

Rising FHA Default Rate Foreshadows a Crush of Foreclosures

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The share of borrowers who are falling seriously behind on loans backed by the Federal Housing Administration jumped by more than a third in the past year, foreshadowing a crush of foreclosures that could further buffet an agency vital to the housing market's recovery.

About 9.1 percent of FHA borrowers had missed at least three payments as of December, up from 6.5 percent a year ago, the agency's figures show.

Although the FHA's default rate has been climbing for months and eating into the agency's cash, the latest figures show that the FHA's woes are getting worse even as the housing market shows signs of improvement. The problems are rooted in FHA mortgages made in 2007 and 2008. Those loans are now maturing into their worst years because failures most often occur two to three years after a mortgage is made.

If the trend continues and the FHA's cash reserves are exhausted, the federal government would automatically use taxpayer money to cover the losses -- a first for the agency, which has always used the fees it charges borrowers to pay for its losses.

As these loans from 2007 and 2008 go bad and clear off of the FHA's books, agency officials said, losses are expected to taper off, aided by the housing market's anticipated recovery and an influx of more creditworthy borrowers, who have flocked to the FHA's home-buying program in the past year.

Agency officials said they have cracked down on poorly performing lenders and announced higher qualifying fees for borrowers. On Monday, the agency projected that the fees should generate \$5.8 billion in fiscal 2011, up from \$2 billion this year. That would fatten the FHA's cash cushion, used to cover unexpected losses.

Beleaguered books

For now, just about every major measure of the agency's financial health is worsening.

The FHA does not make loans but insures lenders against losses. And claims have already spiked. The agency had to pay out on 47 percent more loans in October and November than in the corresponding period a year earlier, according to an FHA report.

The number of loans in foreclosure, including those that have not yet been billed to the agency, has also increased. They were up 26 percent in the last quarter from a year earlier.

FHA Commissioner David H. Stevens, who joined the agency in July, flagged his agency's troubles with the 2007 and 2008 loans in October, when he told a House panel that "rogue players on the margin" immediately migrated to the world of FHA lending after the subprime mortgage market collapsed.

Their aggressive lending tactics attracted borrowers with unusually poor credit profiles to the FHA. "That clearly impacted the books of business in 2007 and 2008, and that performance data is showing up very clearly in today's balance sheet," Stevens said at the time.

Plunging home prices have exacerbated matters by leaving some FHA borrowers unable to sell or refinance their homes because they owe more than their homes are worth. Yet with unemployment running high, many borrowers can't afford to keep up their payments.

Adding to the trouble was a now-defunct FHA program that enabled sellers to cover the down payments of buyers. This meant many borrowers had no skin in the game and were more likely to walk away at early signs of trouble. The program resulted in excessive defaults before it was ended in late 2008, and it is projected to cost FHA an additional \$10.5 billion in losses, Stevens said.

For all these reasons, the FHA projects that it will pay out claims to lenders on one out of every four loans made in 2007 -- the worst rate in at least three decades. The claim rate should be nearly the same on the vastly larger volume of loans made in 2008.

Better borrowers

But agency officials said they have reasons to be optimistic.

The FHA-backed loans made in 2009 tended to go to borrowers with higher credit scores than in previous years. These borrowers turned to the FHA when the mortgage market collapsed and other lending sources dried up. By then, reputable lenders doing business with the agency were already imposing tougher restrictions on FHA borrowers, further boosting the credit profile of those loans. The average credit score of an FHA borrower is now 690, up from 630 only two years ago, agency officials said.

These higher-quality loans are expected to result in lower losses, so the agency should make money on loans issued this year and over the next few years, according to an independent audit designed to gauge the agency's health.

The audit, released in November, found that the cash the FHA set aside to pay for unexpected losses had dipped to historic lows, well below the level required by law. As of Sept. 30, those reserves were estimated at \$3.6 billion, down from nearly \$13 billion a year earlier.

The most recent figure represents 0.53 percent of the value of all FHA single-family-home loans -- far lower than the 2 percent required by Congress.

But Ann Schnare, a former Freddie Mac official, said the situation could be even worse. She said the audit underestimates future losses because it does not take into account all loans that are now overdue, only those that the FHA has paid claims on.

Stevens said his agency has pored over its data to analyze risk and is taking steps to shore up its financial health. "You have a limited set of options under these circumstances: Raise fees [for borrowers] or make policy changes," Stevens said in an interview. "We've done both."

The agency banned 268 lenders from making FHA loans last year, more than double the total terminated in the previous eight years. The FHA suspended six other firms. Among them were some of the largest FHA lenders -- Taylor, Bean & Whitaker and Lend America, both of which shut their doors soon thereafter.

The agency also proposed a rule that would require banks to hold up to \$2.5 million in capital that they can use to repay the agency for losses if they were involved in fraud. Banks are now required to hold only \$250,000.

Borrowers are also facing tougher scrutiny from the agency. People taking out FHA loans will have to pay higher upfront fees, perhaps as early as this spring. Those with especially weak credit scores will also have to put down at least 10 percent instead of the usual 3.5 percent down payment. The amount of money sellers can kick in toward closing costs and other fees will also be limited.