NEED TO KNOW

AMERICANS FOR PROSPERITY FOUNDATION

FEDERAL HOUSING ADMINISTRATION

During the Great Depression, homeownership and home lending levels declined significantly. After the stock market crash of 1929, lenders attempted to preserve their balance sheets by tightening lending standards for home loans—lending only to individuals with stellar credit histories and a clear ability to make payments on time. Individuals could only take out 3- or 5-year mortgages with very high down payments.

In response, in 1934 the federal government created the Federal Housing Administration (FHA), charging it to provide potential home buyers with easy access to home loans. With the FHA's generous taxpayer-backed insurance standing behind them, lenders started to lower requirements on down payments and eventually made it possible for individuals to take out 30-year home loans.

Since its inception, the FHA has used taxpayer money to insure over 34 million home mortgages (2).

FHA'S INTERVENTIONS IN THE HOUSING MARKET

Too often government pursues a laudable goal (such as expanding home ownership), but their interventions can distort the economy, cause individuals to arbitrarily change their behavior, and ultimately leave everyone worse off. The FHA's lending practices are textbook examples.

FHA's goal is to make it easier for borrowers to gain access to affordable housing (a goal the federal government has long pursued). FHA tries to accomplish this by fully guaranteeing the principal and interest payments on any FHA-backed home loans. In other words, if borrowers with an FHA loan fail to make their payments on time or go into foreclosure ("default"), the FHA promises to step in to pay off the rest of the loan – making banks more willing to lend to medium- and high-risk borrowers, or lend to those who can only make a small down payment.

While on the one hand this expands access to homeownership, on the other hand the FHA obligates taxpayers to share the burden for risky (and some-times irresponsible) home mortgages that the free market might otherwise not encourage.

THE 2008 SUBPRIME MORTGAGE CRISIS AND FHA

Following the collapse of the housing bubble and the subsequent recession, Congress turned to the FHA to try to prop up the faltering housing market, granting them significantly increased authority to guarantee even more mortgages. As a result, FHA insured over 4.5 million new loans from 2008-2010—guaranteeing loans at a much faster pace than they had in the past, which vastly expanded their balance sheet.

QUICK FACTS

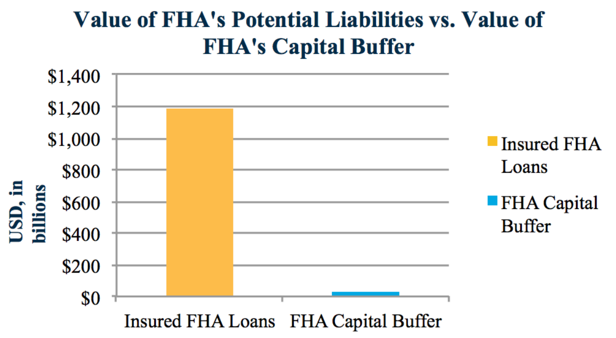
- In an attempt to increase homeownership, Congress created the FHA during the Great Depression to provide people with subsidized access to home loans.
- In 2008, FHA was authorized to guarantee up to $300 billion for new mortgages, including for borrowers with poor credit histories and/or other worrisome financial outlooks.

NOTABLE & QUOTABLE

"The FHA continues to expand and crowd out the private sec- tor. It is guaranteeing more high-risk loans than low-risk ones, has close to one million mortgages in its foreclosure pipeline, and is permitted to project its financial health using accounting rules based on rosy projections extending decades into the future, all the while ignoring that it is already insolvent and needs a bailout to the tune of tens of billions of dollars by any reasonable accounting standard."

-**Edward J. Pinto**, American Enterprise Institute (1)

Unfortunately, this means FHA has placed itself (and consequently, U.S. taxpayers) at an extraordinary amount of risk. In total, FHA now has over $1 trillion in potential liabilities (3). Meanwhile, it only holds only $30 billion as a capital buffer (4). In other words, for every $1 that FHA has in reserve, it guarantees to pay $30 dollars to cover potential mortgage defaults. If too many people default on their FHA guaranteed loans, that buffer will quickly evaporate, leading to a taxpayer bailout to fulfill the rest of FHA's promises. FHA underwent its first bailout of $1.7 billion in 2013 (5).



The problem is made worse because many of the FHA's new loans are quite risky. First, many FHA-insured mortgages go to medium and high risk borrowers—those with poor credit histories, for example. Second, FHA loans allow borrowers to take out loans with extremely low down payments (between 0% and 3%) which leave borrowers underwater if housing prices fall even slightly. Finally, when one of the strongest risk factors for a mortgage default is a job or similar financial stress, defaults are more likely in a weak economy with stagnant growth and high unemployment. A double-dip recession or another wave of widespread employment-related defaults could easily wipe out FHA's real assets.

CONCLUSION

Although people like the notion of every person owning his own home, disastrous unintended consequences can occur when this laudable goal becomes a policy mandate. FHA's intervention in the housing market has backed dangerous lending practices under the assumption that FHA can rely upon taxpayers to cover the cost if all does not go well. Meanwhile, FHA itself is severely under-capitalized. In short, the FHA's guaranteed-lending policies force American taxpayers into a high-risk gamble with billions of dollars at stake.

Endnotes:

1. Edward J. Pinto, FHA Watch—January 2012, American Enterprise Institute (January 23, 2012) (online at http://www.aei.org/article/fha-watch-january-2012/).
2. Department of Housing and Urban Development, (online at http://portal.hud.gove/hudportal/hud?src=/program_offices/housing/fhahistory).
3. Department of Housing and Urban Development, “Monthly Report to the FHA Commissioner,” (May 2012) (online at http://portal.hud.gov/hudportal/documents/huddoc?id=12may.pdf)
4. Edward J. Pinto, FHA Watch—June 2012, American Enterprise Institute (June 19, 2012) (online at http://www.aei/article/economics/financial-services/housing-finance/fha-watch-june-2012/)
5. FHA bailout http://thehill.com/policy/finance/260278-fhas-balance-sheet-continues-strong-rebound