FHA Likely To Be The Next Shoe To Drop

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The FHA is a big reason that home prices haven't fallen even further. The FHA's aggressive lending programs have continued throughout the housing downturn, causing its market share of the mortgage industry to grow from 2% in 2005 to 23% today. The FHA is an even larger percentage of the new home mortgage industry, with nearly 25% market share, according to HUD.

The FHA insurance fund, however, is likely running dry. According to a report from mortgage finance experts (click here to read the report), the FHA will not meet its minimum requirement as of its fiscal year-end, which is only 27 days from now. For months, we have been investigating this and reporting our findings to our clients.

While almost all of the experts believe that Congress would support the FHA if necessary (it's currently self-funded), we wonder if FHA officials will be under pressure to continue tightening their lending policies, which currently allow 96.5% mortgages to people with 600 FICO scores. Already, FHA has contracted its own standards to require a 10% down payment for those with credit scores below 500.

Claims against the insurance fund have climbed, with roughly 7% of all FHA-insured loans now delinquent.

Given the FHA's September 30 fiscal year-end, this financial reality will come to light about the same time that other market forces run out of steam:

Just as the $8,000 tax credit expires.

Just as more of the stalled REO currently held on banks' balance sheets will be coming to market.

The culmination of all these factors means housing could see another leg down later this year or early next year.

Here are key reasons FHA is volatile:

Growing Pains: FHA lending has propped up the housing market since credit tightened and seller-funded down payment assistance went away last fall. The staff required to manage and oversee the tremendous growth has had difficulty keeping pace.

Subprime Wolves: Thousands of mortgage brokers who focused on the subprime market rebranded themselves by shifting into the FHA-backed business. Approved FHA lenders grew from just over 9,600 at the end of FY07 to nearly 14,000 today, according to HUD.

Shifting Distribution: Last November's housing bill increased the size of the loans that the FHA could guarantee. As a result, FHA lending in high-cost states rose rapidly – California, Nevada and even Florida saw their percentage of originations spike. But these are also the states where collateral value has declined the most.

No Guard Dog: It's hard to imagine, but the FHA has no Chief Credit Risk Officer, according to several industry experts including Ann Schnare, a leading FHA and mortgage finance expert with Empiris LLC. A HUD source says they are monitoring risk, however, and FHA Commissioner David Stearns expressed his personal concern in a USA Today article this week.

HUD's audit for FY08 (which ended 9/30/08) showed that the FHA capital ratio declined dramatically from 6.4% to 3.0%, but projected that it would remain above its statutory minimum of 2% going forward. Conditions have changed drastically since that time, and none of the volatile points listed above were factored into that projection.

In June, even the HUD Inspector General conceded that, "if more pessimistic assumptions are factored in, the ratio could dip below 2 percent in succeeding years requiring an increase in premiums or Congressional appropriation intervention to make up the shortfall."

In a study funded by Genworth Financial, Schnare, along with Michael Goldberg of Credit Facilitator Solutions, conducted their own analysis to come up with a more realistic projection of the FHA's capital ratio. Factoring in assumptions about future house price trends and economic conditions from Economy.com, they predict that we'll see a huge capital shortfall against the statutory minimum capital ratio of 2% by the end of this fiscal year – a shortfall of $3 billion in FY09 and $4 billion in FY10.

Recognizing that many of the market forces buoying FHA lending are running out of steam, there is a new effort on Capitol Hill aimed at FHA reform. The bill is officially titled HR 3146, or 21st Century FHA Housing Act of 2009, and its primary focus is to beef up the FHA to handle the swell of new business and to develop a mechanism to take punitive action against unscrupulous lenders and brokers.

Without a strong and active FHA, millions of potential home buyers lose access to mortgage credit. While the FHA is self-funded, it carries the full faith and credit guarantee of the U.S. government. Since taxpayers will be on the hook for credit losses, we suspect that a number of elected officials will call for the FHA to reduce risk. At the very least, expect even tighter credit to have a serious impact on home sales.

In summary, watch the growing controversy regarding the FHA very carefully. The decisions made to allow the FHA to continue lending will have a huge impact on the housing market, particularly when so few entry-level buyers have a substantial down payment.

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