Myths and Facts Regarding the FHA Single Family Loan Guarantee Portfolio

FHA Capital

Myth: FHA will need a "bailout."

Fact: Because of the sweeping changes enacted by FHA since 2009, including an important series of recent steps such as the enforcement actions that resulted in over $900 million in compensation to FHA from settlement agreements with major banks, and further increases to FHA's insurance premiums, it is unlikely that FHA would require additional resources from the U.S. Treasury in FY 2012.

Special assistance from the U.S. Treasury would be needed in the future if expected losses on the most stressed books of business (2005 – 2009) increased substantially. Such a situation would most likely be precipitated by continued declines in home prices at the national level for a sustained period of time. Although HUD does not anticipate such a situation occurring, it also remains vigilant in monitoring housing market conditions and FHA portfolio performance. While additional risks remain for FHA as the economy continues its fragile recovery, the significant reforms and strong enforcement efforts undertaken by this Administration are yielding sound and profitable business, altering the FHA Mutual Mortgage Insurance (MMI) Fund's trajectory and positioning FHA well for the future.

Myth: FHA would be declared insolvent by state regulators were it a private mortgage insurance (MI) company.

Fact: Unlike private mortgage insurance companies with investor-driven profit expectations, FHA is a government agency created to achieve specific public purposes. One of those purposes is to assist in stabilizing housing markets at the very time that private firms choose to pull back from the mortgage finance market. Since its inception in 1934, FHA has acted as a countercyclical force during times of economic stress, ensuring the continued availability of mortgage credit for qualified homebuyers. Such actions on the part of the Federal Government involve taking calculated risks. But without FHA's action during the worst housing crisis since the Great Depression, the recession in the U.S. would likely have been significantly worse.

As attested to by both the independent actuaries and the Office of Management and Budget, FHA has taken aggressive action during this Administration, including increased premiums, heightened lender oversight and enforcement, and other risk management initiatives, to keep FHA as financially sound as possible despite the severe impacts of the recent recession.

Myth: FHA should hold capital levels like a private MI.

Fact: In order to raise capital in the current economic environment, private mortgage insurance companies must isolate their older, weaker books of business from any recent and healthier year-by-year activity. In the private market, new investors will not accept any risk on the older, stressed portfolios. FHA is not a private business that could become insolvent and not recover. It was the economic crisis that eroded MI capital positions, just as it has eroded the capital position of FHA. However, FHA does not need to provide legal separation between older and new books of business because it does not seek to garner private capital with which to finance its insurance activities. FHA does a functional separation of older and newer books of business in terms of its accounting requirements, but there is one consolidated Capital Reserve Account.

Myth: FHA's capital levels can be manipulated by changing house price growth assumptions.

Fact: Congress' definition of FHA's capital requires net present value accounting and projections of life-cycle premium revenues and claim expenses. This is entirely consistent with the accounting treatment required of all other federal government direct loan and loan-guarantee programs. These valuations are updated annually under OMB guidance. By the end of the fifth year of any given book of business, the life-cycle value of FHA loan guarantees is well known and understood.

FHA cannot and does not manipulate its capital levels by changing house price assumptions. For the actuarial valuations that go into the capital ratio estimate, the house price assumptions of an independent vendor are utilized. For the annual budget and accounting reviews by OMB, the house price assumptions are those selected by the Council of Economic Advisors.

Myth: FHA is operating with a dangerously high leverage ratio. That by itself suggests that FHA is on the verge of collapse and that it would not take much for FHA to have a liquidity crisis.

Fact: FHA does not operate with debt leverage as do private firms. Leverage ratios are more about debt positions than capital. High leverage means that a business could easily face a liquidity crisis in its ability to meet institutional debt payments. Because FHA is not leveraged with debt like a private firm, leverage ratios are not meaningful measures of FHA financial soundness.

Myth: FHA is under-reserving for known losses because it does not account for expected losses on loans that are currently delinquent. Such accounting is at the heart of loss reserves for private firms.

Fact: FHA loss reserves do include expected losses for loans in 90-day delinquency, and for loans projected to have a 90-day delinquency in the future. In this way, FHA loss-reserve calculations capture the same information as do private loss reserves.

Myth: FHA does not show its true capital position because it nets projected premium revenue against default losses before calculating its capital. Were future premium revenue removed, it would show negative capital.

Fact: Federal accounting rules for loss-reserve calculations do use future expectations of all cash-flows, but they do so over the entire life of the loans or loan guarantees. In contrast, private firms typically only reserve for expected losses in the next year (four quarters). Near-term cash flow is critically important to a private firm because any negative cash-flow position could result in denial of access to corporate debt. That would result in insolvency of a private business. FHA and other federal programs do not have to protect against loss of access to credit markets because they rely upon the U.S. Treasury for cash-flow management. Thus, life-cycle accounting is used to provide a more complete understanding of the value of the loans or loan guarantees.

Myth: FHA is pursuing a strategy of growing its insured portfolio in an attempt to stay ahead of mounting losses on the loans on its books at the beginning of the housing downturn in 2007.

Fact: FHA does not pursue market share targets, nor does it attempt to gain volume at the expense of private guarantors. The expansion of FHA lending in 2008 and 2009 was entirely market based and driven naturally by the pull-back from the market of Fannie Mae, Freddie Mac, and others. Lenders came to FHA because other means of guaranteeing their mortgage loans were no longer available to them. FHA provided the critical role required of the Federal Government—to assure liquidity in housing markets across the nation. FHA's increased role in the nation's mortgage finance system is a temporary one. Indeed, FHA's insurance volumes have decreased 34 percent since their peak in 2009 and FHA's market share is declining for the first time since 2006. In fact, FHA endorsement volumes are returning to historical norms; in FY 2011, FHA endorsement volume was lower than it was in FY 2003.

FHA Accounting

Myth: FHA accounting permits it to hide its losses in an ever-growing insurance portfolio.

Fact: FHA must maintain accounts for each annual (budget year) cohort of loan guarantees. Every cohort must account for itself, and do so every year. Original and updated estimates of the lifetime value of each cohort of loans are reported by OMB annually, in the Federal Credit Supplement to the President's Budget. Also, in the most recent Annual Report to Congress on the Financial Status of the FHA Mutual Mortgage Insurance Fund (November 15, 2011), HUD showed a cohort-by-cohort accounting of expected lifetime income or loss. That illustration (Figure 16, p. 43) clearly shows that FHA is expected to experience significant dollar losses on some of its outstanding books-of-business.

Myth: FHA uses lax accounting standards.

Fact: FHA abides by all federal accounting standards, and the FHA loan portfolio follows all accounting rules promulgated by OMB for federal direct loan and loan guarantee programs. Those rules have been developed over a 20 year period. FHA's financial statements, and the loss reserves booked in them, are scrutinized annually by an independent auditing firm hired by the HUD Inspector General. This audit is separate and apart from the independent actuarial study and annual review by OMB.

In its FY 2011 audit, FHA received an unqualified (or clean) audit opinion. An opinion is said to be unqualified when the Auditor concludes that the financial statements present fairly, in all material respects, the financial position and its net cost, changes in net position, and combined budgetary resources. An auditor gives a clean or unqualified opinion when there are no significant reservations with respect to matters contained in the financial statements.

FHA Actuarial Modeling

Myth: FHA masks expected losses by using overly optimistic assumptions regarding future home prices.

Fact: The loan-performance projections used by FHA are developed by an independent private firm under contract to produce the independent actuarial study of the FHA Mutual Mortgage Insurance Fund that is required by law. The contractor uses economic forecasts developed by an independent and highly respected private firm. For the most recent study, the independent actuaries used home price and interest rate forecasts from Moody's Analytics. Given the timing of the actuarial study, the Moody's forecasts used for the FY 2011 study were produced in July 2011.

The actuarial contractor also provides results using Moody's alternative economic forecasts, and adjusts those forecasts to be more pessimistic than the actual time series published by Moody's. A summary of those results is provided in HUD's Annual Report to Congress on the MMI Fund.

Myth: The independent actuarial forecasting model must be flawed because it has never predicted in any of its scenarios that FHA would "go broke" and have to be shut down.

Fact: The independent actuaries have shown over the years many economic scenarios in which FHA has negative capital positions. The actuarial forecasts, however, show what could happen, absent any actions taken by FHA management. FHA has responded prudently to the warnings of economic risk that have arisen from its ongoing risk management processes and the annual actuarial reviews, and has taken continual actions to protect the MMI Fund. If HUD had not raised premiums twice in FY 2011, the Fund would have negative capital right now. But HUD was proactive and capital remains positive. The fact that the Fund is still positive is a testament to how serious HUD management is about its fiduciary responsibility to protect the Fund when it receives the annual report of the independent actuaries.

Myth: The independent actuarial forecasting model must be flawed because it shows FHA recovering from a Depression-like scenario, rather than being shut down.

Fact: Depression-like sensitivity runs do show tremendous increases in expected losses on current books of business. For a private firm, that would result in bankruptcy and the likely end of business, absent capital injections from a parent corporation. Should FHA face such a situation, it would receive special assistance from the U.S. Treasury to establish the required loss reserves against the outstanding loan guarantees. Once such a crisis abates, and new business is again profitable, the actuarial projections simply show the period of time in which FHA could be expected to effectively rebuild its capital reserves. There is nothing in that exercise that suggests there are problems with the actuarial forecasting model. It simply reflects the reality that FHA has an actuarially sound program over the long-term. The current stress on FHA's insurance fund is primarily due to legacy books of business and not more recent books, which are performing very well. Thus, the difficulty facing FHA at present is a short term issue which will be resolved over time.

Myth: The actuarial contractor purposefully underestimates future defaults by turning off a variable used in place of unemployment rates that accounts for half of default projections on new books of business.

Fact: There is no such variable in the actuarial model. What the actuarial contractor phased-out in last year's forecasting model (FY 2010 actuarial study) was a variable used to accentuate default rates during the recent economic crisis, independent of loan origination year. In the more recent actuarial model (FY 2011 actuarial study), that was replaced by a re-default indicator that picks up the increased likelihood of default on re-performing loans. That indicator never goes away. Once a loan has a 90-day delinquency spell, and reinstates to current status, the prior-default indicator stays with the loan for the rest of its life, creating permanent elevation in default potential.

Myth: FHA's actuarial model underestimates its risk exposure by treating streamline refinance loans as if they are full payoffs when they are really more like loan modifications.

Fact: Streamline refinance loans do not disappear but are counted as newly insured loans, and with the risk characteristics that are appropriate for them. The actuarial model has a completely separate set of forecasting equations for streamline refinance loans, and they have consistently predicted higher default losses from those loans than from fully-underwritten loans originated in the same time periods. The actuarial model is very sophisticated in the way that it marks-to-market the streamline refinance loans at time of origination (using the valuation from the original fully-underwritten loan and house price indices for the interim), and then continues to update the expected property values throughout the forecast period.

FHA Loan Quality

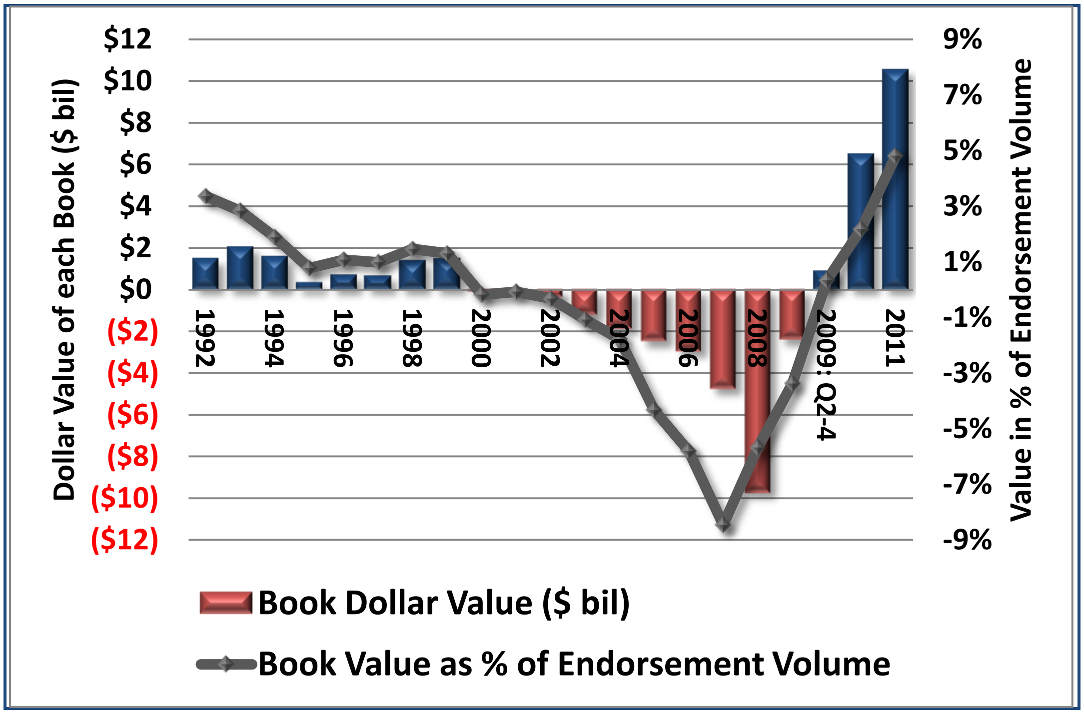
Myth: FHA loans today are just as risky as those it insured prior to 2008 because they still involve low downpayments and house prices are still falling.

Fact: Downpayments by themselves do not define the riskiness of any given loan. FHA has successfully insured low downpayment loans for many years, and has proven that loans with low downpayments can be a vital and appropriate financing mechanism for responsible borrowers. Over the past three years, FHA has enacted the most sweeping reforms in its history to improve the quality of the loans it insures, including a two-step FICO/downpayment policy that requires a minimum 10 percent downpayment for borrowers with FICO scores below 580, and the significantly better performance of FHA loans since the implementation of this Administration's reforms is a testament to the fact that low downpayment mortgages can and do perform well when properly underwritten.

In addition, the fact that a home is "underwater" does not in and of itself indicate imminent default. FHA-insured homebuyers during the past three years have known that they were purchasing homes during uncertain times. They first proved that they had stable employment and income during a time when job losses were at high levels. These borrowers brought with them higher credit scores than any group in FHA's modern history, showing that they are experienced at managing debt obligations. That has shown itself by a steady decline in early-payment default rates from 2008 to 2011.

The figure below displays the sharp contrast in FHA's books of business before and after the reforms instituted by the current Administration.

Estimated Lifetime Value of Each Single-Family Book of Business, 1992-2011



Source: U.S. Department of HUD/FHA.

Myth: FHA continues to insure risky loans. Even on more recent originations, the FHA 90-day delinquency rate is many multiples of that for the GSEs and MIs.

Fact: The credit quality of loans FHA has insured over the past two years is the highest it has ever been, with average credit scores for FHA loans of approximately 700 for both years. Early-payment default rates and current-period serious delinquency rates are a fraction of those seen in earlier books at the same point in their seasoning. While FHA's delinquency rates may appear high compared with GSE and private MI loans, that is primarily because those entities are guaranteeing loans with higher credit quality than they did in the past. Because the recent GSE/MI loans have an average credit score of 750 or better, their delinquency rates are negligible. That can make FHA's delinquency rates appear large in comparison, even though the recent quality of FHA loans is the best in the agency's history.

It is also worth noting that a large percentage of FHA's portfolio is now in its peak default years, while in contrast, 70% of all private market originations and a majority of GSE loans are seasoned more than 5 years and have passed the peak default years. In addition, those books with poorer performance comprise a greater share of FHA's total portfolio now than at this point last year, as FHA's loan volume has gradually decreased over the past couple of years. FHA's two best performing books in 2012 comprise only 40% of FHA's current portfolio, while at this time last year the two highest performing books of business represented 53% of the total portfolio.

Myth: FHA is not accounting for the risk of 1 million borrowers who borrowed downpayment funds via state and local agency programs to monetize first-time homebuyer tax credits.

Fact: Of the 1 million first-time homebuyers that used FHA insurance during the 13 months the tax credit was used most heavily, more than 700,000 borrowers used their own funds to make the down payment—while another 315,000 received gifts from a relative or via a qualified governmental downpayment assistance program. Those making their own downpayment have a to-date "failure" rate (insurance claim or presently in foreclosure) of 0.90 percent and those with downpayment assistance have a rate of 1.1 percent.

Homebuyers using tax credits had to put up real cash for the minimum downpayment in order to qualify for FHA insurance. Thus, they had to demonstrate the ability to save enough funds for a downpayment. What the tax credit did for such households was repay the downpayment funds they had saved and put into the home. Thus, the final financial position of the household was actually stronger than if there were no tax credit. The strength of these borrowers and loans is seen by the higher credit scores of the borrowers at origination and the tremendous decline in early payment default rates on their loans, as compared to loans coming to FHA in 2007 and 2008.

Myth: The continuation of a $729,750 loan limit puts FHA at risk of significant losses.

Fact: The highest dollar value loans in the FHA portfolio actually have the lowest delinquency and foreclosure rates. At the same time, loans with initial balances above $625,500 (the GSE loan-limit ceiling) make up a very small percentage of FHA endorsement activity. During CY 2011, those loans made up only 0.55 percent of all endorsements, representing 2.2 percent of the dollar volume of the endorsements for that year. In terms of shares of the overall active loan portfolio, these high-dollar-balance loans are just 1.2 percent of the dollar value of insured loans (as of December 31, 2011). CY 2011 insurance endorsements above the GSE loan limit floor of $417,000 were 3.2 percent of all activity and 9.6 percent of the dollar volume. They represent 5.7 percent of active insured loan balances.