What's Next For The FHA?

After seesawing from a marginalized player to an industry savior, the future of the agency remains uncertain.

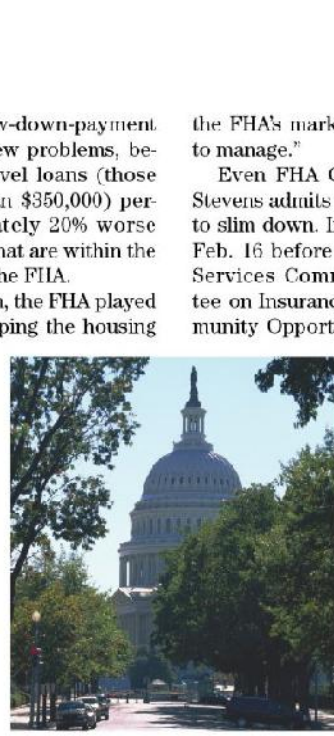
By Phil Hall

In the period prior to the September 2008 collapse of the U.S. economy, the Federal Housing Administration (FHA) had been marginalized to a point of near irrelevancy. At the time, few people imagined that this agency would be poised to become the most dynamic factor in keeping the housing finance system alive.

"The FHA had one of the greatest turnarounds since the career of John Travolta," says Scott Stern, CEO of St. Louis-based Lenders One Mortgage Cooperative and chairman of the Community Mortgage Lenders of America. "They reinvented themselves from not being a factor to being the entity that single-handedly saved the mortgage industry."

But how long can this FHA 2.0 go on? According to a recent study released by the George Washington University School of Business, the FHA has found itself with new problems as a result of its new prominence. Specifically, the report determined that the 2008 expansion of FHA's loan limits - which gave the FHA the ability to insure nearly 90% of the available low-down-payment market - created new problems, because the higher-level loans (those valued at more than $350,000) performed approximately 20% worse than smaller loans that are within the historical scope of the FHA.

"Without question, the FHA played a major role in keeping the housing market afloat during the economic collapse of 2008 and 2009, and we need to be careful about cutting back too rapidly," says Robert Van Order, a professor of finance and co-author of the report. "However, these large loan sizes are unlikely, in the long run, to assist the FHA in reaching its historical constituencies. Our research indicates that larger loans are likely to perform worse than FHA's traditional market, and we are concerned that the rapid increase in the FHA's market share will be hard to manage."



Even FHA Commissioner David Stevens admits that his agency needs to slim down. In testimony delivered Feb. 16 before the House Financial Services Committee's Subcommittee on Insurance, Housing and Community Opportunity, Stevens spoke of the need for a leaner FHA.

"We do not want the FHA to have such a substantial share of the market - and we are very aware of the risks this elevated role poses," Stevens said. "While the FHA's countercyclical role has been essential to providing liquidity to the housing market to prevent further disruptions in the broader economy, the Obama administration believes that meeting the diverse homeownership and rental needs of the country requires a strong, safe and healthy market for private capital."

As for the future, Stevens proposed taking the FHA back to its pre-housing-bubble schematics.

"We want to return the FHA to its traditional role as a targeted lender of affordable mortgages," he continued. "As Fannie Mae and Freddie Mac's market presence shrinks, the administration will coordinate similar reforms at the FHA to ensure that the private market - not the FHA - picks up that new market share."

However, in the absence of a concrete plan for housing finance form, the FHA's role for the near future remains unclear. Does the agency have the ability to maintain its dominant role in the market? Can the private sector fill the void created if the FHA were to voluntarily shrink its market share? Or is it too soon to start talking about shrinking down the FHA's operations?

According to Jordan Brown, CEO of Ponte Vedra Beach, Fla.-based MarketWise Advisors LLC, the FHA spent most of the past nine years in circumstances far beyond its traditional role.

"Their market share increased fivefold over the last five years - from four percent to a little over 19 percent," Brown says. "But their market share from 2002 to 2007 was an anomaly - traditionally, they have an 11 percent to 14 percent share of the market."

Tough enough

Despite early concerns from some parts of the industry that the FHA risked being overextended by being forced to play a much larger role in the market, it appears that the agency has been able to fill the vacuum left by the tumultuous changes in the mortgage banking industry. On the whole, the industry believes the FHA can continue at its current pace.

"I have no doubt that the FHA has the wherewithal and staff to do it," says Kevin Breeland, general manager of Residential Mortgage of South Carolina LLC, based in Mount Pleasant, S.C. "They have become a big player, much larger than the FHA intended to be or is comfortable being."

But can the FHA - and, by extension, the housing finance sector - benefit from the agency maintaining a larger-than-normal market share? Breeland believes that, if anything, the FHA is showing no signs of being readied for shrinkage.

"As underwriting continues to get tighter, government lending through the FHA will get more play," he says.

Mark Greco, president of the Austin, Texas-based 360 Mortgage Group, concurs. "I don't see FHA market share doing anything but increasing," he says. "To have the FHA as a choice is a good thing: FHA spurs homeownership with lower down payments and by being a little less rigid in some quality underwriting guidelines, though it is not to say they're loose in underwriting. Overall, the FHA is a viable and imperative solution for righting the books of financial institutions across the country."

Stern points out that the main reason for the FHA's robust performance has been its adherence to quality.

"The FHA decided they didn't want to be the buyers of last resort," he says. "They've tightened their underwriting guidelines - they did not want to be the dumping ground for all bad credit loans."

"They never lost one cent for the government," observes Dan Cutaia, president and chief operating officer of Fairway Independent Mortgage Corp., headquartered in Sun Prairie, Wis. "They never modernized underwriting requirements, and they have underwritten loans prudently for decades and decades. They have the market share today, because the private sector pulled out of high loan-to-value (LTV) lending. Who's left standing? The FHA, to fulfill the purchase market void."

The more things change...

But will the FHA's strong role remain the new normal? Joseph Murin, former president and CEO of Ginnie Mae and chairman of The Collingswood Group, based in Washington, D.C., predicts that things will remain the same.

"I don't think we'll see the FHA program go away or be minimized, as [it was] over the past decade," he says. "The industry learned its lesson, and I don't think we'll see folks give up on the FHA platform."

Murin adds that the FHA has proven to be a federal housing success story. "Look at their portfolio," he says. "They have very solid underwriting requirements that were never changed. They're making good money for the federal government."

Ruth Lee, vice president of sales at Denver-based Titan Lenders Corp., also believes the current market setup will remain intact for the foreseeable future, albeit for different reasons.

"The FHA has a competitive advantage: a virtually unlimited liquidity supply," she says, adding that there is currently "no exit strategy" to recede from its current market share.

Yet Scot D. Baker, senior vice president of business development for Pyramid Quality Assurance, based in Reno, Nev., predicts that the FHA market dominance will slowly begin to subside.

"I see their share decreasing to about 15 percent, for a number of reasons," he explains. "Fannie Mae now has a viable 97 percent LTV product, while the mortgage insurance companies are looking for more market share. Higher-quality borrowers do not want to be saddled with FHA's mortgage insurance premium for a minimum of five years. Subprime 100 percent loans are never coming back to replace the FHA, as they did from 2001 to 2007."

Mark Milam, vice president at Atlanta-based Fidelity Bank, is already reporting a slowdown in FHA activity.

"I think the future of the FHA is

page 21 ➤

◄ page 13

already here," he says. "In the last quarter of 2010, our FHA originations were down to 10 percent of total volume, versus 35 percent in early 2010. Lenders need a variety of personal mortgage insurance companies and a focus on higher-credit-score borrowers. The FHA will continue to shrink."

Richard Rydstrom, chairman of the Los Angeles-based Coalition for Mortgage Banking Solutions, warns that a continuation of the current setup may not benefit anyone in the long run.

"The FHA/Ginnie Mae tag team is carrying the load and ballooning into a giant," he says. "The securitization pie is missing the private-sector cherries. The private sector must step up, plant the seeds of rejuvenated securitization and/or new product solutions and harvest the majority of the fruit, or we will not fully recover. Without a rejuvenated, robust securitization market or a viable covered-bond piece, the FHA and Ginnie Mae will remain the only major games in town.

"However," he continues, "if default rates become significant, the FHA and Ginnie Mae will enter the hospital as well. They were not designed for this task, and they will be exposed to great risk. If an agreement cannot be reached on the Fannie Mae and Freddie Mac restructuring, and if the securitization market and the new covered-bond market do not add substantial liquidity to the mortgage finance market, then the FHA and Ginnie Mae will remain under great stress and become the next Fannie Mae and Freddie Mac."

Ultimately, industry leaders believe that policymakers will not engineer the FHA's fate. Instead, they believe that the agency will respond to what the market requires. And, for now, it requires the FHA's input and support.

"The FHA is always going to be a big piece of what we're doing, especially with first-time home buyers and middle-class home buyers," says Pat Peavly, executive vice president at McLean Mortgage Corp., in Tyson's Corner, Va. "A lot of people want to buy a house, but they do not have the opportunity to save 10 percent or 20 percent. The FHA obviously has a place for these folks."

A.W. Pickel III, president and CEO of LeaderOne Financial Corp. in Overland Park, Kan., finds the same scenario with his borrowers. "I still hear from agents today about people with decent credit that cannot do a down payment," he says. "Because we cannot do a 100 percent loan, the next best thing is the FHA at 3.5 percent."

"Over the last three years, the FHA's market originations went from three percent to 30 percent," says Rydstrom. "This trend is expected to continue exponentially as the demand and need for FHA products becomes the only avenue for many borrowers in these times of growing negative equity, weakening FICO scores, growing underemployment, exhausted savings and rising debt."

Yet Stern points out that the FHA can only be as good as the industry participants with which it works.

"As an industry, we need to be careful about one thing: The protection of the FHA is very much in the hands of the lenders that sell the loans," he says. "Congress has very little tolerance for an FHA that loses money. We need to do everything we can to ensure sanctity of the FHA insurance fund." SME

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