RSC Republican Study Committee
Financial Services Working Group
Congressman Scott Garrett (R-NJ), Chairman
Congressman Tom Price (R-GA), RSC Chairman

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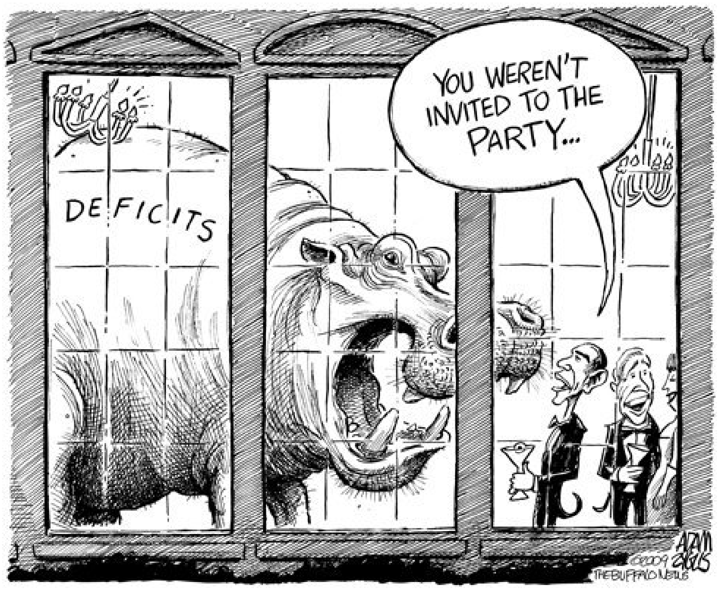
The Next Taxpayer-Funded Bailout: FHA



It's been reported recently that the Federal Housing Administration (FHA) will suffer default rates of more than 20% on the 2007 and 2008 loans. A recent study showed that FHA's key reserve ratio had dropped below the Congressionally-mandated threshold of two percent to a less than expected 0.53 percent. The Report also indicated that the economic value of the Mutual Mortgage Insurance Fund (MMIF) declined over 75 percent from last year, to $2.73 billion. If home prices do not recover, the economic value of the fund could fall below zero which could require HUD to request an appropriation from Congress: ***another government, taxpayer-funded bailout.***

The American taxpayers are tired of bailouts. The FHA announcement that their capital reserve ratio has fallen to 0.53%, just over a quarter of the congressionally-mandated level, calls into question the fiscal soundness of the agency. Many have noted the risk the FHA poses to the taxpayers, including Office of Management and Budget (OMB) Director Peter Orszag, who noted that FHA loans have accrued $15 billion in losses over recent years. We should take significant steps to reduce this risk, starting with increasing the down payment requirement for FHA loans.

How Can We Fix This Problem? The ***FHA Taxpayer Protection Act of 2009*** was introduced earlier this year to require borrowers under FHA-insured mortgages to make down payments of at least 5%. As the sponsor of this legislation, my aim was to shield taxpayers from the risk that the FHA portfolio presents. In addition to the 5% down payment requirement, an increase from the current required rate of 3.5%, the legislation would also prohibit financing of closing costs under such mortgages, and require a Government Accountability Office (GAO) study of FHA fiscal soundness.

By raising the down payment requirement to 5% and studying the challenges presented by the increased leverage ratio, I believe Congress can begin to address the main concerns with the solvency concerns of the FHA. The FHA's own actuarial report provided reasoning to support this increase, as it stated, "Based on previous econometric studies of mortgage behavior, a borrower's equity position in the mortgaged house is one of the most important drivers of default behavior. The larger the equity position a borrower has, the greater the incentive to avoid default on the loan."

Further Reading on The Next Taxpayer-Funded Bailout:

11/30/09 *Washington Post* Editorial "FHA Goes Upmarket"
11/24/09 *Wall Street Journal* Article "Homebuyer Tax Credits Threaten the FHA"
11/21/09 *Washington Post* Article "Expect Tightening from the FHA"
11/18/09 *Wall Street Journal* Blog "Toll: The FHA Is a 'Definite Train Wreck'"
11/13/09 *Wall Street Journal* Op-ed "The FHA's Bailout Warning: Whoops, there it is"
11/12/09 Garrett: "Garrett Expresses Further Concern Regarding FHA Capital Ratio"
10/15/09 AEI's Peter Wallison Op-Ed "Barney Frank, Predatory Lender"
12/01/09 Garrett: "Garrett Introduces FHA Bill Requiring 5% Down Payment"
09/29/09 *Wall Street Journal* Op-Ed "Subprime Uncle Sam"
08/11/09 *Wall Street Journal* Op-Ed "The Next Fannie Mae"
05/05/09 *Wall Street Journal* Op-Ed "The Next Housing Bust"
10/09/08 *Wall Street Journal* Op-Ed "The Next $300 Billion"

Financial Services Committee Update: In addition to holding a hearing on the FHA today at 1pm, the Committee is also concluding consideration of the systemic risk, bailout authority bill. ***The entire financial services regulatory reform overhaul package could be on the House floor as early as next week.***

Also this week
President Obama hosts Job Summit at the White House on Thursday
Fed Chairman Ben Bernanke appears in the Senate for confirmation hearing on Thursday
Employment Situation report due out on Friday

For more information contact Chris Russell at 5-4465 or Brad Watson at 6-9719

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WSJ.com

Homebuyer Tax Credits Threaten the FHA
Funding a down payment with the credit increases the odds the buyer will default.

By ROBERT C. POZEN

A few weeks ago, President Barack Obama signed legislation extending an $8,000 tax credit for first-time home buyers. The refundable tax credit, available even if a family has no taxable income, will enable many more buyers to close on a home. But it also could bankrupt the Federal Housing Administration (FHA) and, by doing so, damage an already weak housing market.

The tax credit was put in place as part of the stimulus package signed into law earlier this year. Initially, it was available only to first-time buyers with a combined income of $150,000 or less ($75,000 for individuals). Approximately 40% of all first-time buyers used the credit in 2009, so extending it was strongly supported by real estate brokers, home builders and their congressional allies.

The extension the president signed makes the credit available to first-time buyers, but also to people who have owned a home for at least five years. In addition, it raises the maximum income for a qualified buyer to $225,000 a year for couples and makes the credit available until mid-2010. (It had been set to expire at the end of this month.)

The problem is that the FHA insures mortgages of homes below certain price levels with such a low down payment that it can be funded solely by the refundable tax credit. And, as we've seen in the recent housing crisis, buyers with no skin in the game are more likely than others to default on their mortgages when the value of their home falls below their mortgage balance.

Here's how the credit allows buyers to avoid putting their own money at risk. Suppose a couple making $60,000 annually buys a home worth $200,000. They can get an FHA-insured loan if they put down 3.5% of the purchase price, about $7,000. The couple will also need to come up with another $1,000 in closing costs, for a total of $8,000. The couple can either dip into savings or borrow that money from relatives or somewhere else on a temporary basis.

After closing, the couple can quickly obtain the $8,000 refundable tax credit to pay off their temporary loan (or replenish their savings). In effect, they will have bought a home without putting any of their own money at risk. Owners who don't sink their own money into a house are much more likely to default on the mortgage.

The FHA already is facing a rising number of serious problems on its insured mortgages. Last week the agency reported that its cash reserves dropped to 0.53% of the $685 billion of total loans it insurers. This is well below the 2% federal law requires the FHA to have in reserves.

Beyond these reserves, the FHA has roughly $28 billion in a capital surplus fund, established by Congress to absorb losses on insured mortgages over the next 30 years. With the reserves and capital in hand, agency officials believe they have enough cushion to avoid needing a federal bailout. But a recent government audit concluded that the FHA would run out of money in 2011 and need a federal bailout if we have a protracted recession.

The deteriorating quality of the FHA's mortgage portfolio is a critical challenge to the housing market and the federal budget. By the end of next year, the FHA's portfolio is projected to rise to $1 trillion. Currently, over 20% of all new home mortgages are insured by the FHA.

Meanwhile, the tax credit for first-time home buyers is expected to cost the Treasury approximately $15 billion in 2009—more than twice the projected cost when Congress approved the stimulus package. Some of the cost overrun is due to fraud. At least 19,000 filers who claimed $139 million in tax refunds under this credit did not actually buy a home, according to Treasury officials. In addition, 74,000 filers claiming a total of $500 million in refunds seem to already have owned a home.

We all want to help first-time buyers acquire homes and support the depressed U.S. housing market. Without real down payments, however, new homeowners are likely to default on their mortgages, and the FHA will probably need a taxpayer bailout.

The Obama administration should increase the requirements to qualify for an FHA-insured mortgage. In addition to the 3.5% down payment, the administration should also require that buyers put down at least half of the tax credit they will receive for buying the home.

Mr. Pozen, chairman of MFS Investment Management and senior lecturer at Harvard Business School, is the author of "Too Big to Save? How to Fix the U.S. Financial System" (Wiley, 2009).