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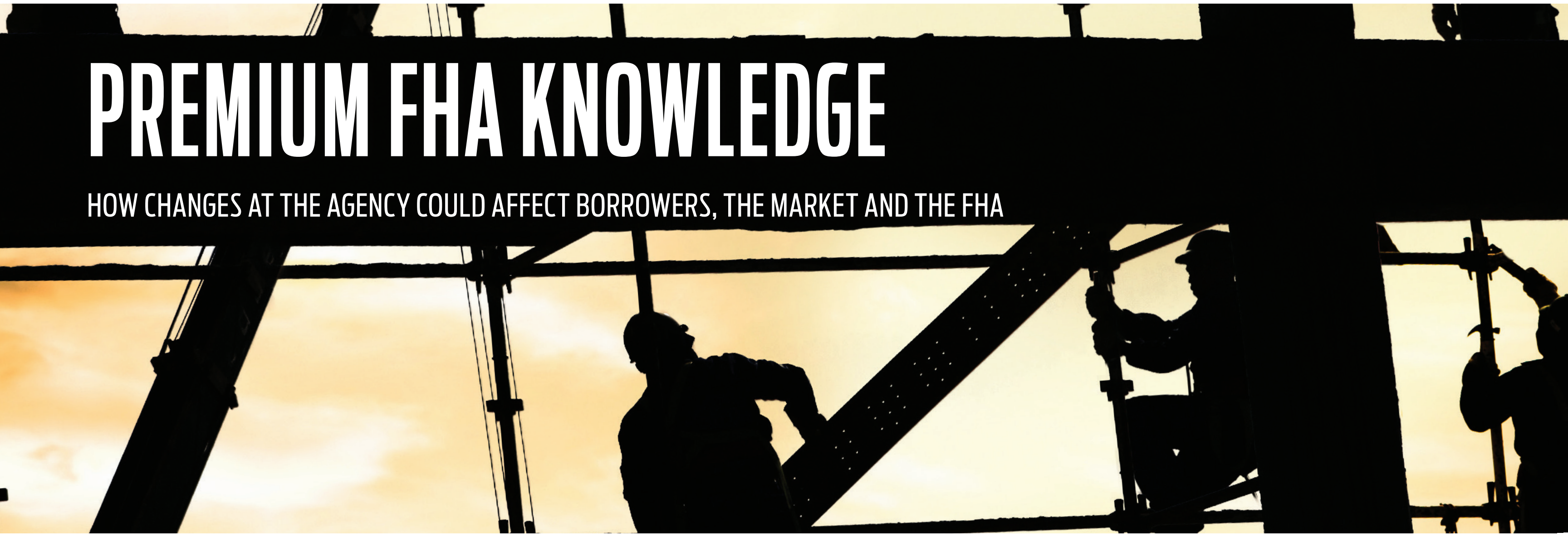

PREMIUM FHA KNOWLEDGE

HOW CHANGES AT THE AGENCY COULD AFFECT BORROWERS, THE MARKET AND THE FHA

As the housing market collapsed around it, the Federal Housing Administration moved in to prop up the remains.

The FHA, at the height of the subprime boom, insured just 3.4% of single-family mortgages originated in 2007, per total dollar volume. That share skyrocketed a year later to 16.1%, trickling down to 12.8% in 2011.

As of mid-November 2011, the FHA oversaw an insurance portfolio of $1.3 trillion.

"FHA has played a huge role in providing liquidity in the mortgage market for the past several years," said Charles Coulter, deputy assistant secretary for single-family housing in the Department of Housing and Urban Development. It's a role that's countercyclical to the dearth of the private market, he said.

After all, it is the reason the government created the FHA. Formed in 1934, the agency helped to shore up a mortgage insurance space that all but collapsed during the Great Depression.

But this time around, as the FHA significantly bolstered its market share during the recession, its own insurance fund suffered. Its reserves, as a percentage of all backed loans, fell to 0.24% in 2011, well below the required 2% level.

That led to insurance premium increases, the latest of which took effect in early April. The FHA says this will help shore up the fund, but others aren't so sure, warning of a possible dip into Treasury Department funds.

"Their scenario is quite rosy, and they're hoping they'll grow their way out of this," said Ed Pinto, a fellow at the American Enterprise Institute, a conservative think tank. "That's not necessarily a recipe for success."

When the FHA makes premium changes, Coulter said it is usually done with the impact on three different areas in mind: borrowers, the housing market and the agency's mutual mortgage insurance fund. The April changes to the one-time, upfront premium are driven primarily by the FHA's shrunken capital ratio, Coulter said.

It's a significant increase, a 75-basis-point boost — up from 1% of the initial mortgage amount. But borrowers can still receive financing on it and fold it into the loan.

"We're doing it in a way that has the least impact on the borrower," Coulter said. An upfront premium increase is not as detrimental as adding onto the annual insurance premium, he said.

But the FHA is also raising its annual premiums on new loans by 10 basis points, though not of its own volition. Legislators included the increase in the December measure to temporarily extend the payroll tax cut, the same one that increased the guarantee fees charged by Fannie Mae and Freddie Mac.

Unlike that g-fee bump, the proceeds from the FHA premium increase will stay with the agency. The FHA also decided to raise rates on mortgages above $625,000 another 25 basis points to address an additional risk in those loans, Coulter said.

The changes probably won't do much to upset the housing marketplace, said Mark Calabria, director of financial regulation studies at the Cato Institute, a libertarian think tank. It could put downward pressure on prices in markets with a constrained housing supply, he said, because borrowers focus more on the monthly payment rather than the loan balance.

Pinto notes the higher upfront rate could also bump up the initial loan-to-value ratio of the mortgage. That's assuming borrowers

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continue to pay the minimum 3.5% down payment, but Pinto said that makes it an even riskier proposition for them.

"Unless house prices really rebound, they're not going to have enough equity to sell the house in three or four years," Pinto said.

REFINANCE REDUCTION

Another set of premium changes that reduce the rates on streamlined FHA refinances could have a more direct, positive impact on existing borrowers.

The move, announced by the White House in early March, will allow certain homeowners to refinance at a lower interest rate with a next-to-nothing upfront premium charge of 0.01%. That's down from 1%, and it also includes a reduced annual premium of 0.55% from 1.15%.

"This is not something the government by itself can solve," President Barack Obama said at the time of the announcement. "But I'm not one of those people who believe that we should just sit by and wait for the housing market to hit bottom."

Eligible mortgages include only those already backed by the FHA and originated before June 2009, the same date used for the Making Home Affordable Program's loan modifications and refinances.

"The principal motivation behind that move was to help homeowners, but to do it in a way to target borrowers that were most affected by the housing downturn," FHA's Coulter said.

Calabria, a former FHA and Senate Banking Committee staffer, isn't convinced the streamlined refinance changes make much difference for borrowers, despite how good it sounds.

"It's fair to say in anybody's defense, what do you do? What is the option?" Calabria said. "It's not easy to address the fundamentals."

The refinance changes, which the Obama administration estimates could affect 2 million to 3 million homeowners, fall mostly on one side of the dichotomy the FHA must maintain.

John Weicher, who led the FHA from 2001 to 2005, said the agency strikes a balance between the public interest and financial stability. At times it will take on more risk to support new homeowners, and in harder spells tighten credit standards and raise premiums to boost its capital ratios.

"Whatever you're doing with FHA, you start with the fact that it's established to promote homeownership," said Weicher, now a senior fellow at the Hudson Institute, a conservative think tank. "It's always a balance, and the balance changes from time to time."

LENDER INCENTIVES

Another change to the streamlined refinance program could drive more lenders to get involved, as the FHA won't count a refinanced mortgage against a company if it defaults. It's the primary reason Fairway Independent Mortgage will now participate in the program, said Dan Cutaia, head of the company's risk management operations.

In 2011, Fairway originated $3.6 billion in loans, a third of those backed by the FHA, according to Cutaia.

It's likely to have more of an effect on lenders, Cutaia said, than the increases on new purchase loans.

"I don't think the premium increases will put a dent in whether or not a borrower is going to buy a house," Cutaia said.

FHA FUND IMPACT

The refinance changes, which go into effect in June, will have a negligible impact on the FHA's reserve fund, Coulter said. Those refinanced loans will likely perform better on reduced premium payments, he said.

Still, Weicher said it's possible the FHA could be missing out on potential revenue, even with a modest dip in defaults.

"You would like to keep the premiums coming in on the good loans," Weicher said. "The benefits for FHA will come somewhere down the road."

The premium increases will add $1.48 billion to the fund over 2012 and 2013, according to recent congressional testimony by Housing and Urban Development Secretary Shaun Donovan. FHA Acting Commissioner Carol Galante told legislators $8 billion total will be added to the reserve fund in 2013. The FHA, in its most recent actuarial review, projects its capital ratio on the reserve fund to go back above 2% in 2014.

"I would not call us worried at this stage of the game," Coulter said, "but I would call us focused."

The FHA's fund will receive a boost, to the tune of nearly $1 billion, from settlements with lenders, including more than $500 million from a Bank of America deal. That helps to cover a $688 million shortfall that the Obama administration estimated for the fund in its fiscal year 2013 budget, but Donovan said that doesn't include revenue from the increased premiums.

The raised premiums signify an FHA that's desperate for cash, Pinto said. The agency has altered overall premiums four times since April 2010, and has paid out $37 billion in insurance claims in the past three years. That's more than double than in the three years prior combined.

Galante said the agency wouldn't need a bailout, but some outside observers aren't so sure. University of Pennsylvania professor Joseph Gyourko said in October that the FHA would need $50 billion to $100 billion from the Treasury Department over the next several years.

A bill in the House, which passed the committee stage in late March, would allow the FHA to raise premiums up to 2.05%, giving the agency more flexibility. The measure held bipartisan support.

But like so much other congressional action during an election year, any changes made to the agency are more likely to be structural than substantial. If and when the FHA needs some extra cash, Calabria said that would likely shift the debate.

"We don't shut government programs down just because their liabilities are greater than their assets," Calabria said. ■