mortgage insurers and investors retreated from the market. In their view, the FHA provided an important countercyclical function and any taxpayer funds currently needed to make it whole are well worth paying. Conservatives, however, say that FHA's emergency lending made homeownership possible for many people, especially in working class neighborhoods, who could not really afford to buy a house. They see the FHA as blocking the return of private capital, wreaking havoc in economically hard-hit neighborhoods, and promoting risky, government-backed lending at a sizeable risk to taxpayers.

That debate, however, is mostly over the past. The critical question now is what should be done to assure FHA's solvency, and return it to its original mission. U.S. policymakers must decide on a course of action that averts a taxpayer bailout of the FHA and lowers its loan limits to enable private capital to resume its normal role in mortgage lending.

While haggling over the appropriateness of the FHA's role before, during and after the housing and financial crises is not without merit, tools are immediately needed at the FHA to bolster the financial state of the Mutual Mortgage Insurance Fund (MMIF) and assess the FHA's role in housing finance moving forward. We propose the following, common-sense guidelines for FHA reform:

Sustained Fiscal Solvency Is the Foremost Policy Concern

FHA lending has grown to be an integral part of facilitating homeownership in neighborhoods across the United States. Leaving the agency without the resources necessary to preserve its defined mission in a fiscally responsible fashion is imprudent. The FHA has long been self-sustaining and preserving that capability is essential. Ensuring the FHA has sufficient capital should be the most paramount concern when considering an agency overhaul. It is both the best way of minimizing taxpayer losses and making certain FHA will be able to continue to serve its mission.

While many policymakers and think tanks reject the notion that the FHA is desperately in need of funds, its consistent underestimation of risk and future losses is worrisome. Any legislative action must put in place a more transparent reporting system to show the FHA is returning to its congressionally mandated capital requirement. This is critical to help assuage concerns that the agency is not doing enough to minimize losses. Assessing the FHA's programs on a fair value basis is also important over the longer term to more adequately price the financial risk the FHA takes on through its guarantees, risk that may ultimately cost taxpayers.

Limit Mortgage Insurance to a Defined and Qualified Target Group

While legislation should immediately address costs and risks borne by taxpayers and ensure the sustained fiscal solvency of FHA, it should also move to confine FHA lending strictly to helping first-time homebuyers from low-to-middle income families achieve the dream of homeownership. Moving towards a system of income-based borrower requirements in place of loan limits would help the FHA support borrowers with a demonstrated need and enhance the role of the private market, especially in the origination of higher-priced loans.

There is widespread agreement across the political spectrum that the role of the FHA should now begin to shrink. More targeted FHA insurance issuance will encourage private capital reentry while increased premiums should additionally be considered to both adequately account for risk and ensure private market participants can compete.

Don't Ignore the FHA's Future Market Role (What Will Be the Relationship between the FHA and the GSEs?)

Reform must also look to the future. The recently announced Qualified Mortgage (QM) rule exempts the FHA as well as Fannie Mae and Freddie Mac from lawsuits from borrowers. Its effect is to enshrine taxpayer-backed lending, at least for now. But reform should clarify the division of labor between the FHA and Freddie and Fannie (aka, the GSEs or government-sponsored enterprises) in a system that has become dominated by government backed lending. The FHA will unarguably continue to play an important part in the housing finance system, and is not going away any time soon. But any changes to the FHA must be made in coordination with efforts to reform the greater housing finance system, particularly the GSEs. Variances in pricing, loan limits, and standards can contribute to mere volume shifts that do not fix the problem. FHA reform should not be made without consideration of the future role of the GSEs and the effects of reforming only a piece of a larger system.

Build Consensus on What Has Been Proposed and What Is Politically Feasible

It is important to remember that reform legislation has been introduced before and the FHA, on its own, is also taking steps to boost its finances. The FHA Emergency Fiscal Solvency Act of 2012 was passed overwhelming in the Republican-controlled House but was never voted on by the full Democratic-led Senate. Efforts by FHA Commissioner Carol Galante and HUD are also underway to put FHA on better financial footing. These include extending mortgage insurance for the life of the FHA guarantee and increasing down payments for borrowers with lower credit scores. Yet much remains to be done. Conservatives and liberals have proposed a host of potential reforms to guarantee the fiscal soundness of FHA. The FHA is empowered to make some changes without legislative action, though the task of ensuring a more targeted and financially sound FHA in the future will likely require Congress. Similar proposals exist across the political spectrum to set better reporting standards, promote better underwriting, prescribe counseling to some borrowers, enhance indemnification authority, potentially raise premiums and change loan limits.

<table>
<tr><th>FHA Administrative Actions[1,2]</th><th>FHA Emergency Fiscal Solvency Act[3]</th></tr>
<tr><td>Currently Being Implemented
• Crackdown on improper lender advertising
• Elimination of seller-funded down payment assistance programs
• Increased down payments
○ <580 FICO
○ <620 FICO & DTI > 43%
○ Above $625,000 loan limit
• 10 basis point increase in premiums
• Annual MIP increase of 155 bps on loans between $625,500 & $729k
• Improved REO management and loss mitigation efforts
Proposed Policy Changes & Requested Legislative Authority
• Moratorium on Full-draw HECM reverse mortgages
• Enforcement of FHA insurance limitations on previously foreclosed borrowers
• Collect premiums on the entire period of insurance coverage
• New policies to incentivize and sometimes require housing counseling
• Authority to transfer servicing
• Revised compare ratio requirement
• Revised indemnification authority and new authority for direct endorsement lenders
• Authority to terminate origination and underwriting approval</td><td>• Mandatory Annual premium floor (0.55 percent)
• Strengthened FHA indemnification authority
• Require the FHA to investigate all loans that go seriously delinquent in first 2 years
• Increased Annual Premium Authority
• Semi-annual reports to Congress in time of stress
• Capital plan to return to 2 percent
• One-time GAAP review of FHA fiscal conditions</td></tr>
<tr><td colspan="2">Existing Authority
• Increase annual premium 30 basis points
• Increase upfront premium by 1.25 percent to 3 percent
• Some indemnification provisions
• Reduce seller concessions from 6 percent to 3 percent
• Increase down payment from 3.5 percent to 5 percent</td></tr>
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[1] Letter from Federal Housing Administration Commissioner Carol Galante to U.S. Senator Bob Corker (R-TN); (December 18, 2012); http://www.corker.senate.gov/public/_cache/files/940b16a2-a401-418f-b409-

[2] "Annual Report to Congress: Fiscal Year 2012 Financial Status: FHA Mutual Mortgage Insurance Fund," (November 16, 2012), http://portal.hud.gov/hudportal/documents/huddoc?id=F12MMIFundRepCong111612.pdf

[3] H.R. 4264, "FHA Emergency Fiscal Solvency Act of 2012," http://thomas.loc.gov/cgi-bin/bdquery/z?d112:HR04264:@@@D&summ2=m&