

The FHA Does Not Produce Sustainable Homeownership

Government Involvement in Residential Mortgage Markets

Sponsored by: the Federal Reserve Bank of Atlanta

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'Mortgage' - just another word for trouble

- Market home ownership aggressively to borrowers with poor credit.
- Push families into homes they can't afford.
- Saddle them with loans that barely build equity.
- Provide no incentives for fiscal discipline.
- Tolerate high failure rate, leaving families in financial ruin and communities reeling.

FHA has a history of abusive lending

“We have been fighting abuse, fraud, and neglect of the FHA program that has destroyed too many neighborhoods and too many families' dreams of homeownership for more than 25 years....The FHA program has a national default rate 3 to 4 times the conventional market, and in many urban neighborhoods it routinely exceeds 10 times. In addition, the FHA program is hemorrhaging money....”

Statement by the late-Gale Cincotta (a long-time community activist) made before the Subcommittee on Housing and Community Opportunity of the House Financial Services Committee, April 1, 1998

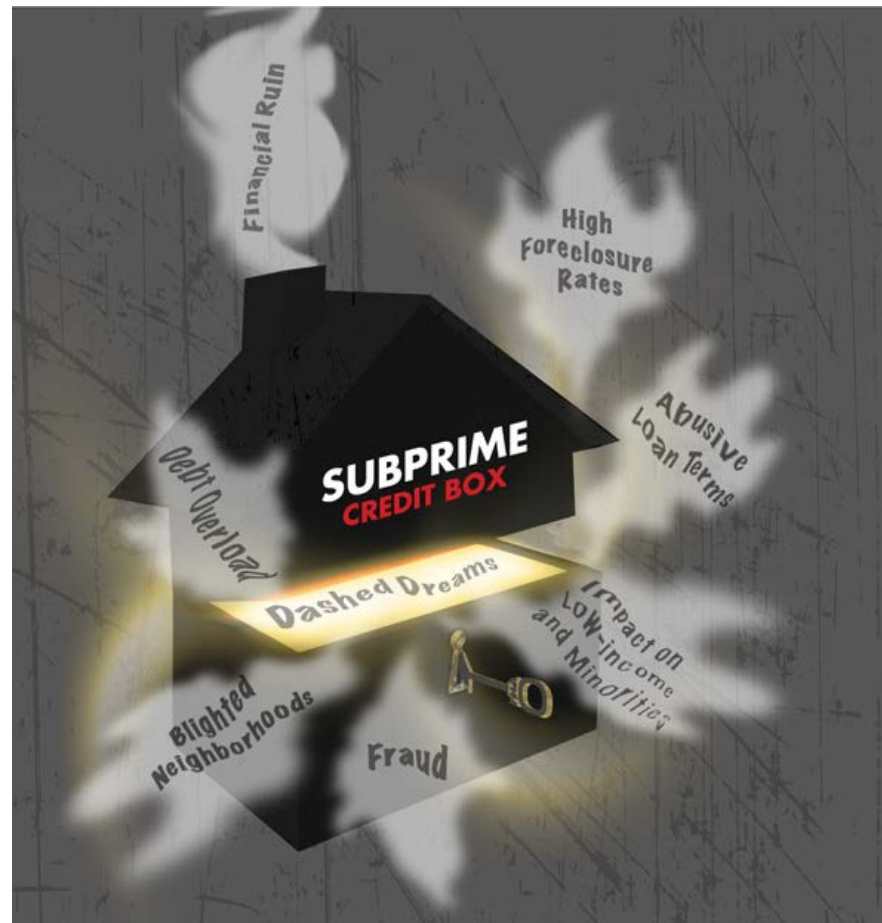
FHA's Original Goal: End 'Mortgage' Becoming Another Word for Trouble

- When established in 1934 by Congress, FHA implemented commonsense underwriting standards—increasing down payments to a minimum of 20%, establishing reliable and speedy loan pay downs with a 15-20 year loan term, using a residual income test to assure a borrower's reasonable ability to pay, and requiring demonstration of a good credit history.
 - From 1934 to 1960, these standards helped millions upon millions of Americans safely and confidently achieve the American dream of eventually owning their home free and clear of a mortgage and helped increase the homeownership rate to new heights.
 - Over its first 20 years, the FHA paid only 5,712 claims out of 2.9 million insured mortgages for a cumulative claims rate of 0.2%.

FHA Underwriting Standard--1936

- **“To be economically sound, a mortgage must be based on good security and involve a borrower with characteristics and income which indicate a strong probability that the debt will be paid off in accordance with conditions of the transaction. Such a mortgage transaction is mutually advantageous to the borrower, the mortgagee, and the Federal Housing Administration.”**

1957 Onward - 'Mortgage' Became Another Word for Trouble. Again!

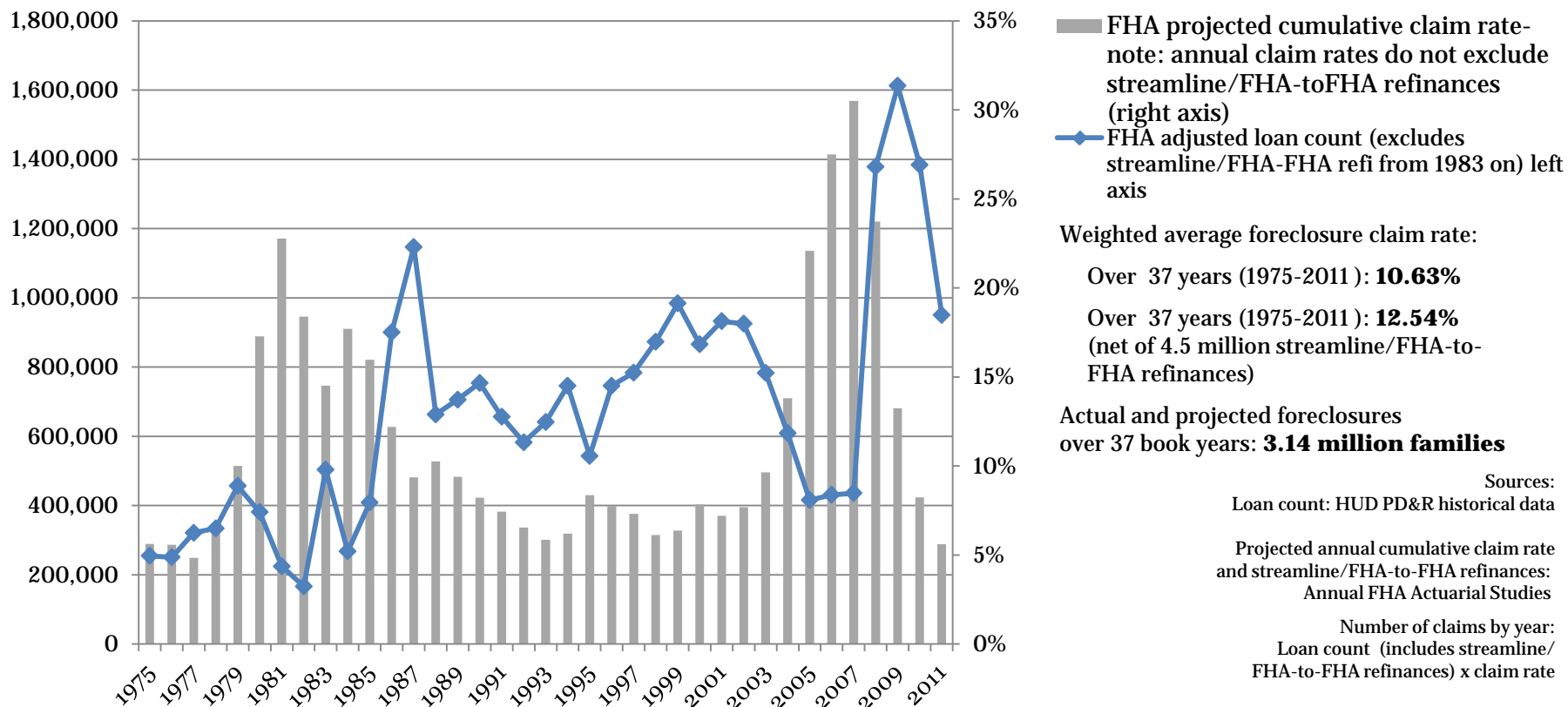


FHA and HUD Made Foreclosures Commonplace Across America

- Starting in the late-1950s Congress imposed increasingly lax standards for FHA insurance.
 - From 1975 to 2011, over 3 million FHA borrowers would lose their homes to foreclosure.
- Beginning in the early-1990s, powerful lobbies, politicians, and HUD replicated FHA's abandonment of commonsense underwriting at Fannie Mae, Freddie Mac, and throughout the mortgage market.
 - 8 million families would experience foreclosure from 2007 to the present.

FHA Claim Rate of 10.63% = Family Failure Rate of 12.54%

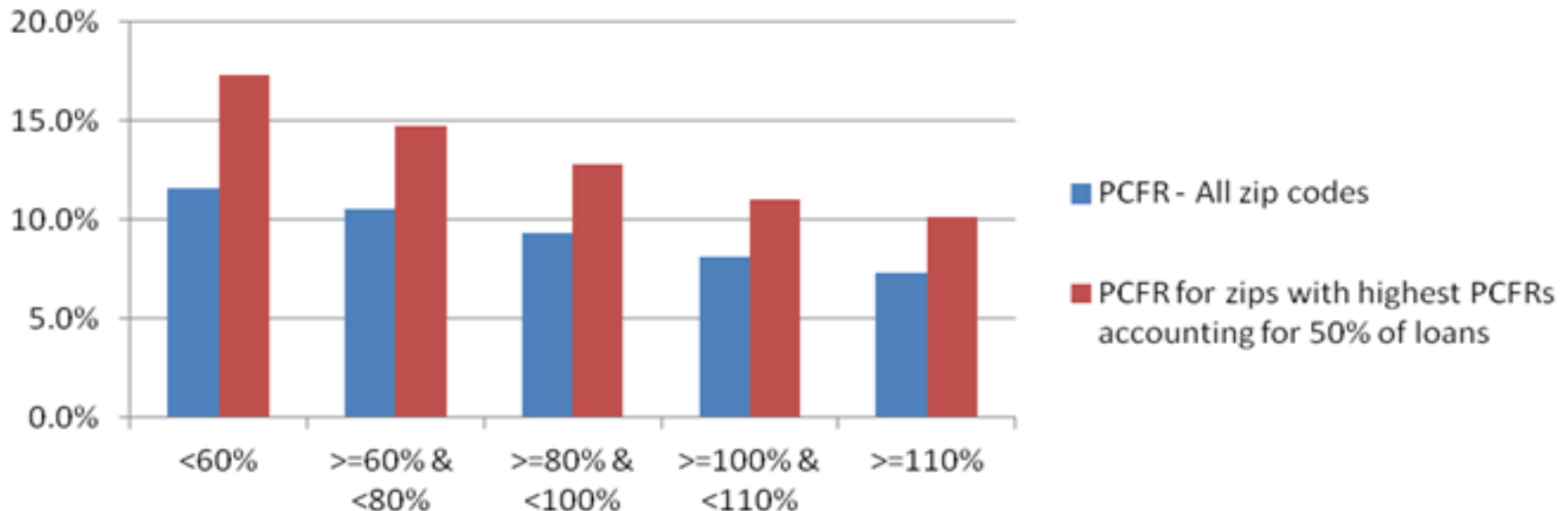
- WEIGHTED AVERAGE FORECLOSURE CLAIM RATE OF 12.54% FOR 1975-2011
3.14 MILLION FORECLOSURES AND 1 IN 8 FAMILIES



Foreclosures Disproportionate Impact...

Zip codes with less than median-incomes have a projected foreclosure rate averaging 10 percent, with half averaging 15 percent.

Projected cumulative foreclosure rate (PCFR) by percent of median area income (FY 2009-10)



Cross-subsidies Pay for Catastrophic Losses in Working Class Neighborhoods

- The five zip codes in Atlanta with the highest projected failure rates had rates that ranged from 24 to 30 percent.
- The five zip codes in Atlanta with the lowest projected failure rates had rates that ranged from 2 to 4 percent.
- The five zip codes in Miami with the highest projected failure rates had rates that ranged from 21 to 33 percent.
- The five zip codes in Miami with the lowest projected failure rates had rates that ranged from 4 to 6 percent.

See Appendix I.

Harm to a Family's Credit

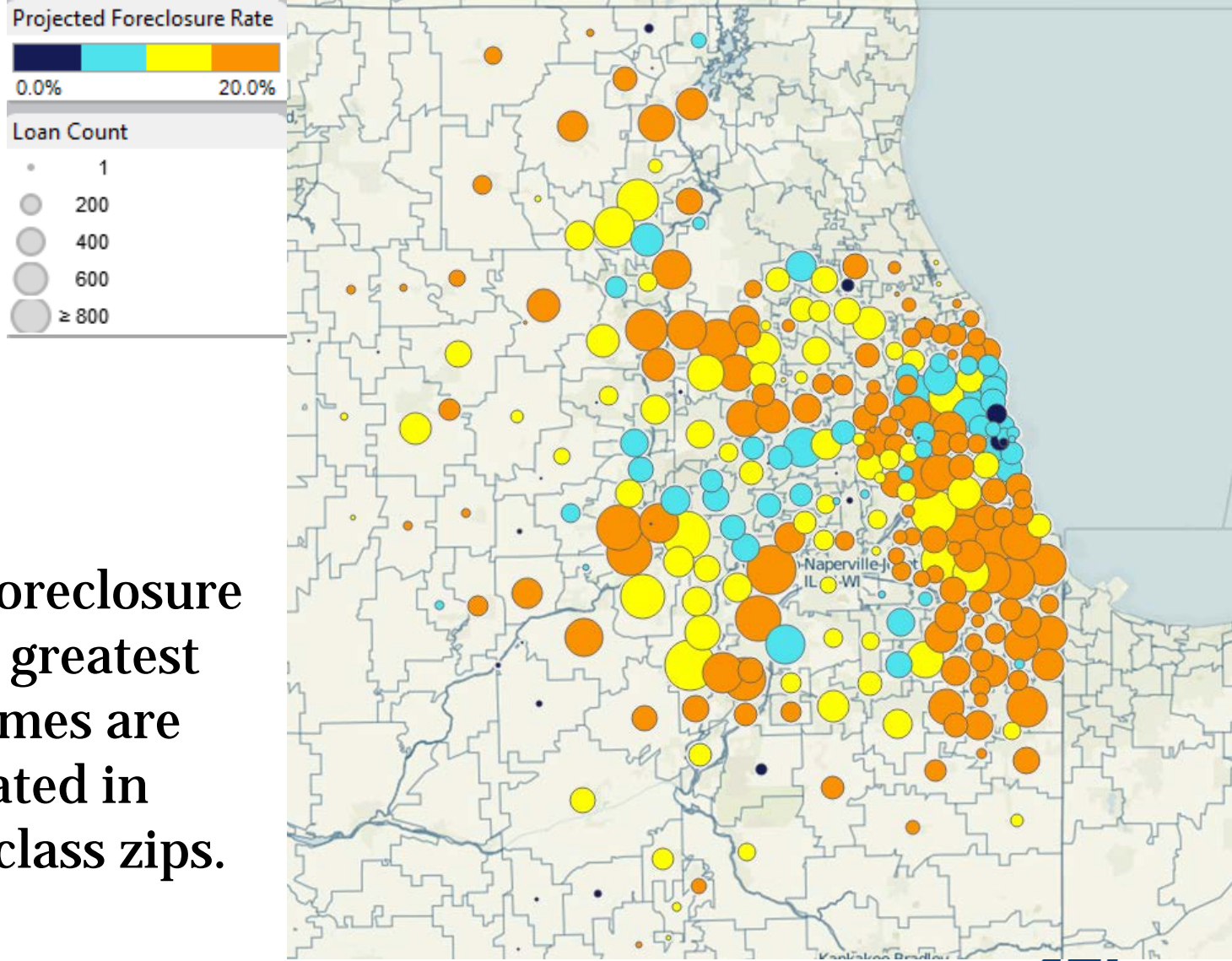
- Foreclosed borrowers denied access to most forms of credit for 3-to-5 years and limits on the ability to rent.
 - Denied the opportunity to build equity, provide security for their family, and have the down payment for their next home as their family grows.
- At a projected foreclosure rate averaging 10 percent, nearly 1 in 5 FHA loans is delinquent 30 days or more at least once in a two year period.
- In a working class neighborhood with a projected foreclosure rate averaging 17 percent*, nearly 1 in 3 FHA loans is delinquent 30 days or more at least once in a two year period.
- Mortgage delinquencies negatively impact credit scores, access, and credit cost (see Appendix B).

*Foreclosure rate for FHA borrowers with a FICO score of 620-659.

Harm to Communities

- Reduction in neighboring property values.
- Blight and higher levels of crime.
- Poorer health.
- Disproportionate impact on children, seniors, and minorities.
- Stress on community services.
- Reduced property tax receipts.

Chicago: Projected Foreclosure Rate

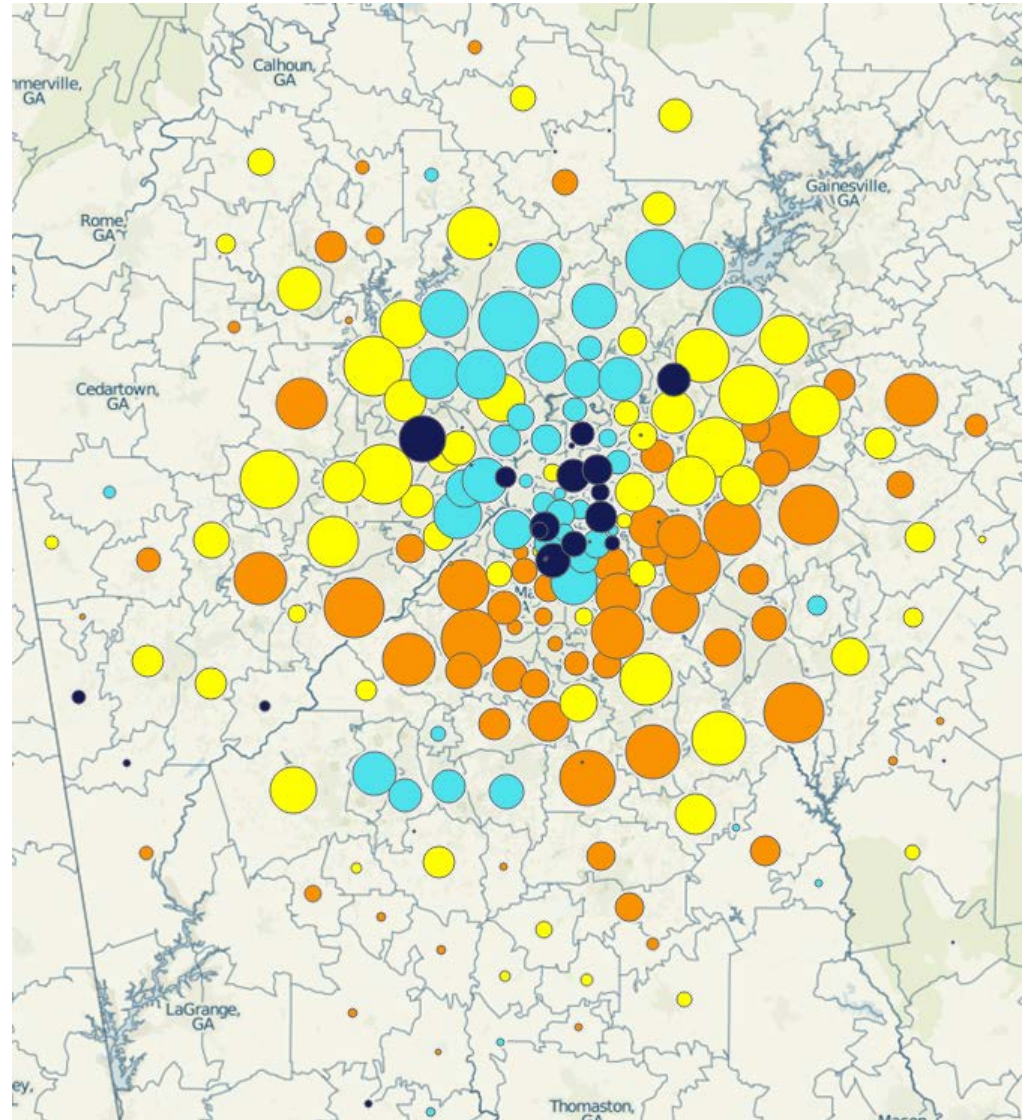
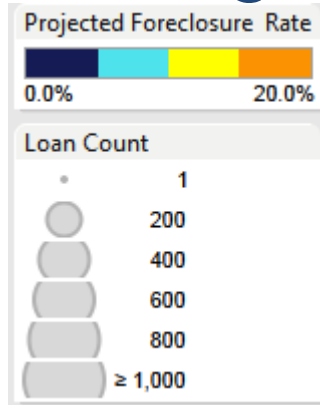


Highest foreclosure rates and greatest loan volumes are concentrated in working-class zips.

Quadrant of Doom - Chicago

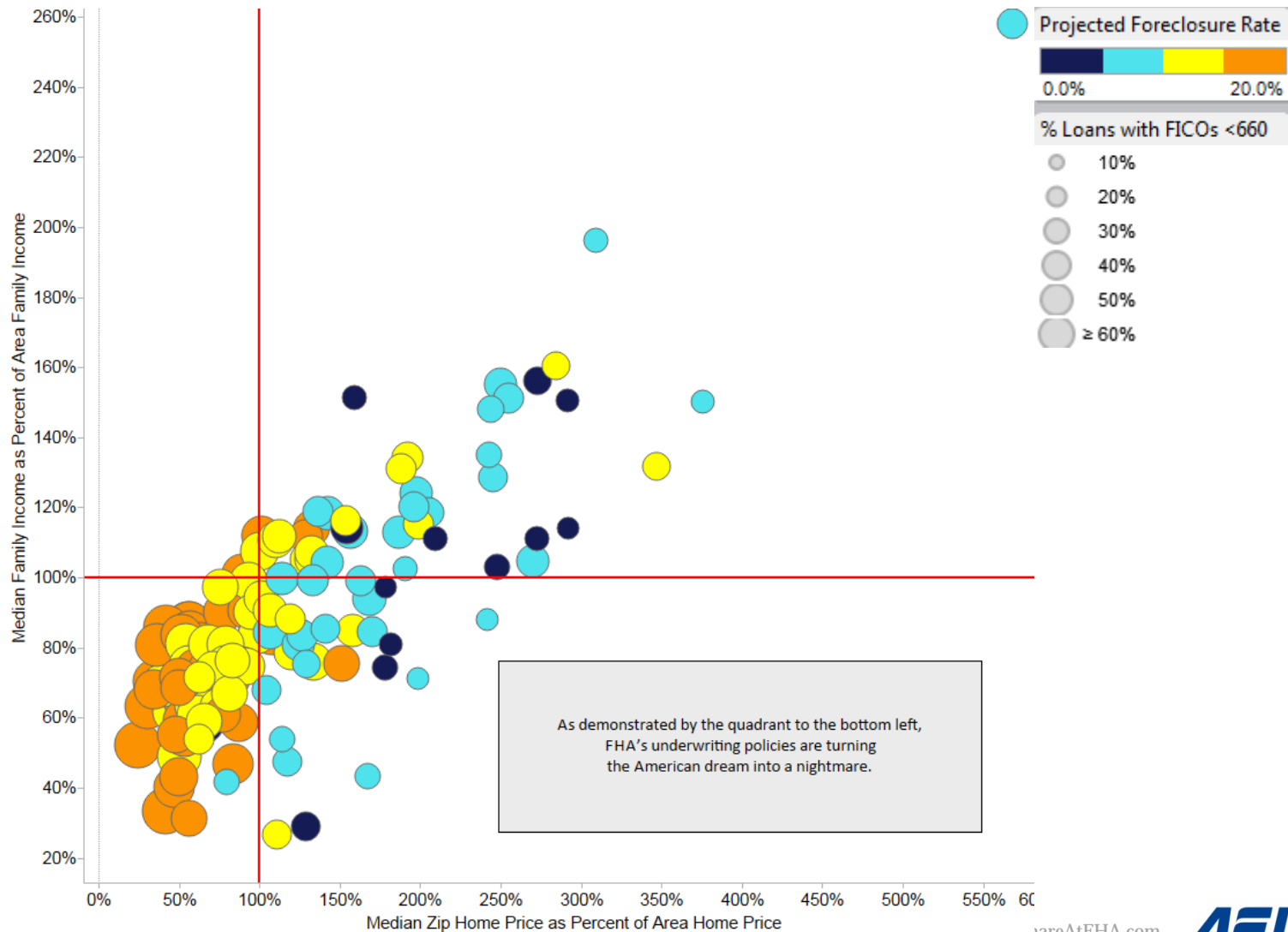


Atlanta: Projected Foreclosure Rate

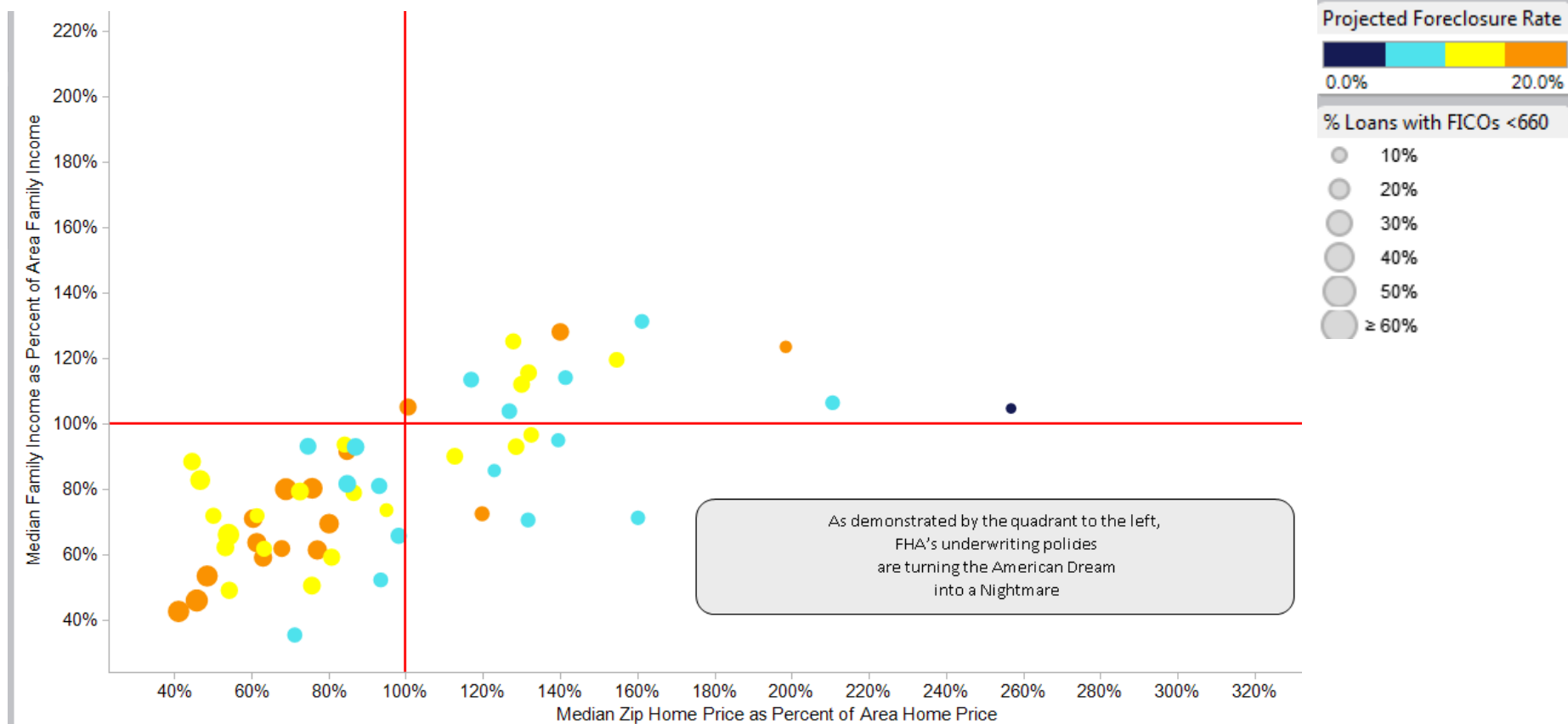


Highest foreclosure rates and greatest loan volumes are concentrated in working-class zips.

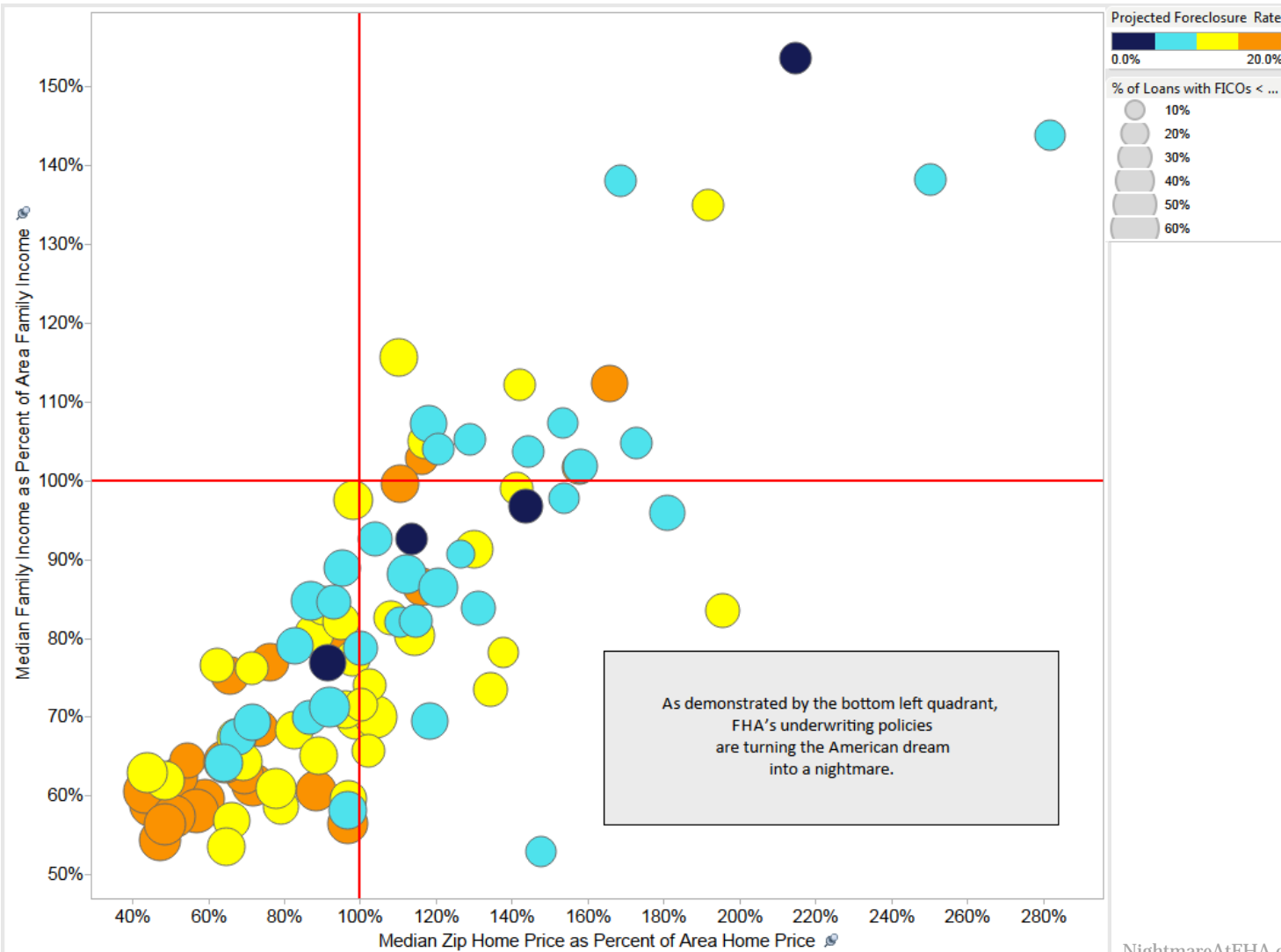
Quadrant of Doom - Atlanta



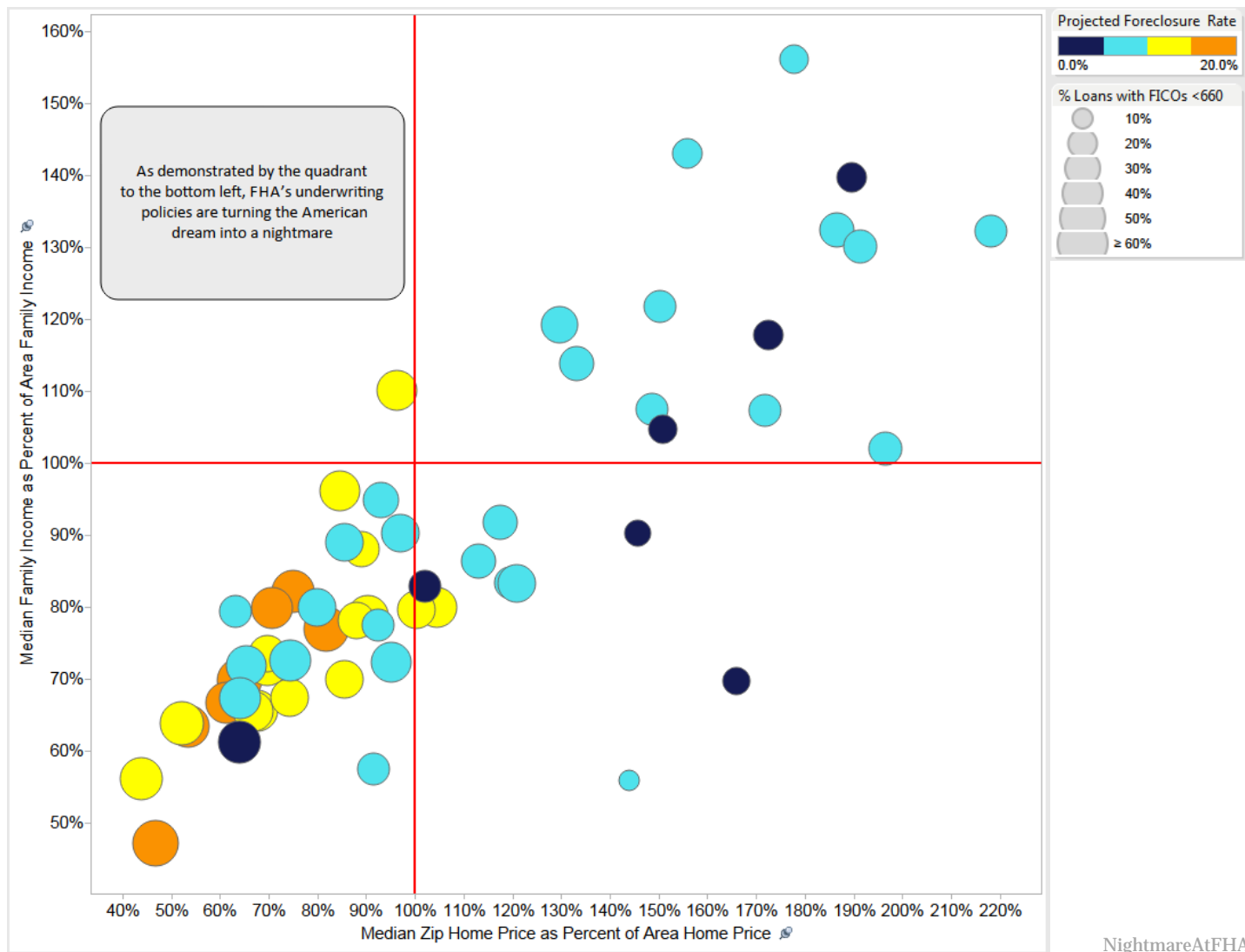
Quadrant of Doom- Miami



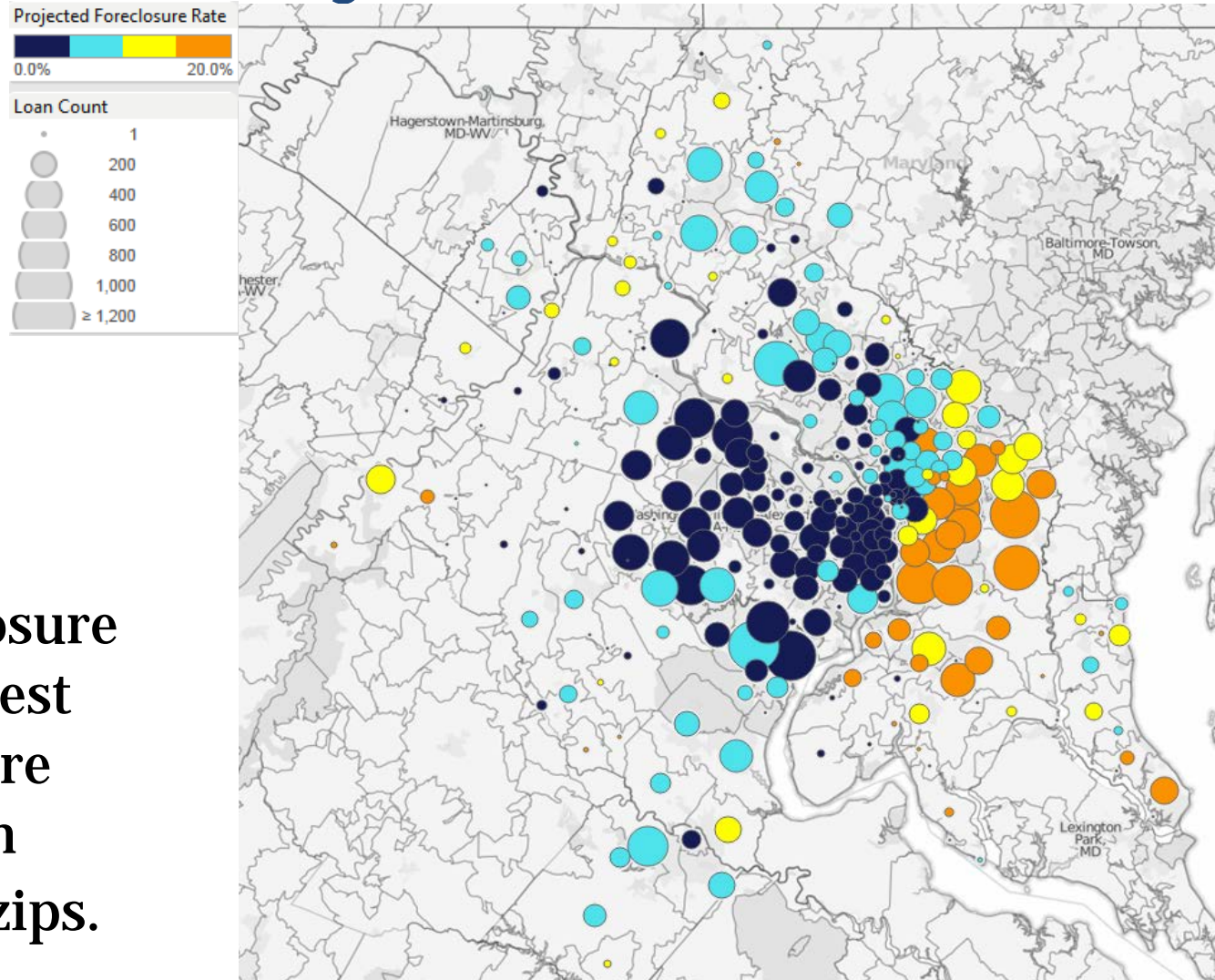
Quadrant of Doom - Tampa



Quadrant of Doom - Charlotte

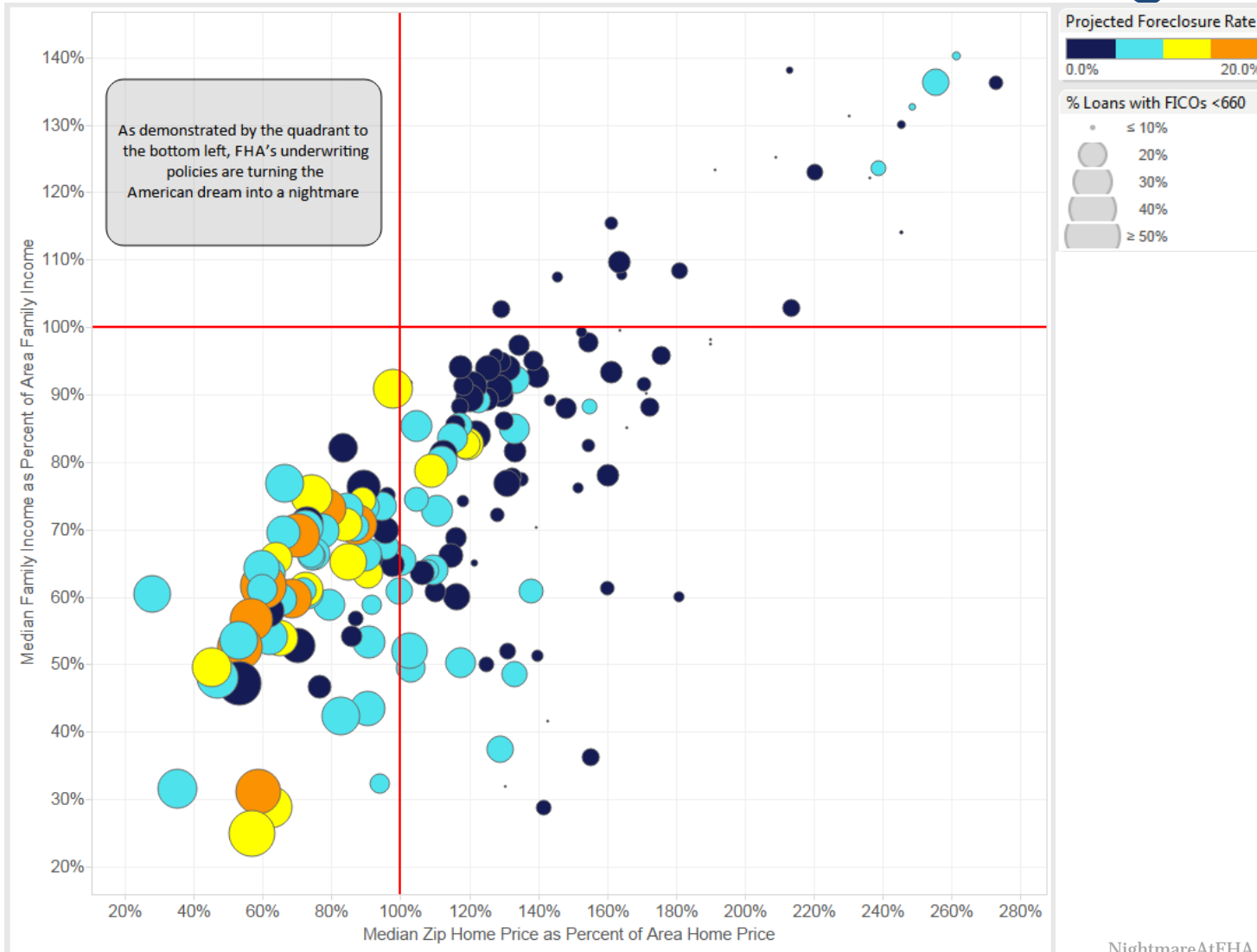


Washington, DC: Projected Foreclosure Rate



Highest foreclosure rates and greatest loan volumes are concentrated in working-class zips.

Quadrant of Doom - Washington, DC



Financing Failure, Zip by Zip



This is Atlanta, GA zip code 30349. With a 20.6% projected foreclosure rate for 2009-2010, one in five families may well lose their homes.

In 2009, the FHA or VA guaranteed seventy-eight percent of home purchase loans in that zip code.

City:	ATLANTA
Loan Count:	1,299
Median Family Income as Percent of Area Family Income:	64%
Median Zip Home Price as Percent of Area Home Price:	54%
Percent of Loans with FICOs < 660:	53.58%
Projected Foreclosure Rate:	20.6%
Zillow Home Price Index-Aug. 2012:	\$117,000
Zip Code:	30349

Image Source: www.Zillow.com

WORKING CLASS COMMUNITIES DESERVE COMMON SENSE REFORM

- Reduce coverage below 100 percent (Section 234 of the Protecting American Taxpayers and Homeowners Act of 2013 (PATH))–Appendix C;
- Advise consumer as to foreclosure risk based applicant’s risk profile (Section 236 of PATH);
- Limit seller concessions to 3 percent (Section 263 of PATH)–Appendix D;
- Utilize residual income test (Section 267 of PATH)–Appendix E;
- Reinstitute vetted appraisal panels with rotational assignment–Appendix F;
- Introduce countercyclical stress test and countercyclical LTV ratios–Appendix G;
- Underwrite for risk – balance down payment, loan term, FICO, and debt-to-income (DTI to achieve meaningful equity–Appendix H; and
- Support accumulation of meaningful equity by prohibiting second mortgages and cash out refinances and by requiring any rate reduction on a rate and term refinance to be dedicated to faster amortization.

The relevant public policy question

- What is the tolerance for failure for loans under such a government program?
- What is the tolerance for failure given the concentration of failure that occurs with respect to working class families and neighborhoods?
- Answer: These common sense reforms will allow FHA to reduce its cycle default rate to 6-7%.

Appendix A: Needy Families Deserve FHA's Full Attention

Category	% in 580-675 FICO*	Ratio to Non-Hispanic white
Non-Hispanic white	20.5%	1:1
<u>Black</u>	<u>38%</u>	<u>1.9:1</u>
<u>Hispanic</u>	<u>30%</u>	<u>1.5:1</u>
<u>Low-income census tract (<50% of median)</u>	<u>33.5%</u>	<u>1.60:1</u>
<u>Moderate-income cen. tract (>49% & -<80% of median)</u>	<u>29.75%</u>	<u>1.45:1</u>
<u>Minority population >=80% for census tract</u>	<u>33.75%</u>	<u>1.65:1</u>
<u>Age: <30 years</u>	<u>31.1%</u>	<u>1.5:1</u>
<u>Age : 30-39 years</u>	<u>28%</u>	<u>1.35:1</u>
Urban census tract	23%	1.1:1
Rural census tract	23.8%	1.16;1
All	23%	1.1:1

* Estimates based on www.federalreserve.gov/boarddocs/.../creditscore/creditscore.pdf

Appendix B: Credit Score Impact Distribution by Demographic Groups

	Fed study interest rate	Fed study credit score distribution	Fed study default rate	FHA serious delinquency rate	Non-Hispanic white	Black	Hispanic
Credit score band							
<580	9.56%	11%	30%	30%	8%	33%	17%
580-619	8.94%	8.50%	18%	20%	7%	20%	13%
620-659	7.30%	10.50%	14%	11%	9%	15%	16%
660-719	6.40%	19%	5%	2%	20%	17%	24%
>719	6.10%	51%	1%		55%	16%	30%
Some results interpolated to standardize across credit score bands							

Source: Federal Reserve, *Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit*, May 2007, www.federalreserve.gov/boarddocs/rptcongress/creditscore/creditscore.pdf.

Appendix B continued: Credit Score Impact of Financial Distress

Mortgage Delinquency Impact To FICO® Score



	Consumer A	Consumer B	Consumer C
Starting FICO Score	~680	~720	~780
FICO® Score after these events:			
30 days late on mortgage	600-620	630-650	670-690
90 days late on mortgage	600-620	610-630	650-670
Short sale / deed-in-lieu / settlement (no deficiency balance)	610-630	605-625	655-675
Short sale (with deficiency balance)	575-595	570-590	620-640
Foreclosure	575-595	570-590	620-640
Bankruptcy	530-550	525-545	540-560

Source: FICO® Banking Analytics Blog. ©2011 Fair Isaac Corporation

Appendix B continued: Credit Score Recovery from Financial Distress

Estimated Time For FICO® Score To Fully Recover

FICO

	Consumer A	Consumer B	Consumer C
Starting FICO Score	~680	~720	~780
FICO® Score after these events:			
30 days late on mortgage	~9 months	~2.5 years	~3 years
90 days late on mortgage	~9 months	~3 years	~7 years
Short sale / deed-in-lieu / settlement (no deficiency balance)	~3 years	~7 years	~7 years
Short sale (with deficiency balance)	~3 years	~7 years	~7 years
Foreclosure	~3 years	~7 years	~7 years
Bankruptcy	~5 years	~7-10 years	~7-10 years

Source: FICO® Banking Analytics Blog. ©2011 Fair Isaac Corporation

APPENDIX C

REDUCE COVERAGE BELOW 100%

- VA pays up to an average of 25%, averaging 25% while FHA pays up to 100% of the claim amount, averaging 63%.
- FHA's loss rate is an estimated 5 times the VA's (2 times the incidence and 2.5 times the severity).
- The VA charges 1/3 FHA's premium (present value basis).
- VA Issuers absorb 1.6 times the overall loss rate compared to FHA issuers for the same fee.

APPENDIX C CONTINUED

NightmareAtFHA.com

VA'S 25% COVERAGE

- **Did not deter ability to play a countercyclical role.**
 - VA's volume tripled from 2007 to 2009.
 - In 2009 the VA's median FICO score was 705, similar to the FHA's median of 694.
- **Did not deter ability to serve underserved borrowers in a sustainable manner.**
 - In 2005, 43% of the VA's originations had a FICO between 600-679, virtually identical to FHA's 44%.
- **VA has experienced substantially lower serious delinquency rates than the FHA for decades and are currently half the FHA rate (2001-2012).**

APPENDIX D

Excessive Seller Concessions

- In July 2010, FHA Commissioner Stevens proposed eliminating seller concessions $>3\%$.
 - FHA allows up to a 6% seller concession vs. 3% for conventional market:
 - The incidence of concessions and the average concession is highest for loans $< \$180,000$ (lowest loan size for which FHA provided data).
 - When concession is $>3\%$, default rate 1.9 times that of loans where 0%
(1/3 of FHA loans below \$180,000 have a 0% concession.)
 - When concession is $>3\%$, default rate 1.3 times that of loans where $>0\%$ and $\leq 3\%$.

APPENDIX E

Utilize Residual Income Test

- VA requires underwriters to identify and verify income available to meet:
 - The mortgage payment
 - Other shelter expenses (includes utilities and maintenance)
 - Debts and obligations (includes job related expenses such as child care)
 - Family living expenses
 - Residual income needs
- The resulting debt-to-income ratio (DTI) is secondary to residual income as an underwriting factor.



APPENDIX F

Reinstitute Vetted Appraisal Panels

- **Achieves Alignment of incentives:**
 - Panel selected based on experience and geographical competence (VA)
 - Size: 4500 (VA) vs. 55,000 (FHA). VA did 40% of the FHA's volume (2012)
 - Reopening of local panel based on need, additions based on competence (VA)
 - 2012: goal of increasing VA panel size from 4600 to 5800 , now at 5200
 - Assignment based on rotation (VA) vs. lender selection (FHA)
 - Three benefits of appraiser panels merit special mention:
 - Appraiser independence takes away a tool from unscrupulous parties.
 - Appraiser independence results in greater identification of needed property repairs and shortcomings.
 - "Tidewater Initiative"
 - Quality control (VA)
 - VA staff appraisers or designated lenders
 - Minimum of 10% of work is field reviewed

APPENDIX G: Countercyclical Policies Designed to Lean Against a Boom

- Countercyclical capital stress test:
 - A risk-based capital model to determine the amount of capital that is sufficient for the FHA to maintain adequate capital to cover all credit losses which are projected to occur at the higher of the rates determined as follows:
 - Consistent with a nationwide economic recession of average severity based on nationwide economic recessions since 1950 or
 - The result of house prices reverting to their long term value trend. Long term value trend shall be determined over a multi-decade and shall utilize fundamental trend values such as replacement costs, rents, household income, or consumer prices

APPENDIX G: Countercyclical Policies Designed to Lean Against a Boom

- A Countercyclical Loan-to-Value ratio (CCLTV) reflecting the underlying sustainable lending value trend.
 - The standard for the CCLTV shall consider the sustainable lending value based on long-term trends, in addition to the current price, thus creating a standard for a countercyclical loan-to-value ratio.
 - The sustainable lending value trend shall take into account the result of house prices reverting to their long term value trend.
 - Long term value trend shall be determined over a multi-decade and shall utilize fundamental trend values such as replacement costs, rents, household income, or consumer prices.

Appendix H: Underwrite for Risk

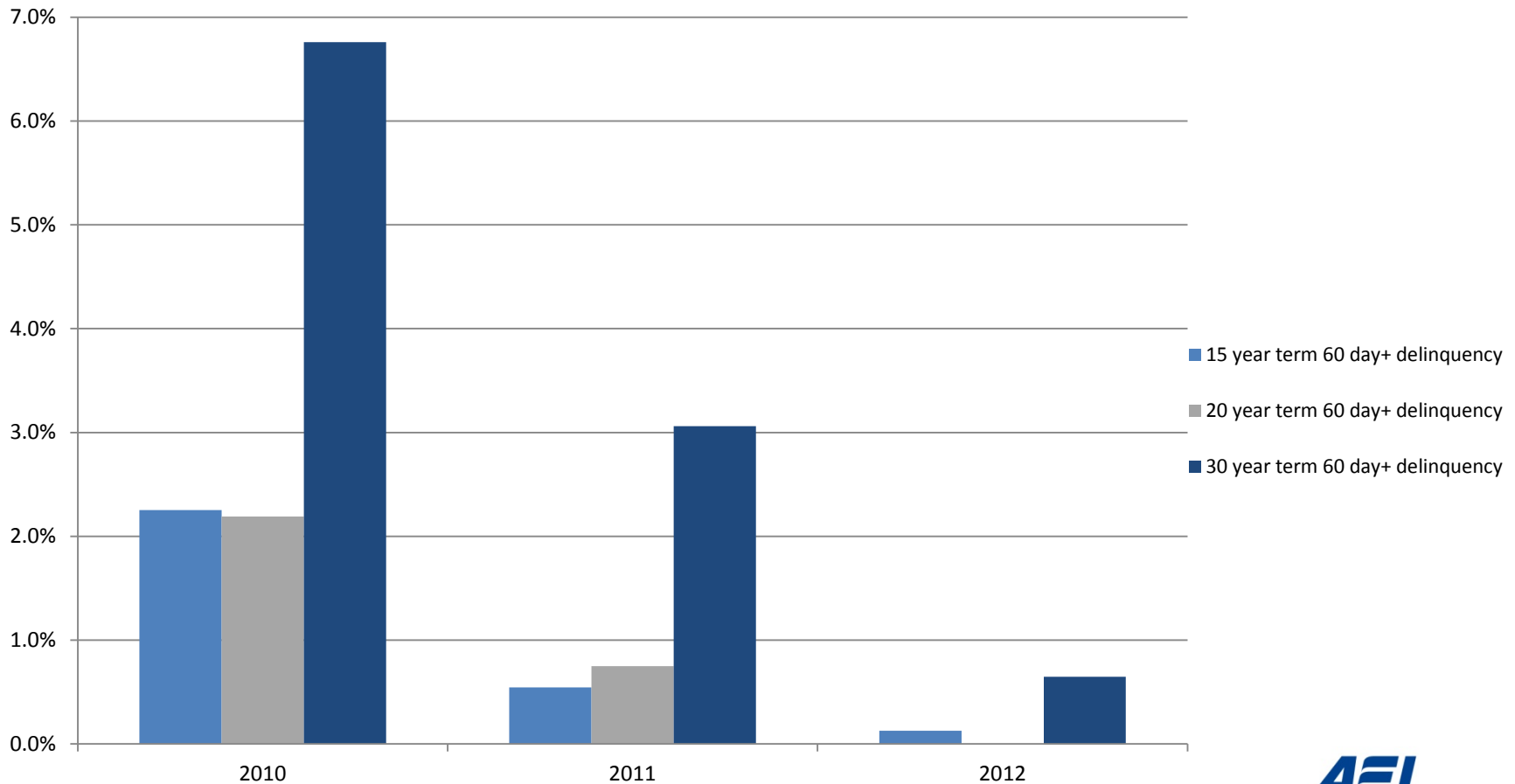
Balance Risk to Achieve Sustainability

Balance down payment, loan term, FICO, and debt-to-income ratio to expand access to borrowers with lower FICO scores, reduce expected defaults, and achieve meaningful equity. Lenders originate few FHA loans with FICOs below 640 because the likely cycle failure rate is 20-25%.

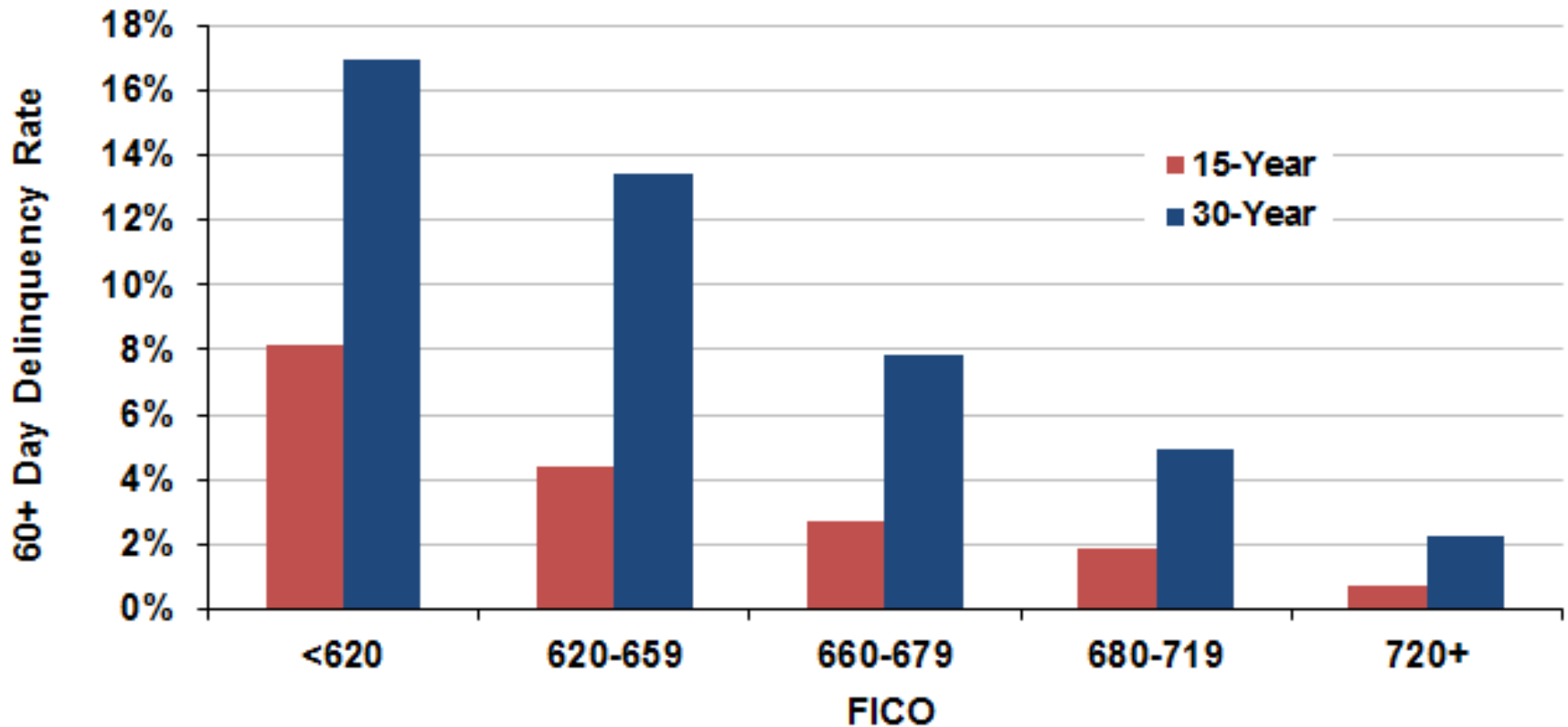
FICO	Maximum LTV limit	Maximum loan term	Maximum total DTI	Equity after 4 years	MIP Upfront/annual
580+	97.25% (current)	30 years		8%	30 yr.: 1.75%/1.30-1.35% 15yr.: 1.75%/0.45-0.70%
660-675	95.5% (proposed)	30 years	<50%	10%	30 yr.: 1%/1.50%
620-659	95.5%/90% (proposed)	20/30 years	<50%/40%	16%/15%	21 yr.: 1%/1.50% 30 yr.: 1%/1.50%
580-619	92%/85% (proposed)	15/20 years	<45%/40%	26%/25%	15 yr.: 1%/1.50% 20 yr.: 1%/1.50%

Appendix H: Underwrite for Risk

15 and 20 Year Terms Perform Well

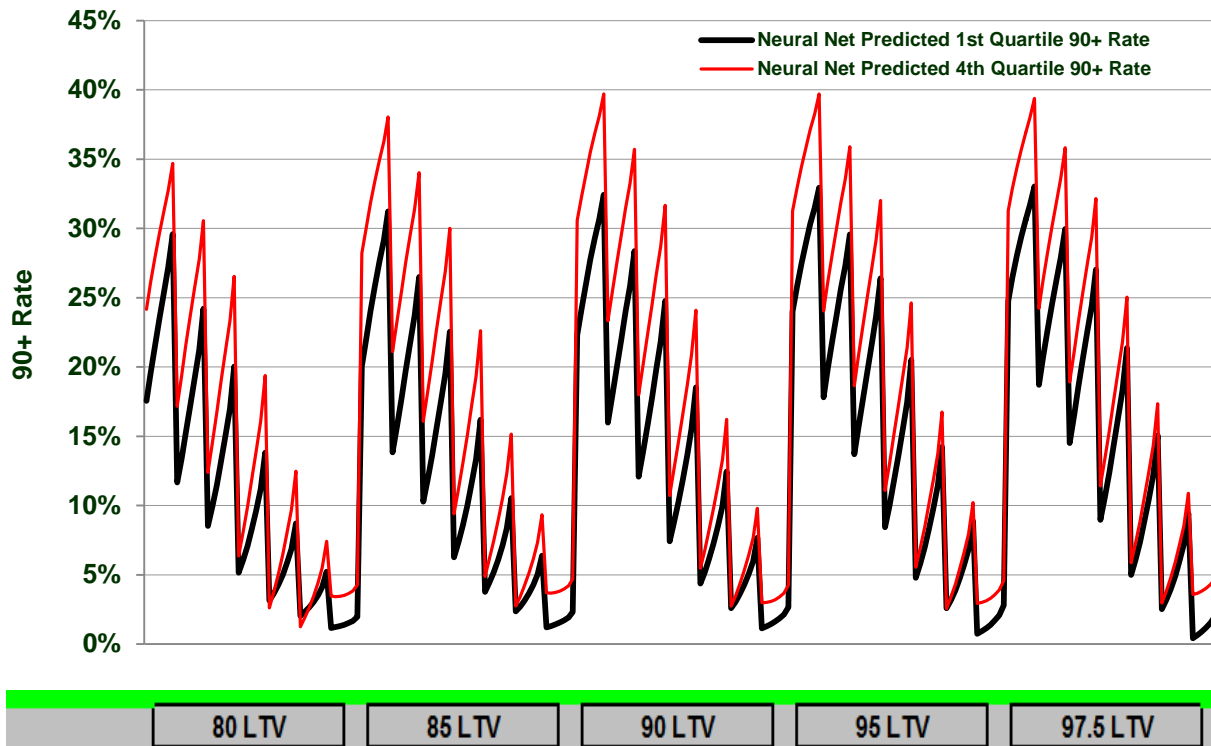


Appendix H: Better Performance for 15 Year Term across All FICO Bands - 2010



Appendix I: Disproportionate Impact on Working-Class Communities

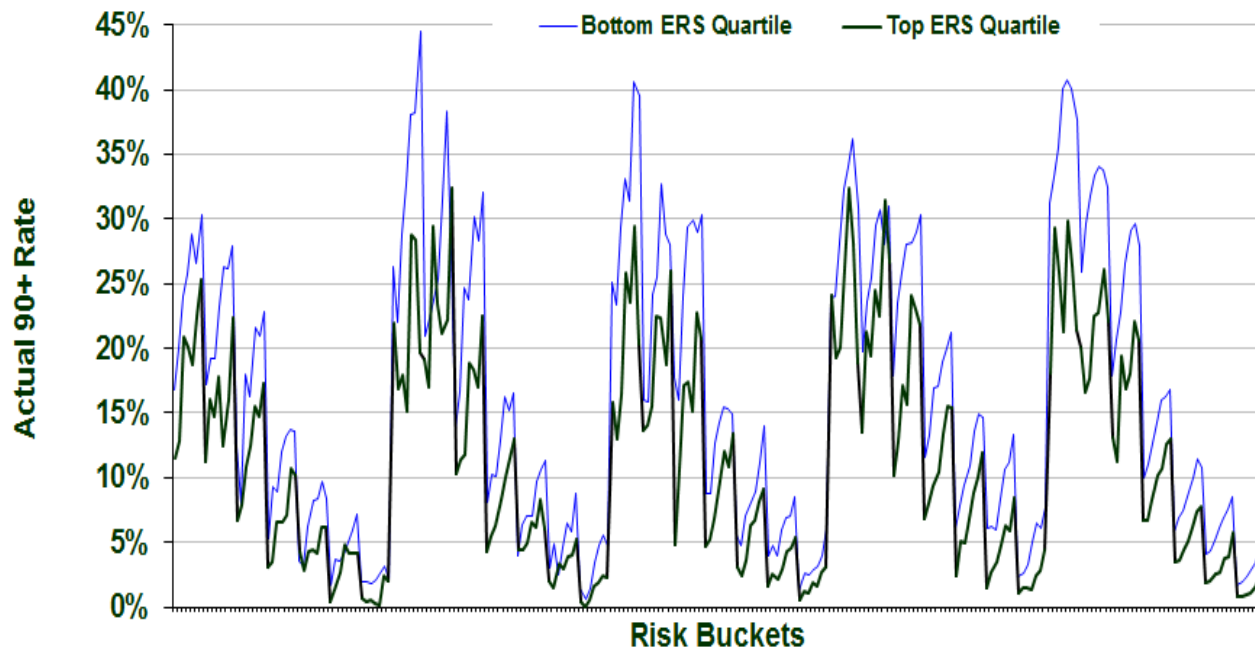
Neural Net Predicted 90+ Rate By Risk Bucket
1st & 4th Interthinx Risk Index Quartiles



Loans to FHA borrowers in zip codes with a higher fraud risk score (FRS) perform worse than loans in zips with a lower FRS, even when borrower risk factors such as FICO score, down payment, and DTI ratio are held constant across 245 risk buckets. An FHA borrower in a zip code in the 4th quartile (the 25% of the zips with the highest FRS), on average, had a 31% higher likelihood of being 90+ days delinquent compared to a borrower with the same risk factors living in a zip in the 1st quartile (the 25% of the zips with the lowest FRS).

Appendix I: Disproportionate Impact on Working-Class Communities

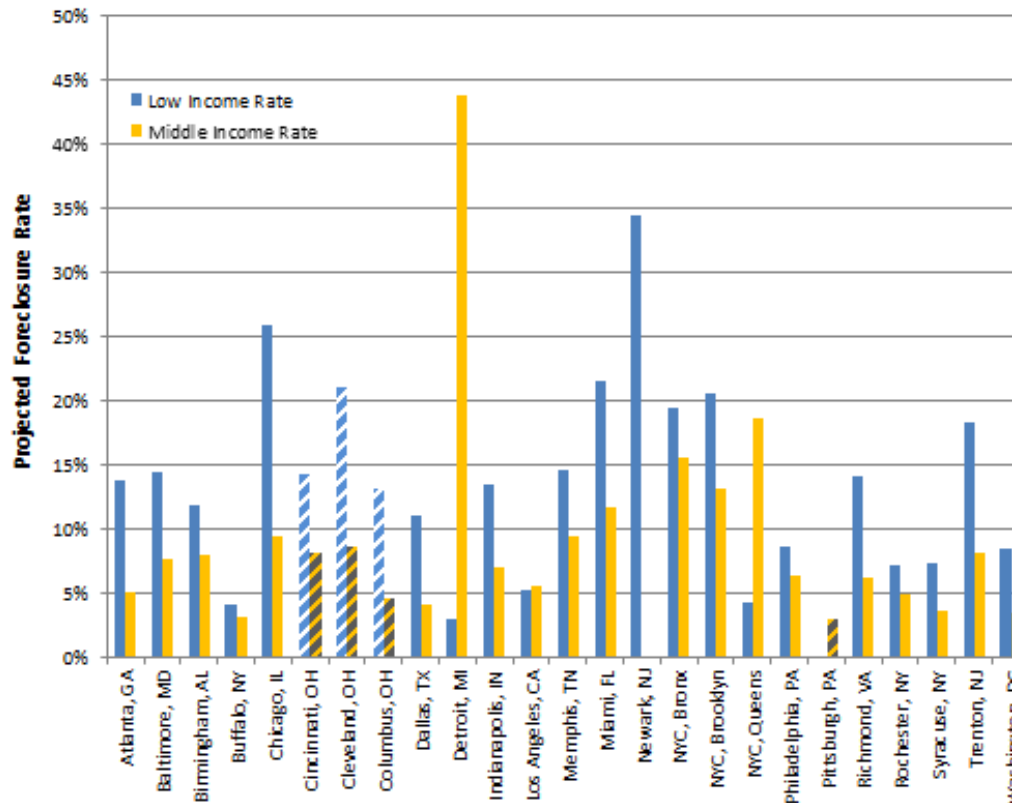
*Actual 90+ Rates by Risk Bucket
For Loans In Zip Codes In 1st & 4th Quartiles Of Average ERS*



From a study showing that an FHA borrower living in a zip code in the fourth quartile (those with a mean Equifax Risk Score of 519 to 673) had an average 45 percent higher likelihood of being 90+ days delinquent compared to a borrower with the same risk characteristics (measured across 245 risk buckets) living in a zip code in the first quartile (with mean Equifax Risk Scores of 721 to 826).

Appendix I: Harm To Working-Class Families and Communities

FHA Loan Projected Foreclosure Rate
Low Income Census Areas vs. Middle Income Census Areas
(22 cities plus 3 New York boroughs)



Note: FHA Loans originated in 2009 and 2010. Projected Foreclosure Rate is calculated as a weighted average based on loan volume.

From a recent study where 19 of 23 cities had higher FHA projected foreclosure rates in low-income zip codes than in middle-income zip codes.

Replicates the National Training and Information Center's' 2002 study for the same 22 cities (did not include Pittsburgh).

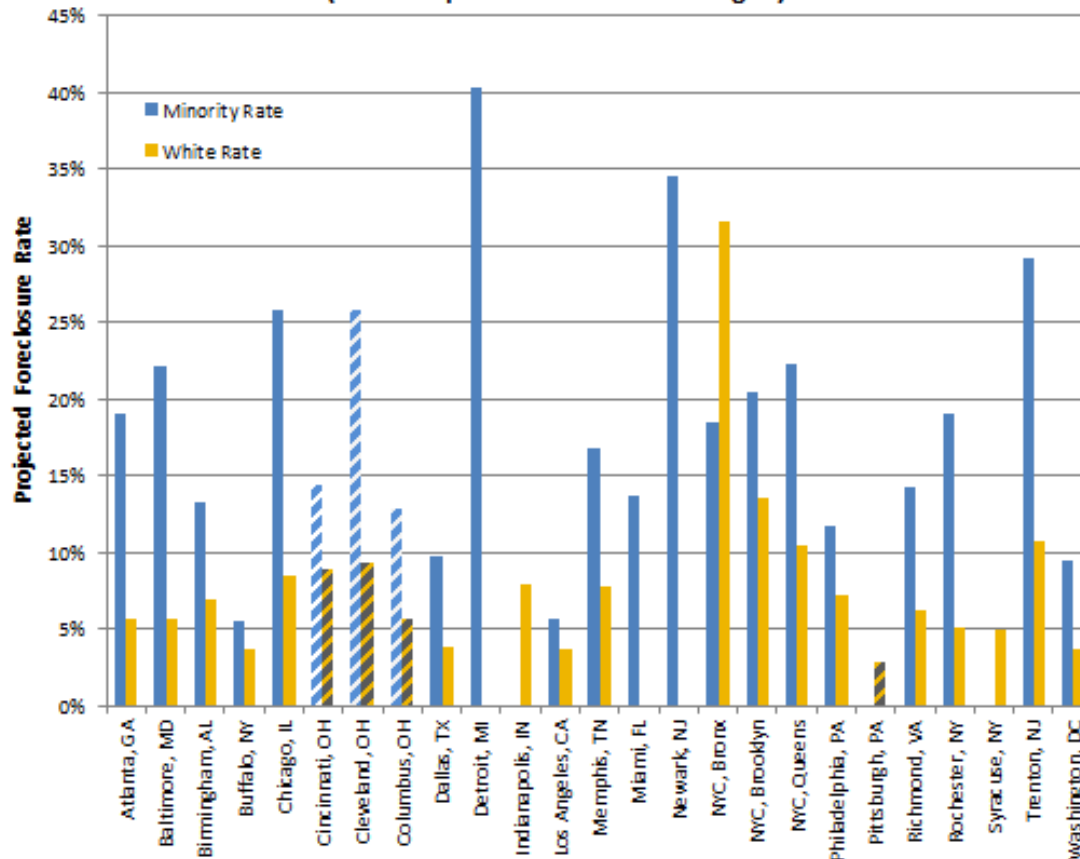
That study found 21 of 22 cities had higher FHA loan default rates in low-income census tracts than in middle-income census tracts.

Low income zip = <50% of median income

Middle income zip = 80%-120% of median income

Appendix I: Harm to Minority Families and Communities

FHA Loan Projected Foreclosure Rate
Minority Census Areas vs. White Census Areas
(22 cities plus 3 New York boroughs)



Note: FHA Loans originated in 2009 and 2010. Projected Foreclosure Rate Ratios are calculated as a weighted average based on loan volume.

From a recent study where 18 of 22 cities had higher FHA projected foreclosure rates in minority zip codes than in white zip codes.

Replicates the National Training and Information Center's' 2002 study for the same 22 cities (did not include Pittsburgh).

That study found 19 of 22 cities had higher FHA loan default rates in minority census tracts than in white census tracts.

**Minority zip = >80% minority
White zip = <20% minority**