With an eye toward the reforms that will likely take place in the 112th Congress, the Report will evaluate FHA residential mortgage activity and examine steps the agency is taking or may consider to ensure its long term viability, while fulfilling its historical goals. The series will take a closer look at some of the tough questions facing Congress and FHA. Future pieces will discuss a number of FHA reforms intended to limit the government’s exposure and reduce taxpayer risk, including:

- FHA’s loan limits,
- The manner in which FHA is utilizing its new indemnification policy, and
- Other underwriting guidelines and policies.

This first report focuses on loan limits.
INTRODUCTION AND BACKGROUND

FHA is a government-run mortgage insurance company whose business has traditionally been to insure low-down payment home mortgages for low- to moderate-income and first-time buyers. It began during the Great Depression as a device for stimulating the housing and mortgage markets and has evolved since then. Over time, it has charged premiums that have more or less covered costs. However, because it sells insurance to borrowers with generally worse than average credit history and with low-down payments, it is sensitive to business cycles, particularly declines in property values. While many things affect default losses, a wide range of research strongly suggests the central role of negative equity in explaining mortgage defaults. The combination of low-down payments and declining property values since 2006 has produced unprecedented numbers of loans with negative equity, which has been the major factor in recent FHA claims rate increases.
The information provided in Table 1 shows delinquency performance over the most recent 10 quarters for which we have data. It indicates that while FHA-insured mortgages performed better than subprime loans, FHA had higher percentages of troubled loans than the prime market. Historically, FHA has had difficulty competing with conventional lending because of limits imposed on the size of loan it could insure and the greater flexibility of conventional underwriting schemes. FHA has also taken on a countercyclical role because of the ability of conventional lenders and private mortgage insurers (PMI) to avoid markets where prices are falling. Ambrose, Pennington-Cross and Yezer note that FHA’s share of urban markets rises as the local economy goes into decline, consistent with the mission and historically countercyclical nature of FHA business.

Recent FHA history can be summarized by three observations. First, there has been a surge in mortgage defaults with ensuing increases in claims and a corresponding decline in reserves, a problem that has afflicted the entire mortgage lending industry. Second, while FHA continues to have higher default rates than the conventional market, it has performed relatively well in the sense that default rates on FHA-insured loans have gone up less than those of both subprime loans and conventional loans (See Table 1). Third, FHA’s market share has fluctuated wildly since the turn of the millennium, falling during the peak subprime years and increasing sharply lately.

FHA’s relatively favorable default loss performance is due to a combination of circumstances that arose because of its policies and the behavior of conventional lenders. In particular, FHA benefited from lost market share during the subprime boom. To a large extent, this was due to FHA’s structure, which tends to be “hard-wired” by legislation. This rigid structure makes it difficult for FHA to adapt to market changes. As a result, it lost market share to the subprime business, which was more flexible and had lower standards, at exactly the right time. The relatively good performance was also due to policy choices. As it lost market share after 2002, FHA did little to change its rules and compete with subprime lending.

In the past, FHA’s inability to react left it open to adverse selection or “cherry-picking” by other vehicles (private insurance and second mortgages), likely hurting its profitability over time. In this most recent instance, FHA’s rigidity actually helped stem losses, as market share revolved around rapid execution rather than credit quality. However, FHA might not be so fortunate going forward. The recent increase in market share presents important management issues, both because of problems managing rapid growth and the possibility of a new surge in cherry-picking.

### Table 1

<table>
<thead>
<tr>
<th>Date</th>
<th>Prime Conv</th>
<th>Subprime Conv</th>
<th>FHA</th>
</tr>
</thead>
<tbody>
<tr>
<td>1Q08</td>
<td>0.77</td>
<td>5.68</td>
<td>3.19</td>
</tr>
<tr>
<td>2Q08</td>
<td>0.93</td>
<td>6.04</td>
<td>3.19</td>
</tr>
<tr>
<td>3Q08</td>
<td>1.29</td>
<td>7.01</td>
<td>3.73</td>
</tr>
<tr>
<td>4Q08</td>
<td>1.86</td>
<td>9.40</td>
<td>4.55</td>
</tr>
<tr>
<td>1Q09</td>
<td>2.21</td>
<td>10.54</td>
<td>4.61</td>
</tr>
<tr>
<td>2Q09</td>
<td>2.44</td>
<td>11.47</td>
<td>4.80</td>
</tr>
<tr>
<td>3Q09</td>
<td>3.06</td>
<td>13.33</td>
<td>5.35</td>
</tr>
<tr>
<td>4Q09</td>
<td>3.70</td>
<td>14.98</td>
<td>5.85</td>
</tr>
<tr>
<td>1Q10</td>
<td>3.67</td>
<td>14.82</td>
<td>5.17</td>
</tr>
<tr>
<td>2Q10</td>
<td>3.29</td>
<td>13.94</td>
<td>4.83</td>
</tr>
</tbody>
</table>

Source: Mortgage Bankers Association: National Delinquency Survey

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The recent rise in volume also raises questions about who FHA should be serving. During the collapse of credit markets after 2007, FHA served as an insurer of last resort for almost the entire market, as the size of its loan limit was raised. Going forward the question is whether, as the need for this insurer of last resort fades, FHA should return to its former role—servicing low- to moderate-income and first-time homebuyers.

EXPANSION AND REFORM

FHA is at a critical juncture. Its fiscal year 2010 actuarial data show it is below its statutorily-required 2 percent capital ratio, at 0.5 percent, and expanding its market share rapidly. It was put into this position as a result of the decline in property values and, in the case of increased market share, as a necessary step to mitigate the damage from the 2008 recession, as a credit crisis and collapse of the mortgage market forced the federal government to take action.

Largely because of Congressional increases in loan limits (see Figure 1 below), FHA’s share of the market has increased sharply, from under 5 percent of the overall market in 2007 to over 20 percent recently. That number is the overall share by dollar volume (including loans for both purchase and refinance). As a share of the number of home purchase loans, FHA swelled from 6.6 percent in 2007 to 30.1 percent in 2008 and then 56.4 percent in 2009. The key question going forward is whether the size of FHA’s market share represents sound national housing policy: should the government provide a 100 percent guarantee on such a large portion of home mortgages, many of which are originated with very small down payments, leaving the homeowner with a thin layer of equity? Can FHA manage this risk and is the low-down payment mortgage good for homeowners?

FIGURE 1

Following the expansion of its loan limits in 2008, FHA market share rose dramatically.

In 2010, Congress proposed a number of FHA reforms to better manage risk amid growing demand for FHA-insured mortgage loans. These changes were part of the FHA Reform Act of 2010, bipartisan legislation that included the following:

- **Mortgage Insurance Premium (MIP) flexibility**, so FHA can adjust premiums to reflect increased risk and higher delinquencies, reducing the risk to the program and benefiting lower risk consumers. In 2010, FHA increased the annual mortgage insurance premium, for instance, from 50 or 55 basis points to 85 or 90 basis points, depending on LTV. This pricing flexibility is important for FHA, particularly as the agency continues to approve loans with high debt-to-income (DTI) ratios, which are generally considered a higher risk.

- **Enhancements to FHA’s sanctioning authority**, as Congress gave FHA the ability to demand indemnifications for poorly underwritten loans from a majority of lenders, meaning it can require that most lenders indemnify the insurance fund against losses that arise from substandard underwriting.

- **Risk management improvements**, such as an expansion of FHA’s Credit Watch Authority and enhancements to FHA’s Neighborhood Watch System. These acts of transparency put lenders on notice that their loan performance will be accessible for scrutiny by the public and the media. While these are important risk management improvements, limits remain on FHA’s indemnification authority to better protect against fraud and lender failure.

These reforms are important for managing risk. Nonetheless, there needs to be a delicate balancing act to ensure that FHA is not pushed too far, as was the case with the subprime market, which experienced a comparable increase in market share after 2002. So there are pluses and minuses. FHA is in a relatively good management position, but it has grown very rapidly. It is still in a position to be selected against, and it cannot count on house price growth to bail it out.

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**THE INTENT OF FHA**

In response to the Great Depression, FHA was founded in 1934 to execute the provisions of the National Housing Act. Its original intent was to serve low-income, first-time home buyers, particularly minorities. Its mission was to create more housing opportunities for those with low or moderate incomes or flawed credit histories. In 1948, Congress approved the National Housing Policy Act, thereby stating FHA’s mission as the following: “[T]he policy to be followed in attaining the national housing objective hereby established shall be: 1) private enterprise shall be encouraged to serve as large a part of the total need as it can; 2) government assistance shall be utilized where feasible to enable private enterprise to serve more of the total need.”

Through its insured loans, which required relatively low-down payments compared with conventional mortgages, FHA promoted homeownership in an effort to build economic prosperity. Indeed, FHA successfully achieved its mission with a safe and straightforward product—the 30-year fixed-rate mortgage with a down payment requirement.

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4 By permitting an increase in the annual premium, FHA can lower the upfront premium which reduces the risk to the program but is also fundamentally better for the consumer. The upfront premium is not refundable for those consumers who remain in the home only a short time while the annual premium is only paid for as long as the borrower is in the home, meaning the annual premium is inherently fairer.

5 U.S.C., Title 42, Chapter 8A, Subchapter I, § 1441
LOAN LIMITS

Loan limits have risen very rapidly since the credit crunch began. In 2006, FHA could insure loans of up to $200,160 in all markets, and in higher cost markets could insure loans of up to $362,790. This policy permitted FHA to insure approximately 60 percent of the available low-down payment market. These loan limits kept FHA market share limited and prohibited it from insuring high-cost homes. In response to the 2008 housing crisis, FHA loan limits were revised to insure loans of up to $271,050 in all markets, and in higher markets loans of up to $729,750.

When the revised formula was adopted, it permitted FHA to insure nearly 90 percent of the available low-down payment market. Because home prices continue to fall and the loan limits do not fall with them, FHA’s minimum loan limits are now approximately $100,000 above the median national home price of $173,200. FHA can now insure approximately 95 percent of the available housing market. A borrower now has to be among the highest 3.8 percent of all households in the United States, earning at least $200,000 per year to qualify for home purchase at the upper end of FHA loan limits.

Historically, low-income families qualifying for mortgage financing have represented a small percentage of the housing market, as did FHA. But since its loan limit expansion in late 2007, FHA has been insuring relatively fewer low-income loans and has now expanded its loan limits to $729,750. In 2010, FHA insured more than 70 percent of all loans having 95 percent or higher loan-to-value (LTV) ratios. This may have been an excellent idea when alternative sources of mortgage credit collapsed, but now that this lending has recovered, the continued need for high loan limits and high LTV lending at these limits is open to question.

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6Analysis provided by Genworth Financial using Corelogic Servicing Data set
8The income of $200,000 assumes $768,000 house, 5 percent down payment, $729,750 loan amount, 5 percent interest rate, 1.5 percent property tax (of house value), 0.25 percent homeowners insurance (of house value) and 31% debt-to-income ratio.
ANALYSIS

We base our analysis on the findings of the Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance Fund, Fiscal Year 2010

The report suggests that FHA needs to earn a substantial surplus in order to boost its reserves back up to its congressionally mandated 2 percent ratio. This will happen naturally as the economy improves, but only in limited ways. Even under the best of circumstances, we cannot expect property values to grow as they did in the late 1990s and early to mid-2000s. For a low-down payment program, this creates a significant problem. FHA has simultaneously moved into higher income lending as its loan limits have been increased. A question is whether this new market will be profitable and allow cross-subsidization of FHA’s traditional market. The Annual Report suggests that it will.

To determine if this is indeed the case, we looked at FHA data from its 2008 book of business to determine FHA performance rates by loan limit.

This is depicted in Table 2. The table suggests that going up market is not a likely scenario for finding a higher percentage of good loans and more net revenue—at least not given the performance of loans underwritten in 2008—unless FHA can charge more for high-balance loans. The table suggests a worsening in defaults as loan size increases from FHA’s normal clientele, later leveling off and declining. The highest class, loans over $500,000, has about the same default rate as FHA’s traditional business.

TABLE 2

<table>
<thead>
<tr>
<th>Loan Amount</th>
<th># ETD Bad*</th>
<th># Orig Loans</th>
<th>Bad Rate%</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100,000 and Below</td>
<td>15,009</td>
<td>169,495</td>
<td>8.86%</td>
</tr>
<tr>
<td>$100,001 – $150,000</td>
<td>27,019</td>
<td>288,163</td>
<td>9.38%</td>
</tr>
<tr>
<td>$150,001 – $200,000</td>
<td>24,645</td>
<td>251,664</td>
<td>9.79%</td>
</tr>
<tr>
<td>$200,001 – $250,000</td>
<td>16,175</td>
<td>152,441</td>
<td>10.61%</td>
</tr>
<tr>
<td>$250,001 – $300,000</td>
<td>9,398</td>
<td>86,115</td>
<td>10.91%</td>
</tr>
<tr>
<td>$300,001 – $350,000</td>
<td>5,210</td>
<td>45,377</td>
<td>11.48%</td>
</tr>
<tr>
<td>$350,001 – $400,000</td>
<td>2,867</td>
<td>23,460</td>
<td>12.22%</td>
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<tr>
<td>$400,001 – $450,000</td>
<td>1,224</td>
<td>9,944</td>
<td>12.31%</td>
</tr>
<tr>
<td>$450,001 – $500,000</td>
<td>632</td>
<td>5,130</td>
<td>12.32%</td>
</tr>
<tr>
<td>$500,001 and Greater</td>
<td>896</td>
<td>9,022</td>
<td>9.93%</td>
</tr>
<tr>
<td>GRAND TOTAL</td>
<td>103,075</td>
<td>1,040,811</td>
<td>9.90%</td>
</tr>
</tbody>
</table>

* Bad loans: loans currently 90 or more days delinquent and loans having already terminated in default

Data Source: CoreLogic Servicing Data set as of March 2010

11Analysis provided by Genworth Financial using CoreLogic Servicing Data set.
12Ibid.
In his Foreword, Secretary Donovan makes a number of very important points. First, FHA helped avert an even greater fiscal crisis by providing guarantees for more than 50 percent of home-purchase mortgages during 2009.\textsuperscript{13} This is certainly one of FHA’s two central missions and it has performed admirably, aided by HUD’s actions in holding lenders responsible for poor credit quality of loans that it underwrites.\textsuperscript{14} Second, the Secretary notes that “we are committed to stepping back from this role and supporting the return of private capital to the market.”\textsuperscript{15}

Unfortunately, there is no discussion of the plan for “stepping back” elsewhere in the report. In fact, at times it appears that the current FHA program is being sold as a “cross-subsidy,” in which better risks are overcharged to support losses elsewhere in the program both over time and within cohorts. Indeed, in April 2010, FHA increased the up-front premium charged on new insurance endorsements although stress tests of the 2010 book of business indicate that it is in the black even under very pessimistic scenarios regarding house price changes. In part, this reflects the need to restore the capital ratio to congressionally-mandated levels. This will not be easy to pull off; overcharging one line of business to subsidize another line risks getting the worst loans as the better ones gravitate to cheaper alternatives. The Annual Report gives the impression that the enlarged book of business is part of the model for growing FHA out of this position of capital inadequacy. It is silent on how “stepping back” is to be made consistent with increasing capital.

It is also the case that large loan sizes are inconsistent with FHA’s primary mission of helping first-time and minority homebuyers. Table 12 in the Annual Report indicates that average home price for first-time homebuyers only increased from $100,000 to $167,700 over the 2000 to 2010 period.\textsuperscript{16} Given current movements in home prices, this number is unlikely to increase at a rapid rate. Tabulations from the 2009 Home Mortgage Disclosure Act (HMDA) data depicted in Table 3 indicate that 95 percent of both African-American and Hispanic borrowers who selected FHA mortgages had loan amounts under $300,000. Thus, loan limits beyond this size are not necessary to serve first-time and minority borrowers.

\textsuperscript{13}FHA insurance financed the purchase of one-third of newly constructed home purchases.
\textsuperscript{14}See the discussion of Managing Counterparty Risk on page 38 of the report including actions to debar individuals sanctioned by HUD and higher net-worth requirements for FHA approved lenders.
In summary, despite improvements cited above, FHA lacks flexibility in pricing and underwriting, in a way that is similar to the position of rating agencies in the subprime market a few years ago. Its underwriting is transparent and changes slowly. This lack of flexibility compared to conventional lending and insurance gives delivery options to loan originators, who can deliver the worst loans that barely qualify for FHA insurance and sell other loans with cheaper credit enhancement. This suggests that those who take the position that high loan limits will allow FHA to earn a surplus on large mortgages need to think about the data in Table 2 and about adverse selection possibilities. If FHA tries to charge more for high-balance loans, it risks getting the worst loans, and there is no reason to expect that the prices of high-cost houses will grow in value especially rapidly to produce extra equity for their owners.

95% of all borrowers in minority classifications are served at a Loan Limit of $350K
POLICY OPTIONS

There are several policy solutions that can be implemented to address FHA’s large and risky market share. First, FHA could revert to using the current area median home price, rather than the 2008 estimate, as the basis for its regional limits. As we have mentioned, home prices have fallen dramatically since 2008, leaving FHA’s minimum loan limits approximately $100,000 above the average. Using current house prices will ensure that FHA insures loans that are reflective of the average housing market. Moreover, the 2008 stimulus legislation enacted by Congress allows FHA, Fannie Mae and Freddie Mac to guarantee loans of up to 125 percent of the median home price in high-cost markets. Reducing this 125 percent multiple would also make significant progress toward returning FHA to its traditional role. Finally, reducing both the high and low end of FHA’s loan limits from $271,050 in all markets and in higher markets up to $729,750 would also reduce its market share.

More broadly, a holistic review of underwriting and pricing guidelines is important to limit the extent to which FHA can be selected against. This would include reevaluating debt payment to income (DTI) ratios. From 2003, FHA is approving twice the number of loans with DTI ratios above 45 percent, which is considered high risk in the conventional market. Specifics on these reforms and what they will accomplish will be discussed at length in our next Assessment Report.

CONCLUSIONS

Without question, FHA played a major role in keeping the mortgage market afloat during the economic collapse of 2008 and 2009. However, by continuing to insure mortgages for the highest income borrowers, FHA is undertaking risks that it has not undertaken before and for which its capacity may be too small. The data above do not suggest that larger loans can be effectively used to subsidize other books of business as the 2008 vintage performed approximately 20 percent worse than smaller loans that are within the historical scope of FHA.

Additionally, larger loan sizes (above $300,000) are unlikely to assist FHA in reaching its two historical constituencies—first-time homebuyers and minorities.

Now is a good time to reexamine FHA’s market both because it is not clear as public policy that we should be insuring low-down payment loans for higher income borrowers and because there are very serious questions about FHA’s capacity to carry large market share successfully. For nearly 70 years, FHA’s market share has expanded and contracted as necessary. FHA’s history does not suggest that it needs to insure half the mortgages in the market. If it expands beyond its capacity, it risks being unprepared to anchor the housing market should we suffer another economic collapse.

We wish to thank Genworth Financial for contributing data tabulations for this report upon request, as well as for support to our respective research centers.

Analysis provided by Genworth Financial using CoreLogic Servicing Data set
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