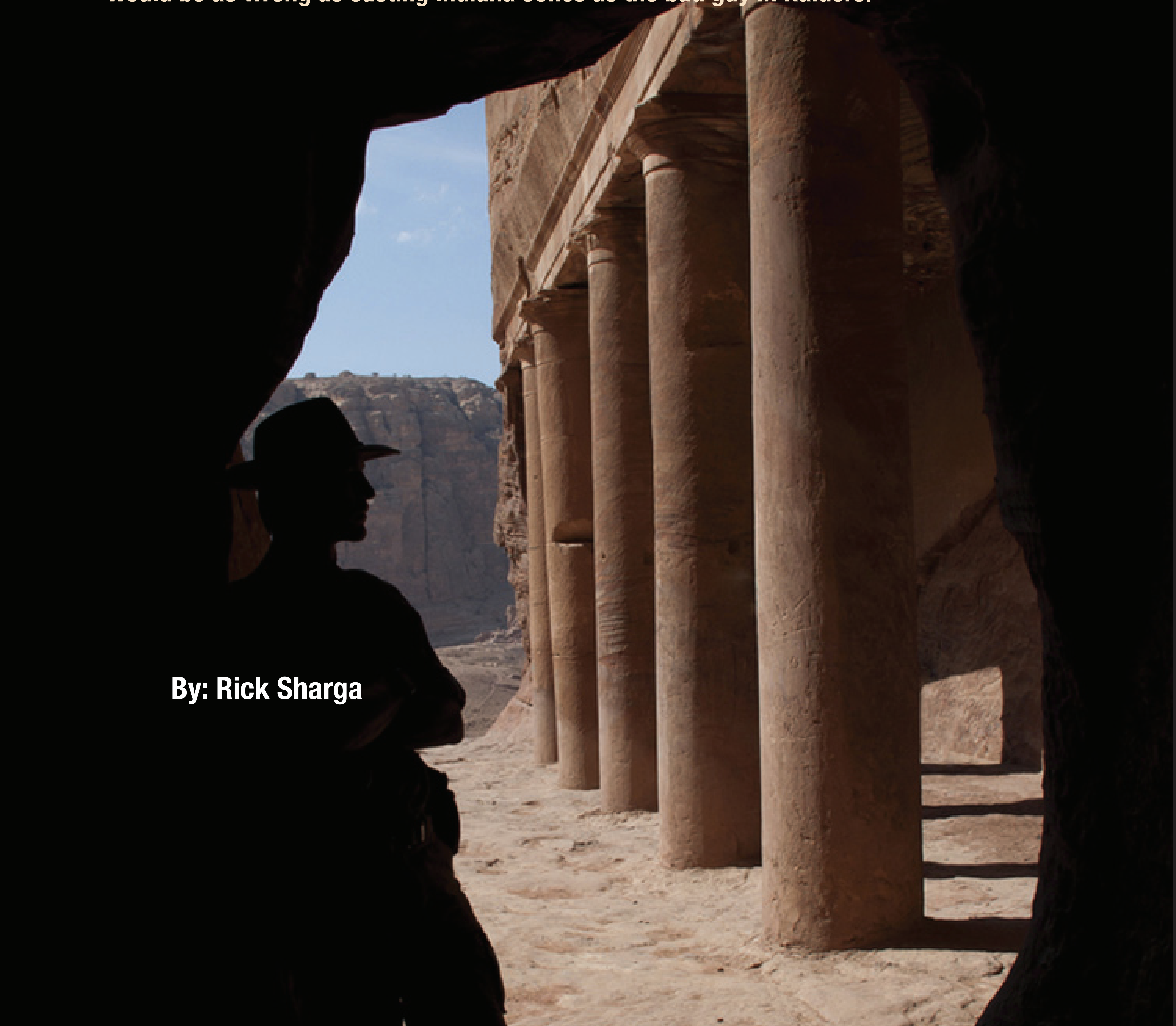
The True Hero of Mortgage Lending

Casting the FHA as a villain in this movie we call the mortgage industry would be as wrong as casting Indiana Jones as the bad guy in Raiders.



By: Rick Sharga

I'm a big fan of Indiana Jones.

Anytime you can use a phrase like "swashbuckling archeologist" and it actually makes sense, you know you have something special. The Indiana Jones character was a throwback to all of the Hollywood heroes of yesteryear – dashing, charming, a bit of a rogue, tough and yet quite the ladies' man.

But what set the character – and the movies – apart was the extraordinary writing. Despite plot lines that might be described as "formulaic," the writers found ways to inject humor, surprise and intrigue into the mix. And sometimes turn an anticipated result completely upside down.

One of my favorite scenes in Raiders of the Lost Ark, for example, takes place in a conversation between Indy and his faithful friend Sallah, the "best digger in Egypt," who has been hired to help the Nazis with the excavation. The Nazis, in their efforts to find the legendary Ark of the Covenant, have built a scale-model version of the ancient city of Tanis and used a replica of the Staff of Ra to calculate the location of the Well of Souls. Once the location had been determined, the Germans put their own legendary engineering prowess to work, and were well on their way to finding the Ark.

Except for one thing, as Indy happily discovered: they were digging in the wrong place. Unfortunately for the Nazis they had missed an important piece of data and made their staff seven and a half inches too short, which skewed everything else that happened from that point forward.

This, in an admittedly round-about way, brings us to the subject of the Federal Housing Administration (FHA).

Recently, the FHA has come under a barrage of criticism, most notably a 93-page missive from Edward Pinto at the American Enterprise Institute (AEI) titled How the FHA Hurts Working-Class Families and Communities. While the report makes some valid points and raises some interesting questions, the overall conclusion – that FHA policies have caused untold damage to borrowers, neighborhoods and communities – seems to be about as far off the mark as the Nazi diggers in Raiders.

ARCHEOLOGICAL EXPLORATION

Some historical perspective might be useful here.

Back in the Paleolithic Age of the mortgage industry, circa 1934, the United States was in the midst of the Great Depression. Mortgage loans were limited to 50% of the value of a home, and typically had payment terms lasting from three to five years with a balloon payment at the end.

Not surprisingly, America was a nation of renters, with home ownership rates hovering around 40%. And with the economy in a shambles, the prospects of ever owning a home were bleak for the majority of Americans.

Enter the FHA, with its mission of helping first-time homebuyers – especially lower and middle income homebuyers –purchase a home. And the FHA has done just that, with remarkable success, over the ensuing 78 years, having insured over 34 million single-family mortgages and more than 47,000 multifamily project mortgages over that period of time. Today, the FHA insures between 4-5 million single-family mortgages and approximately 13,000 multifamily project mortgages. And, despite all the bashing the organization has been subject to, current estimates show that less than 10% of all these loans are seriously delinquent.

The FHA has made home ownership a possibility for millions of American citizens throughout its storied history – from financing military housing and homes for returning veterans and their families in the 1940s to providing nearly 50% of home purchase mortgages for African American and Hispanic/Latino borrowers in 2012. And the FHA has reliably stepped into the breach when the market has faced crises: providing emergency financing during the high inflation period of the 1970s; replacing private mortgage insurers who pulled out of oil-producing states during the recession of the 1980s; and stepping in to offer refinancing when the most recent housing bubble burst in 2008. In fact, Moody's Analytics indicated that as bad as the recent housing market crash was, home prices would have fallen another 25% were it not for the presence of the FHA.

Rather than "hurting" working-class families, the FHA has given them a chance for homeownership that they wouldn't have otherwise had, improving the financial well-being of the overwhelming majority of these families, and helping fuel the long-term growth of the housing market, which has contributed mightily to the country's economic growth. Since the FHA's origination, home ownership rates in the U.S. soared from 40% to a peak of 68.1% in 2001.

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DIGGING IN THE WRONG PLACE

But if the FHA helped fuel this growth, can't an argument be made that it must have contributed to the excesses of the housing bubble that inflated wildly out of control from 2000-2006, before exploding disastrously in 2008?

Well, no. Not a very good argument, at least.

The AEI paper focused on two years – 2009 and 2010 – that may well have been two of the worst years in the history of U.S. real estate, and in the history of the FHA. The paper also focused on 9,000 zip codes, all of which had lower median incomes than the surrounding metro areas in which they were located, and all of which were in areas that had been hard hit by the foreclosure wave that began in 2007.

If one were to create a report based on data collected from the highest risk borrowers in the highest risk neighborhoods during two of the worst years in the history of the real estate market, one should probably not be surprised to find bad results.

But the cause and effect relationship here has been turned on its head. The FHA didn't create the bad economic conditions in these neighborhoods, and it certainly didn't write the loans that sent many neighborhoods across the country into economic free fall. During the boom years of the early 2000's, the FHA was virtually locked out of the market, having been replaced with a plethora of ill-advised and ultimately disastrous – mostly subprime – loan products: negative amortization; 125% LTV; pick-a-pay ARMS; no-money-down; stated income, no-doc/low-doc; piggy back seconds. The industry even coined a phrase to describe how bad the products were: NINJA (No Income, No Job, No Asset) loans. The FHA, with its quaint requirements for full documentation, a modest down payment and an insurance premium was considered archaic and largely unnecessary. Until the financial market meltdown.

During 2009 and 2010, the FHA refinanced massive amounts of loans from borrowers who found themselves in equally massive trouble, when those exotic loans turned out to be ticking time bombs…all going off at once. Many, perhaps most, of these disintegrating loans had been made to sub-prime borrowers, who typically had income and FICO scores too low to qualify for conventional loans.

There is no disputing the notion that loans issued to borrowers with low FICO scores and relatively low incomes, and who make low down payments will default at higher rates than borrowers with high FICO scores, high incomes and who make larger down payments. But the bor-

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rower who doesn't meet those traditional underwriting standards has been the prototypical FHA borrower over the years, and on the whole, has performed very well.

It's fair to ask what can be done to reduce the number of borrowers with FHA loans who default. It's illogical, however, to suggest that the FHA purposefully reaches out to ensnare these borrowers into loans that it knows won't perform. It's also reasonable to ask why the FHA is insuring high dollar loans for high-income borrowers with high FICO scores. But in the absence of a viable secondary market, and the continuing problem of too-tight credit standards, the FHA is often the only viable option available for these borrowers.

It's also worth noting (and probably a topic for a separate article) that the FHA has modified its program over the past year to adjust for current market conditions. The average FICO score on an FHA loan today is 700. There are new, more stringent, requirements for lenders who want to work with the FHA. And insurance premiums have been raised to account for higher risk.

I admit I'm a bit biased when it comes to the FHA. Without it, I wouldn't have bought my first home. At the time, back in 1995, I was earning a decent living and had a good FICO score, but simply hadn't put aside the 20% down payment I thought I'd need to make a purchase. Then a real estate agent told me about this wonderful program that required a much smaller amount of cash. Three months later, I purchased my first home. Ironically, I was able to get a less expensive loan with a 10% down payment and private mortgage insurance. But the existence of the FHA program is what gave me the confidence to get into the market – something I suspect I have in common with millions of other homeowners.

Casting the FHA as a villain in this movie would be as wrong as casting Indiana Jones as the bad guy in Raiders. And casting it aside would be disastrous for the housing market. ❖

About The Author

Rick Sharga is Executive Vice President at Carrington Mortgage Holdings, LLC. One of the country's most frequently-quoted sources on foreclosure, mortgage and real estate trends, Rick has appeared on NBC Nightly News, CNN, CBS, ABC World News, CNBC, FOX and NPR. Rick has briefed government organizations such as the Federal Reserve and Senate Banking Committee and corporations like JPMorgan Chase, Citibank and Deutsche Bank on foreclosure trends, and done foreclosure training for leading real estate organizations such as Re/Max, Prudential and Keller Williams.