



# Too Early to Sound the FHA Alarm

The Federal Housing Administration Is Financially Vulnerable but Its Future Depends Most on Stability in the U.S. Housing Market

By Sarah Wartell and John Griffith  
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## Introduction

The Federal Housing Administration, or FHA—the government mortgage insurer that helps make homeownership affordable to first-time homebuyers and lower-income families—has so far weathered arguably the worst housing crisis in history without taxpayer assistance. This is a remarkable achievement at a time when many other mortgage-invested financial institutions needed government bailouts.

By playing a key countercyclical role, FHA prevented a more devastating over-correction in the housing market. Without FHA hundreds of thousands and perhaps millions of homeowners might not have had access to mortgage credit in the wake of the financial crisis, which would have further chilled housing demand, depressed home prices, exacerbated the Great Recession of 2007-2009, and slowed our already tepid economic recovery even more.

But concern has arisen that FHA could soon run out of money and require taxpayer support for the first time in its 77-year history. While serious, these concerns should not be overblown.

This issue brief details the financial condition and actuarial projections for FHA's Mutual Mortgage Insurance Fund, which backstops all of the agency's single-family housing programs, looking specifically at conservative calculations that are by any measure overblown when weighed against more realistic projections. We then detail the tools available to FHA to deal with a more severe than expected housing market in the coming years—tools that could enable the agency to continue its crucial role in the U.S. housing market without costing taxpayers a dime.

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## The current state of FHA

FHA faces significant losses ahead from loans insured in the years immediately preceding the financial crisis, when mortgage originators turned to FHA to sustain their volume as private actors began to withdraw from some market segments. FHA's independent actuaries predict more than one out of every four loans insured in 2007 alone will result in an insurance claim and the 2008 book alone will bring losses of close to \$10 billion. For the most part these loans were made before FHA put in place appropriate controls to stem risks in this new business.

Those loan books also contain a high concentration of so-called "seller-financed down payment assistance loans," in which sellers covered the required down payment at the time of purchase in exchange for inflated purchase prices. Loans with seller-financed down payment assistance experienced considerably higher claim rates than comparable nonassisted loans, according to FHA's actuaries. These often-fraudulent assistance programs were later banned from FHA insurance programs by the Housing and Economic Recovery Act of 2008.

While losses from these pre-crisis loans will likely continue for several years, FHA's post-crisis loan books are expected to have significant positive net economic value, due in part to increased fees and tightened underwriting standards. The 2011 book, for example, is expected to bolster FHA's Mutual Mortgage Insurance Fund's reserves by \$10.5 billion, while the new 2012 book of business is projected to add another \$8.1 billion, according to the actuarial report.

Still the capital reserves in the Mutual Mortgage Insurance Fund are uncomfortably low. The most closely watched statistic in the actuarial report is the so-called "capital ratio," the amount of excess cash the agency has on hand to cover unexpected insurance claims, reported as a percentage of total insurance-in-force.

FHA is required by law to maintain a capital ratio of 2 percent, meaning it has to keep an extra \$2 on reserve for every \$100 of insurance liability, beyond what is necessary to cover expected claims. The Mutual Mortgage Insurance Fund's current capital ratio is just 0.24 percent, about an eighth of the legal threshold, according to the financial report.

This is a big problem but not one that should be overstated. First, it's important to understand what exactly we're talking about here. As required by law, the Mutual Mortgage Insurance Fund still holds \$29 billion in its so-called "financing account" to cover all expected insurance claims over the next 30 years. The capital ratio reflects additional cash reserves of \$4.7 billion to cover any unexpected losses beyond this reserve for expected losses.

So even when that ratio falls below the 2 percent threshold, FHA still has cash on hand to cover its immediate insurance liabilities, based on reasonable expectations in the mortgage market. Think of it as the difference between a checking account you use to pay your bills and a savings account you keep tucked away for a rainy day.

But that's not the way some conservative analysts have presented the data. Edward Pinto of the American Enterprise Institute recently said that FHA maintains a "\$2.55 billion equity cushion on \$1.077 trillion of exposure," yielding a "422:1 leverage ratio." Pinto later compares this position to that of the now-defunct Wall Street investment bank Lehman Brothers, which had a leverage ratio of about 30-to-1 before going under in 2008.

This analysis is misleading. For starters Pinto ignores the financing account. FHA actually has about \$34 billion on hand to cover about \$1 trillion of insurance-in-force. Pinto also seems to conflate insurance liabilities and capital reserves with financial "leverage," which traditionally means investing or lending with borrowed money. In reality, FHA's financial position cannot be compared to that of the big banks before the crisis because FHA does not hold debt on its balance sheet.

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### Actuarial calculations on the state of FHA

While the Mutual Mortgage Insurance Fund's capital ratio is currently uncomfortably low, there is a reasonable chance it will recover in the coming years without taxpayer support—even if the current malaise in the housing market continues. More than anything else, FHA's solvency depends on the extent to which housing prices continue to fall or rebound in the next three years.

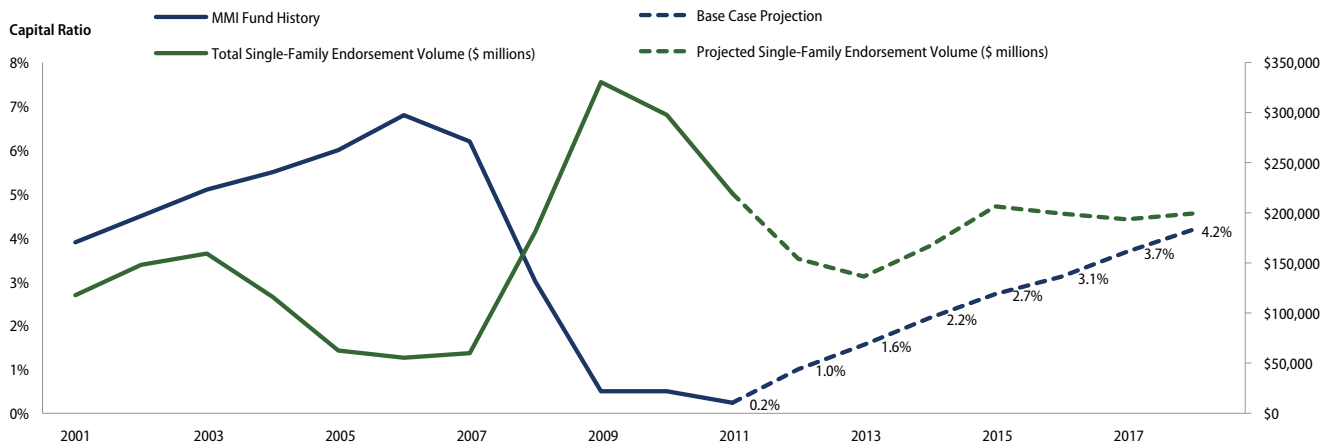
Like most private insurers, FHA's performance is heavily dependent on the health of the sector it insures. When home prices fall, borrowers who suffer unemployment or other economic shocks are more likely to default on their mortgages and FHA also recovers less in the event of a default. Both factors result in bigger losses for FHA.

FHA's actuaries predict the ratio will return to the required 2-percent threshold by 2014, assuming a 5.6 percent fall in house prices in 2011 and a slight rebound in subsequent years. The predicted recovery is attributable to the high expected economic value of the 2010–2012 loan books of business. (see Figure 1 on next page)

FIGURE 1

### The Mutual Mortgage Insurance Fund's capital ration will likely recover

Annual MMIF capital ratios and Single-Family Volume, with base case projections for 2012-2018 (projections assume a 5.6% fall in house prices in 2011, and slight growth in 2012-2018)



Source: Federal Housing Administration, "Annual Report to Congress Fiscal Year 2011 Financial Status of the FHA Mutual Mortgage Insurance Fund."

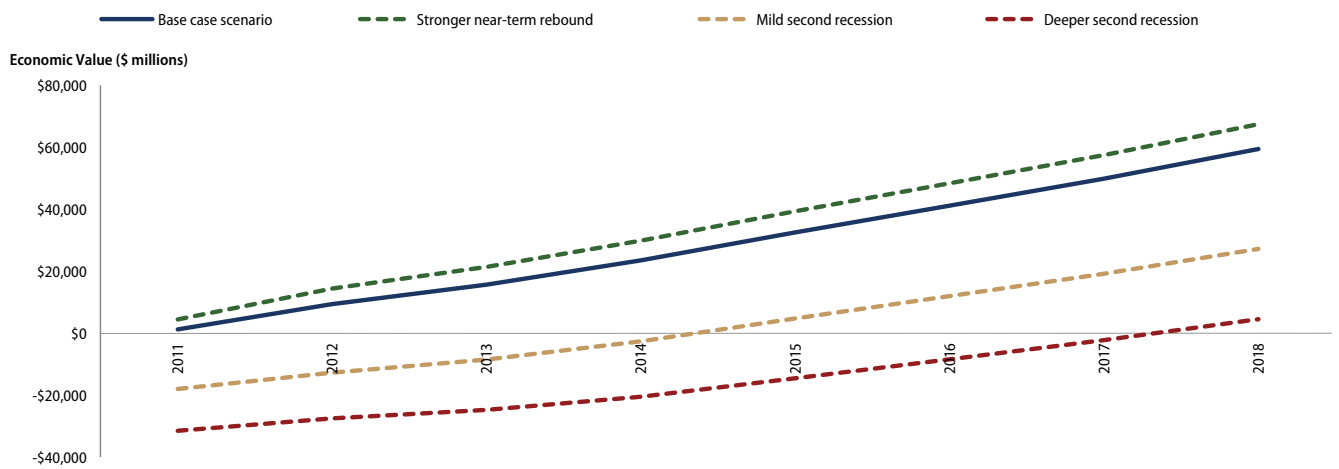
Of course, these predictions assume a relatively stable housing market in the coming years. Which brings us to the multibillion-dollar question: What happens to the Mutual Mortgage Insurance Fund if housing prices fall significantly again?

According to FHA's financial report, if home prices fall another 9 percent over the next two years, the fund's capital reserve will likely run dry, meaning FHA will no longer have reserves for unexpected future claims. If measures are not taken in advance to bring in more revenue, such a scenario could force FHA to seek taxpayer support for the first time in its history.

The independent actuarial review confirms that under more pessimistic economic scenarios, in which the housing market enters into a "mild second recession," the Mutual Mortgage Insurance Fund could have a "negative economic value" by the end of this fiscal year, meaning it will not even have enough cash to cover all expected future claims. In the case of a "deeper second recession," the fund's reserves could be as much as \$31.5 billion in the red by the end of the year. All things considered, then, FHA's actuaries estimate about a 50-50 chance the Mutual Mortgage Insurance Fund will maintain a positive capital reserve in the coming years, assuming no policy changes. (see Figure 2 on next page)

**FIGURE 2**  
**Gauging the Health of FHA**

Projected value of the MMI Fund over various economic scenarios



Source: Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year 2011.

The mistaken conservative take on FHA

AEI’s Edward Pinto argues that these “pessimistic” scenarios are actually more likely than FHA admits. As evidence, Pinto cites a September 2011 [survey](#) of economists and industry experts from MacroMarkets, which predicted significantly less growth in home prices between 2012 and 2015.

But Pinto neglects to mention two important facts here. First, FHA’s projection for a 5.6 percent decline in home prices is more than twice the MacroMarkets average for that year. Second, MacroMarkets survey contains a “wide variety of individual views,” as described in the official press release. The findings represent anything but consensus among participants: While one respondent predicts a 22 percent increase in home prices over the next five years, another expects a 22 percent decrease over the same period.

Pinto also ignores several economic forecasters that seem to agree with FHA’s actuaries. The actuarial model depends on a sophisticated home price model from Moody’s Analytics—a model that is widely respected as an industry leader. The near-term projections are also consistent with (and in many cases more conservative) than forecasts from [Freddie Mac](#), the [National Association of Realtors](#), the [Mortgage Bankers Association](#), and [Fiserv](#). (see Figure 3 on next page)

To be sure, other forecasters are less optimistic, but very few predict anywhere near a double-digit drop in the coming years, which is what we'd need to see before FHA required assistance from taxpayers. Fannie Mae expects home prices to stay about even in 2012 before starting to rise in 2013. The real estate information firm Zillow predicts prices will decline another 3 to 5 percent before reaching a definitive bottom in 2012 "at the earliest." And PIMCO, the world's largest bond fund, recently estimated that U.S. home prices may drop another 6 percent to 8 percent before they hit bottom.

Indeed, no one can be certain what will happen in the housing market over the next few years, but that hasn't stopped some analysts from prematurely sounding the alarm of an impending FHA bailout. Joseph Gyourko of the Wharton School, in collaboration with AEI, recently released a report predicting FHA will require recapitalization of "at least \$50 billion, and likely much more," even if housing markets do not deteriorate severely. "Quick and substantial economic and housing market recovery," Gyourko writes, is the "primary way for FHA to avoid generating substantial losses for American taxpayers."

But Gyourko's analysis overstates the case. His \$50 billion number is an estimate of the total capital necessary for FHA's Mutual Mortgage Insurance Fund to meet the required 2 percent ratio while covering future losses. This disregards FHA's countercyclical role and the nature of the capital-ratio mandate, especially during times of economic duress.

The 1990 Cranston-Gonzalez National Affordable Housing Act, which mandates that FHA maintain a capital ratio of at least 2 percent, says that the secretary of the Department of Housing and Urban Development may "propose and implement any adjustments to the insurance premiums" when this goal is not being met. So FHA need not regenerate its capital reserves in one fell swoop. By law, the HUD secretary is required only to come up with a viable recapitalization plan.

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## Steps taken by FHA to prepare for the worst

In fact, HUD has already taken many of the necessary steps toward recapitalizing the fund. FHA has increased insurance premiums three times since 2009 to the highest levels in its history. It has also enforced new rules that require borrowers with low FICO credit-rating scores to put down higher down payments, taken steps to control the source of required down payments, and overhauled its single-family loan-review policies and procedures.

## Different forecasts for home price appreciation

FHA's near-term market forecast is actually more conservative than most home price forecasts by source, 2011-2013

	2011	2012	2013
Moody's/FHA Base Case Scenario	-5.6%	1.2%	3.8%
Freddie Mac	-1.0%	0.0%	1.5%
National Association of Realtors *	-4.0%	2.6%	N/A
Mortgage Bankers Association	-3.1%	0.7%	3.7%
Fiserv (current 12-month projections) *	-3.6%	2.4%	N/A

\* Forecasts from these sources do not go beyond 2012

Source: Center for American Progress, drawn from the different forecasters in the table.

Even if home prices do not turn around soon, FHA still has tools at its disposal to bolster its reserves without taxpayer dollars, namely through further adjusting premiums or tightening underwriting standards. Premium adjustments are especially promising given current market conditions because low interest rates leave room for borrowers to absorb slightly higher fees without creating an affordability barrier to access.

In contrast, higher underwriting standards—especially higher down payment requirements—on top of existing tightened standards could make it difficult for a broad swath of homeowners to obtain mortgages. This would put further downward pressure on housing demand, contributing to continued home-price weakness, and creating further risk to the Mutual Mortgage Insurance Fund.

FHA's immediate financial future is inextricably linked to the health of the housing sector—and the economy as a whole—in the coming years. Helping the housing market and broader economy recover must be a top priority for Congress and the Obama administration. If that happens, FHA's current financial condition will likely improve on its own.

*Sarah Rosen Wartell is Executive Vice President of the Center for American Progress. John Griffith is a Research Associate with the Center's housing team.*