

# How the FHA Hurts Working-Class Families and Communities

Presented at 2013 Policy Summit on  
Housing, Human Capital, and Inequality

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Edward Pinto, Resident Fellow

American Enterprise Institute

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The views expressed here are those of the author alone  
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# Selling Hope, Delivering Harm

- Market home ownership aggressively to borrowers with poor credit.
- Push families into homes they can't afford.
- Saddle them with loans that barely build equity.
- Provide no incentives for fiscal discipline.
- Tolerate high failure rate, leaving families in financial ruin and communities reeling.

# Study Posed Three Research Questions

- Which loans are most likely to suffer a foreclosure?
- Which zip codes and metro areas will bear the brunt of the foreclosures forecasted to result from 2009 and 2010 books?
- What should be FHA's acceptable maximum tolerance for failure?

# 9,000 Neighborhoods Exposed to Needless Risk

Historically, prime loans have a foreclosure rate of *less than 1 percent*.

But in 9,000 zip codes across America, where the median income is below the metro area rate ...

The projected foreclosure rate exceeded *10 percent*.

And the average rate was *15 percent*.

# This is not the first time

“We have been fighting abuse, fraud, and neglect of the FHA program that has destroyed too many neighborhoods and too many families' dreams of homeownership for more than 25 years....The FHA program has a national default rate 3 to 4 times the conventional market, and in many urban neighborhoods it routinely exceeds 10 times. In addition, the FHA program is hemorrhaging money....”

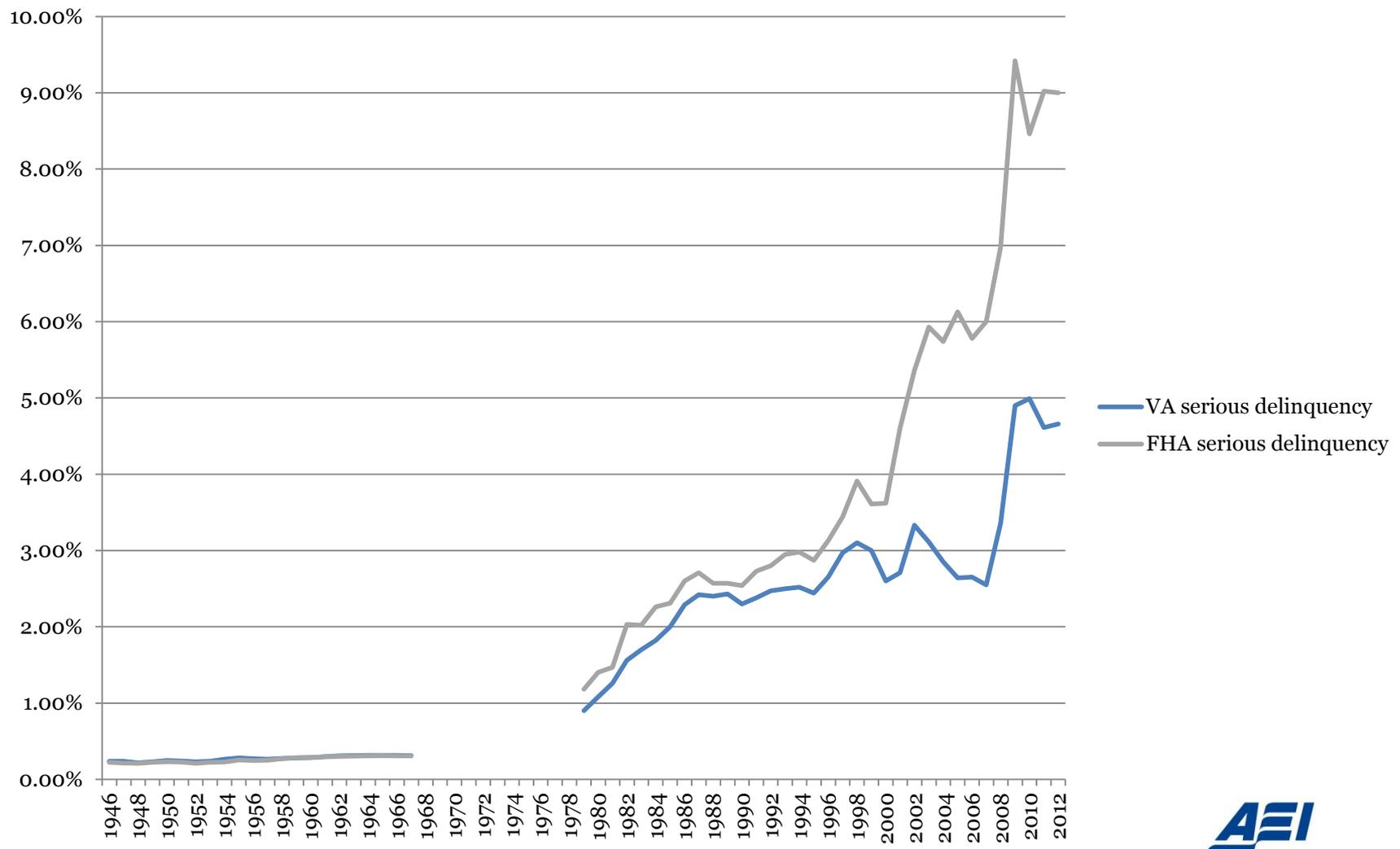
Statement by the late-Gale Cincotta (a long-time community activist) made before the Subcommittee on Housing and Community Opportunity of the House Financial Services Committee, April 1, 1998

# FHA Has Made Foreclosures Commonplace Across America

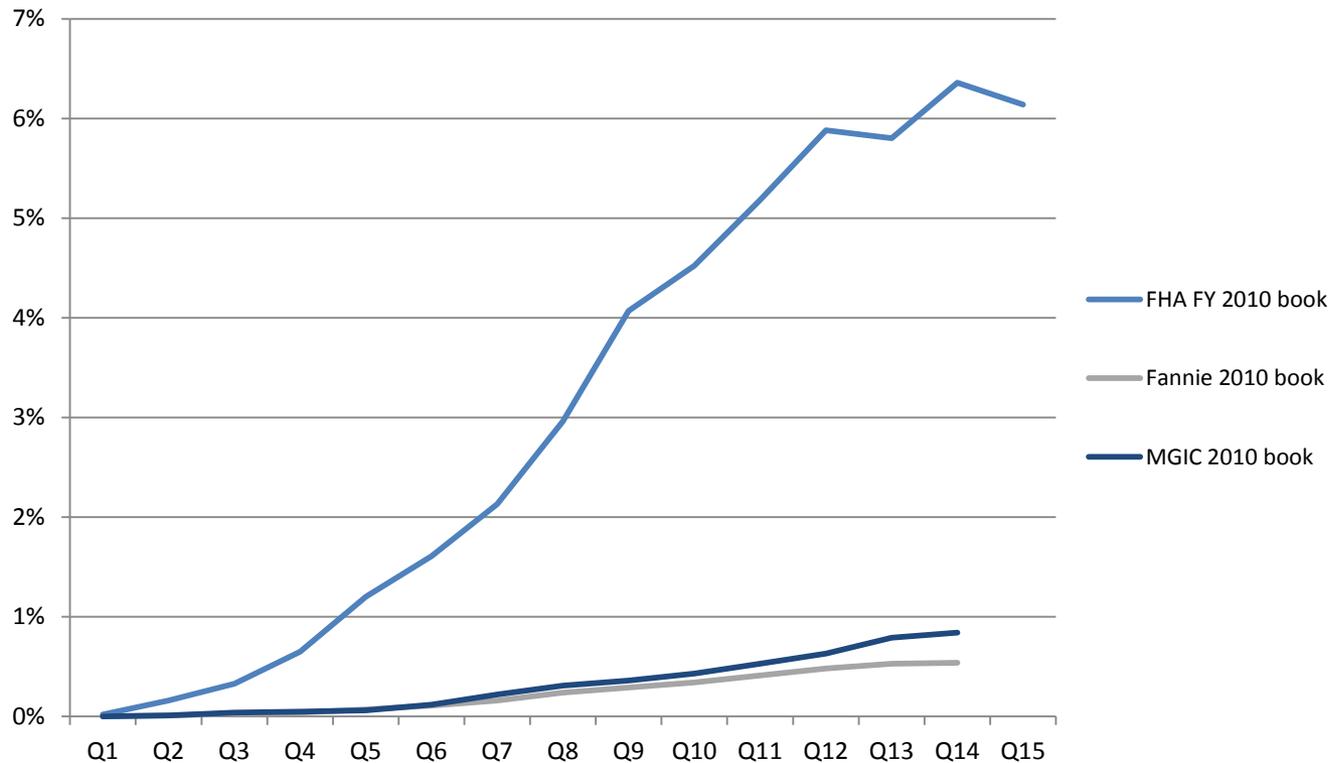
- Over the period 1975 to 2011, more than 3 million, or 1 in 8 FHA-insured families will suffer a foreclosure—an abysmal record made worse by the fact that lower-income and minority families have suffered even higher foreclosure rates.
  - In arriving at this rate, 4.5 million streamline/FHA-to-FHA refinances were excluded.
- Compare to 1934-1954, when FHA paid 5,712 claims out of 2.9 million insured mortgages for a cumulative claims rate of 0.2 percent with a severity rate of 9%.
- The FHA has been selling hope and delivering harm.
  - This is the result of systemic deficiencies in the FHA's insurance program—a lack of proper [alignment of incentives](#), foreclosure-prone lending practices, and poor management practices. A long history of cross-subsidizing high-risk loans with lower-risk loans has enabled the disproportionate impact on lower income and minority families to continue.

But as Irving Welfeld (*HUD Scandals: Howling Headlines and Silent Fiascos*) observed in 1992: “averaging out is not a defense.” 

# VA and FHA Serious Delinquency Rates



# FHA, Fannie, and MGIC's 2010 Books: Compare Serious Delinquency Trends



\*Number of elapsed quarters since the beginning of FY 2010. There have only been 10 elapsed quarters for calendar year 2010.

Sources: FHA Single-Family Mutual Mortgage Insurance Fund Programs Quarterly Report to Congress FY 2013 Q3, miscellaneous Fannie Mae Credit Supplements, and miscellaneous MGIC Portfolio Supplements

# It Doesn't Have to Be This Way

FHA should be...

*The provider of responsible mortgage credit to low- and moderate-income Americans and first-time homebuyers.*

*See Appendix A for demographic groups requiring FHA's full attention.*

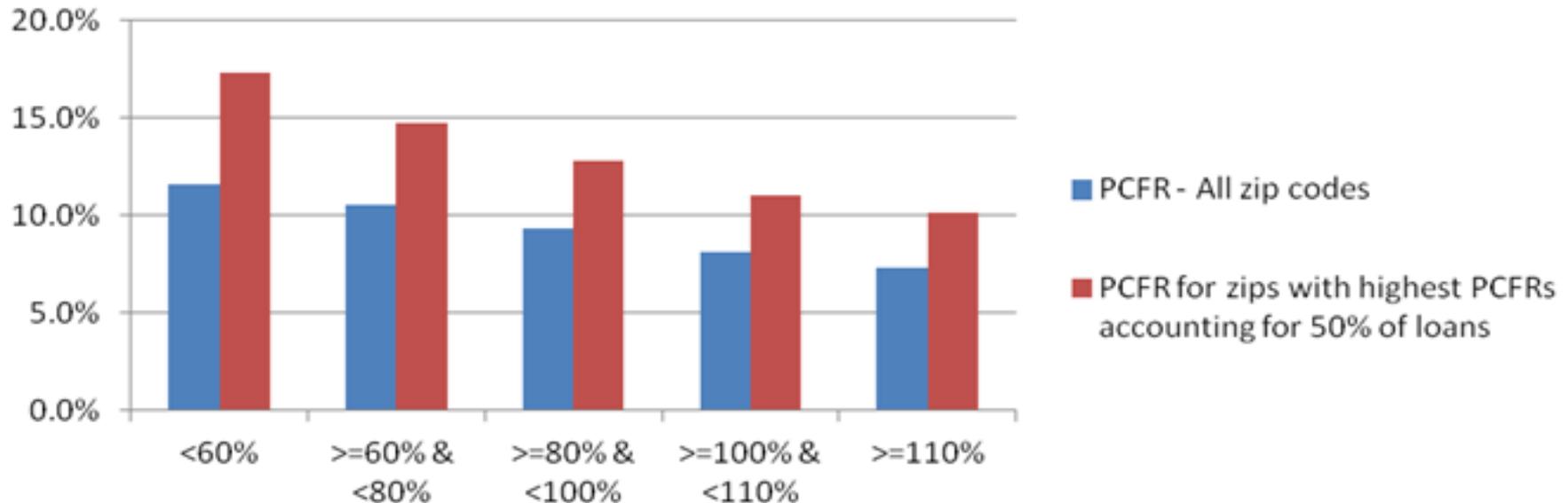
# The Study: Big-Picture Findings

- *Not* a review of pre-crisis, sub-prime lending. Focus is on loans insured by FHA in FY 2009 and 2010 – well *after* the market's collapse.
- Families are nudged onto a tightrope with no safety net. “*A broken water heater or leaky roof away from failure.*”
- FHA policies are backfiring in dramatic fashion, from Cleveland and Atlanta to Chicago and DC.

# Foreclosures Disproportionate Impact...

Zip codes with less than median-incomes have a projected foreclosure rate averaging 10 percent, with half averaging 15 percent.

**Projected cumulative foreclosure rate (PCFR) by percent of median area income (FY 2009-10)**



# Cross-subsidies Pay for Catastrophic Losses in Working Class Neighborhoods

- The five zip codes in Cleveland with the highest projected failure rates had rates that ranged from 21 to 33 percent.
- The five zip codes in Cleveland with the lowest projected failure rates had rates that ranged from 1 to 2 percent.
- The five zip codes in Cincinnati with the highest projected failure rates had rates that ranged from 17 to 20 percent.
- The five zip codes in Cincinnati with the lowest projected failure rates had rates that ranged from 2 to 3 percent.

# Harm to a Family's Credit

- Foreclosed borrowers denied access to most forms of credit for 3-to-5 years and limits on the ability to rent.
  - Denied the opportunity to build equity, provide security for their family, and have the down payment for their next home as their family grows.
- At a projected foreclosure rate averaging 10 percent, nearly 1 in 5 FHA loans is delinquent 30 days or more at least once in a two year period.
- In a working class neighborhood with a projected foreclosure rate averaging 17 percent\*, nearly 1 in 3 FHA loans is delinquent 30 days or more at least once in a two year period.
- Mortgage delinquencies negatively impact credit scores, access, and credit cost (see Appendix B).

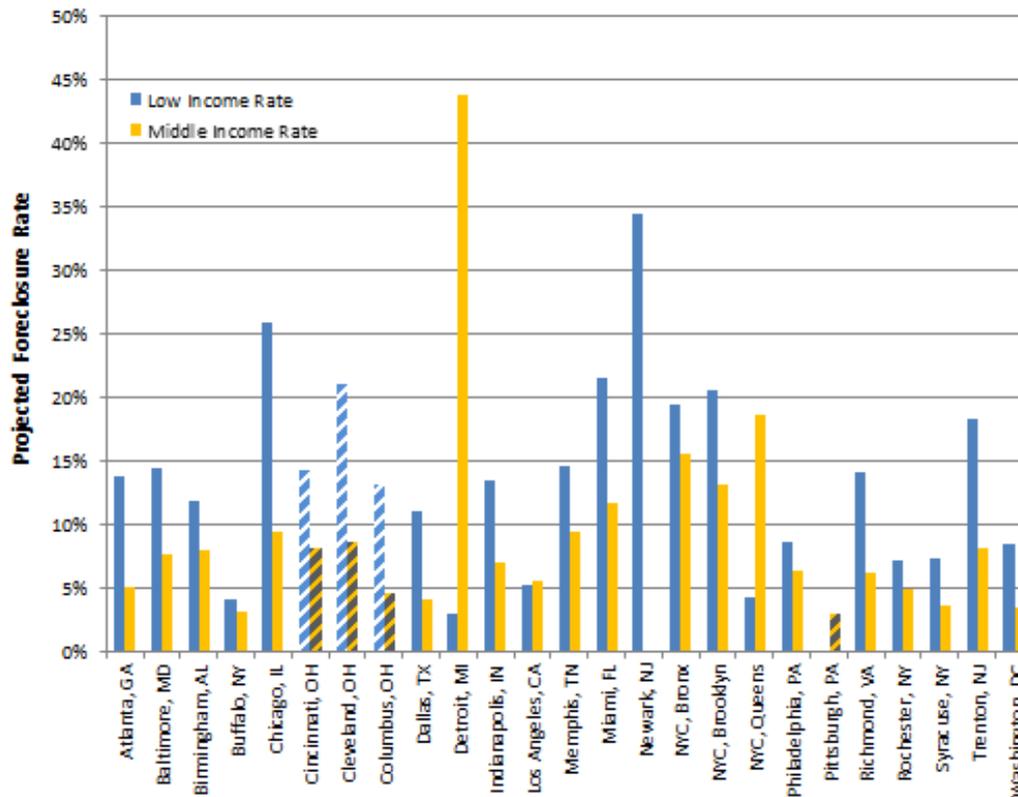
\*Foreclosure rate for FHA borrowers with a FICO score of 620-659.

# Harm to Communities

- Reduction in neighboring property values.
- Blight and higher levels of crime.
- Poorer health.
- Disproportionate impact on children, seniors, and minorities.
- Stress on community services.
- Reduced property tax receipts.

# Harm To Working-Class Families and Communities

FHA Loan Projected Foreclosure Rate  
Low Income Census Areas vs. Middle Income Census Areas  
(22 cities plus 3 New York boroughs)



Note: FHA Loans originated in 2009 and 2010. Projected Foreclosure Rate is calculated as a weighted average based on loan volume.

From a recent study where 19 of 23 cities had higher FHA projected foreclosure rates in low-income zip codes than in middle-income zip codes.

Replicates the National Training and Information Center's 2002 study for the same 22 cities (did not include Pittsburgh).

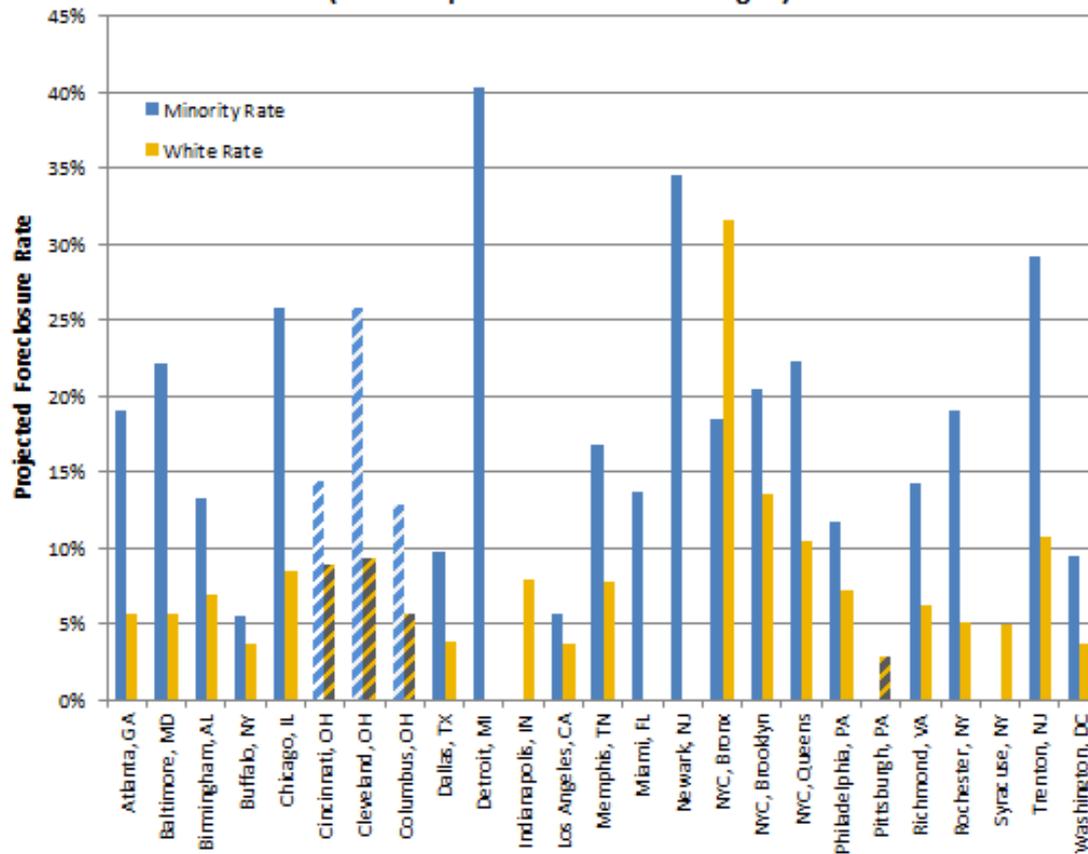
That study found 21 of 22 cities had higher FHA loan default rates in low-income census tracts than in middle-income census tracts.

Low income zip = <50% of median income

Middle income zip = 80%-120% of median income

# Harm to Minority Families and Communities

FHA Loan Projected Foreclosure Rate  
Minority Census Areas vs. White Census Areas  
(22 cities plus 3 New York boroughs)



Note: FHA Loans originated in 2009 and 2010. Projected Foreclosure Rate Ratios are calculated as a weighted average based on loan volume.

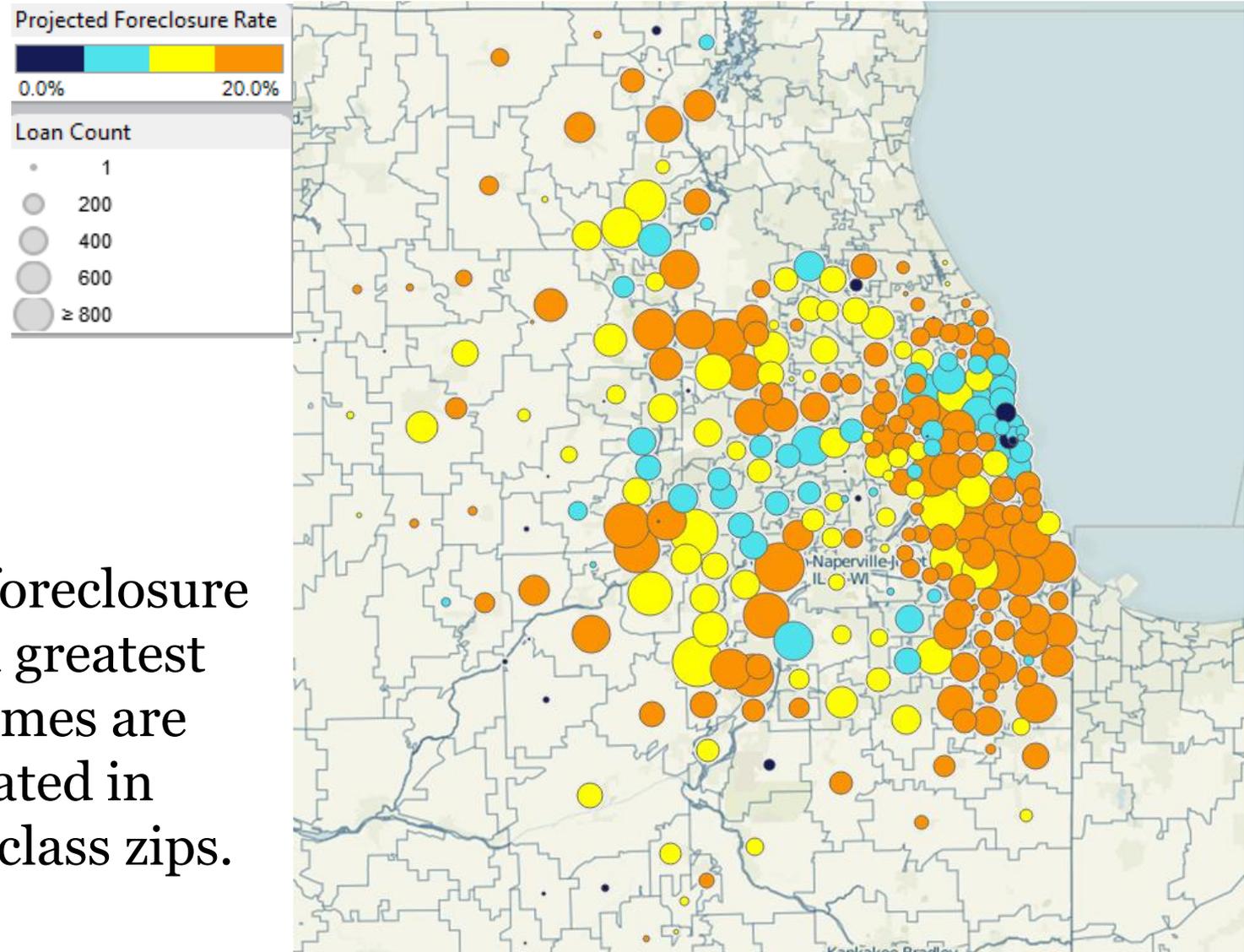
From a recent study where 18 of 22 cities had higher FHA projected foreclosure rates in minority zip codes than in white zip codes.

Replicates the National Training and Information Center's 2002 study for the same 22 cities (did not include Pittsburgh).

That study found 19 of 22 cities had higher FHA loan default rates in minority census tracts than in white census tracts.

Minority zip = >80% minority  
White zip = <20% minority

# Chicago: Projected Foreclosure Rate

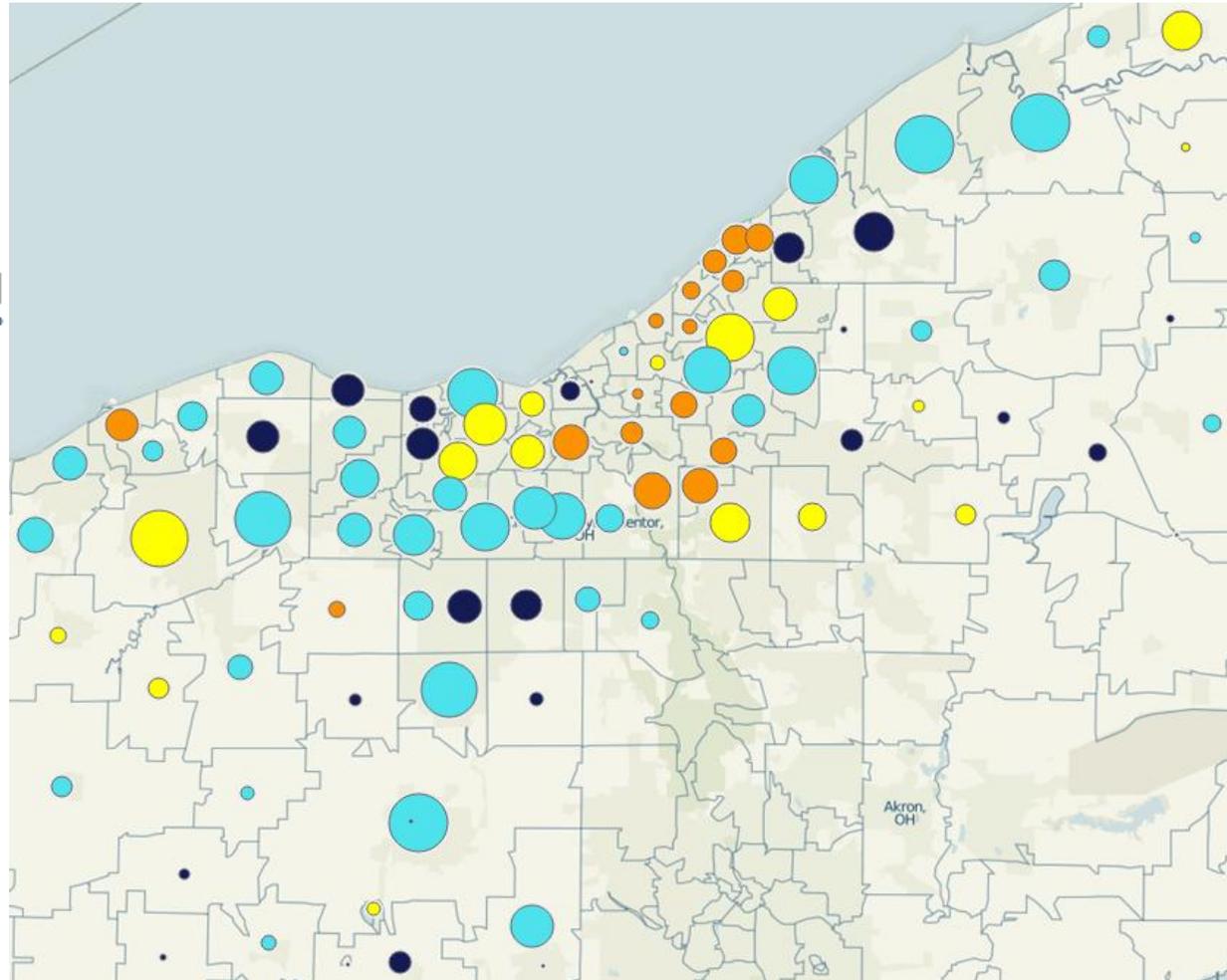
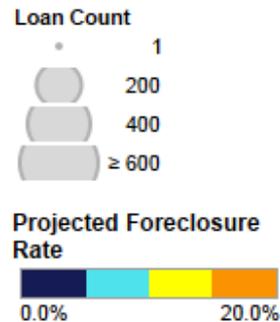


Highest foreclosure rates and greatest loan volumes are concentrated in working-class zips.

# Quadrant of Doom - Chicago

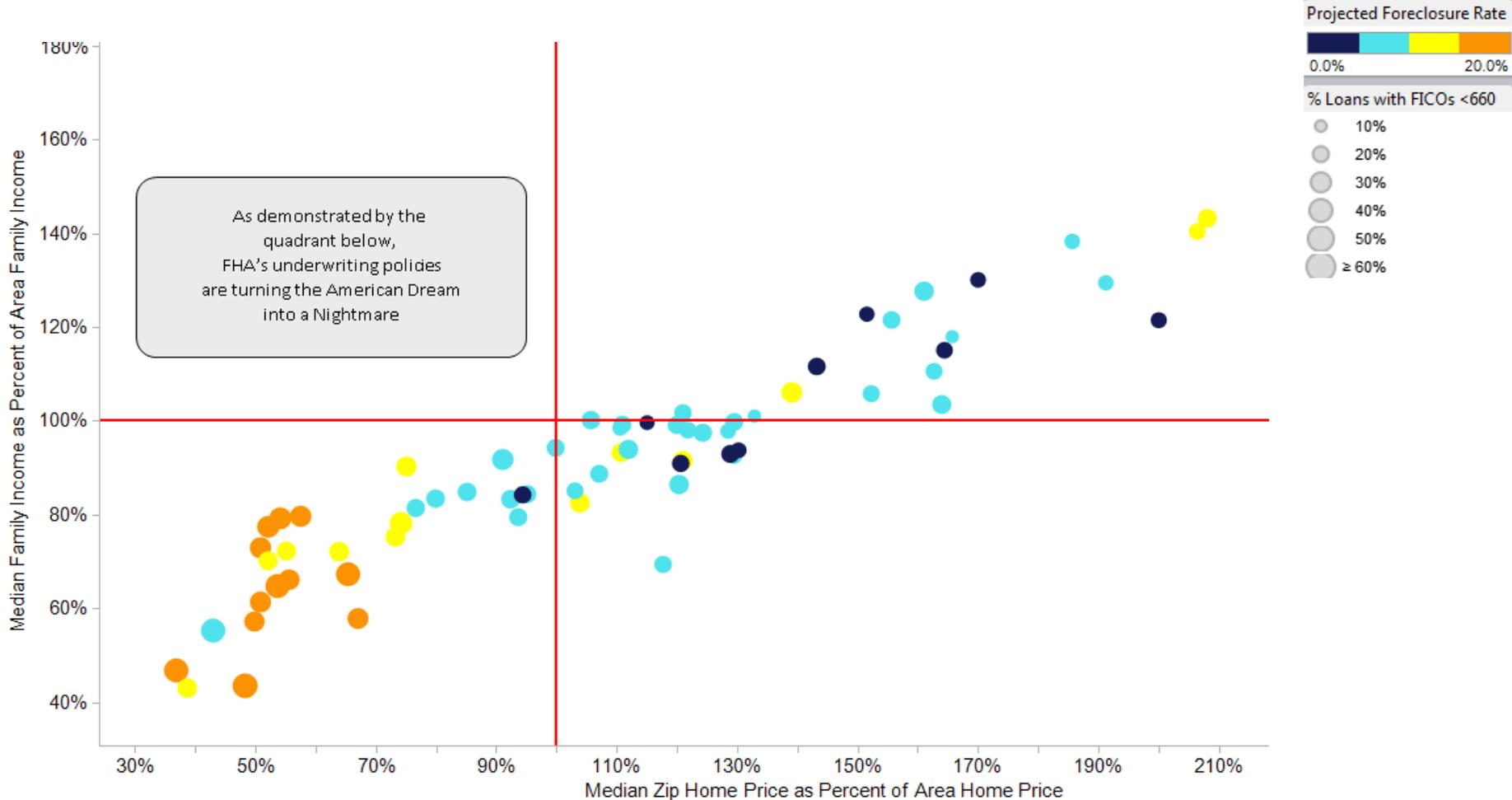


# Cleveland: Projected Foreclosure Rate

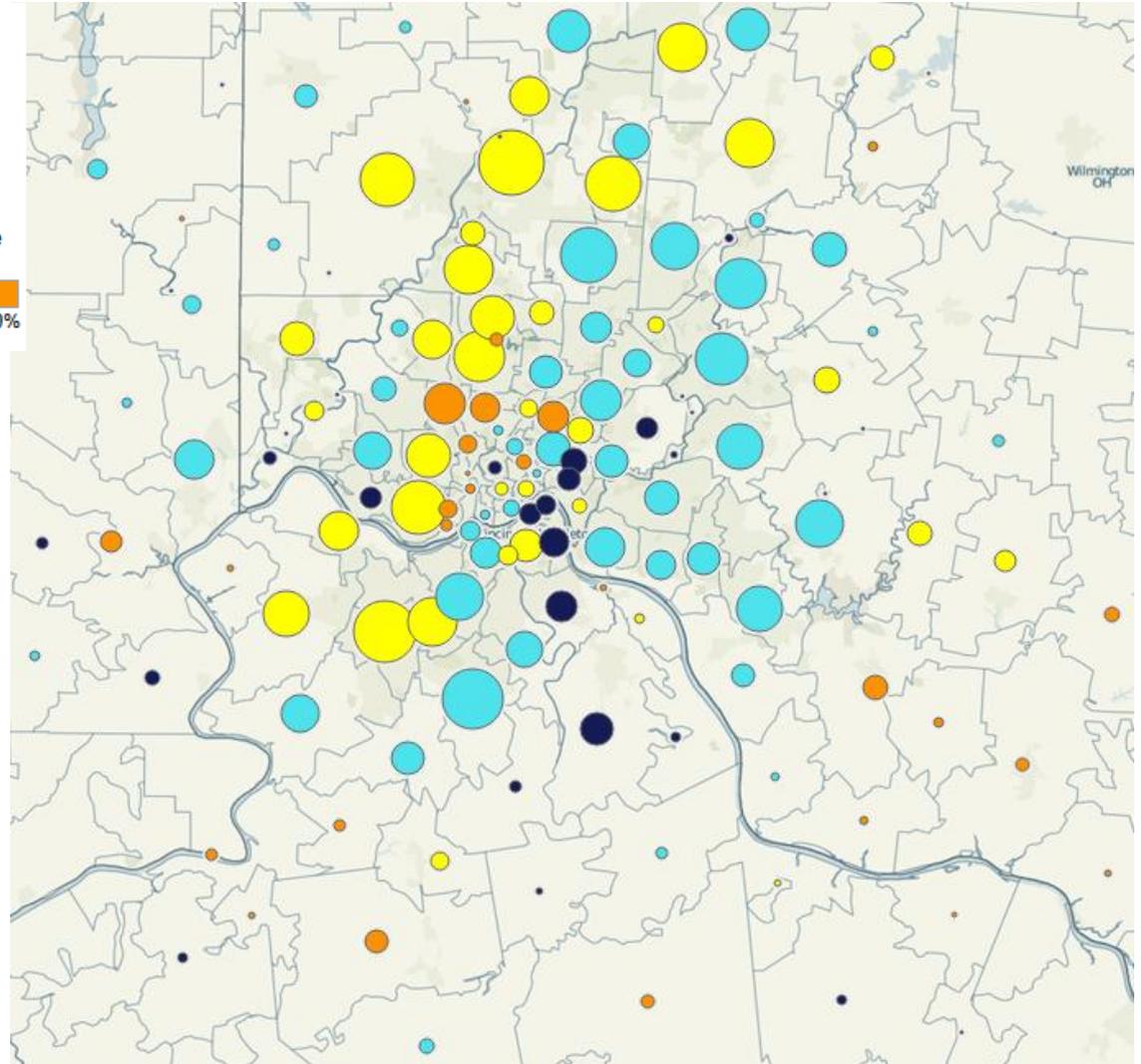
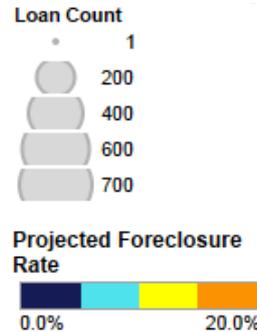


Highest foreclosure rates and greatest loan volumes are concentrated in working-class zips.

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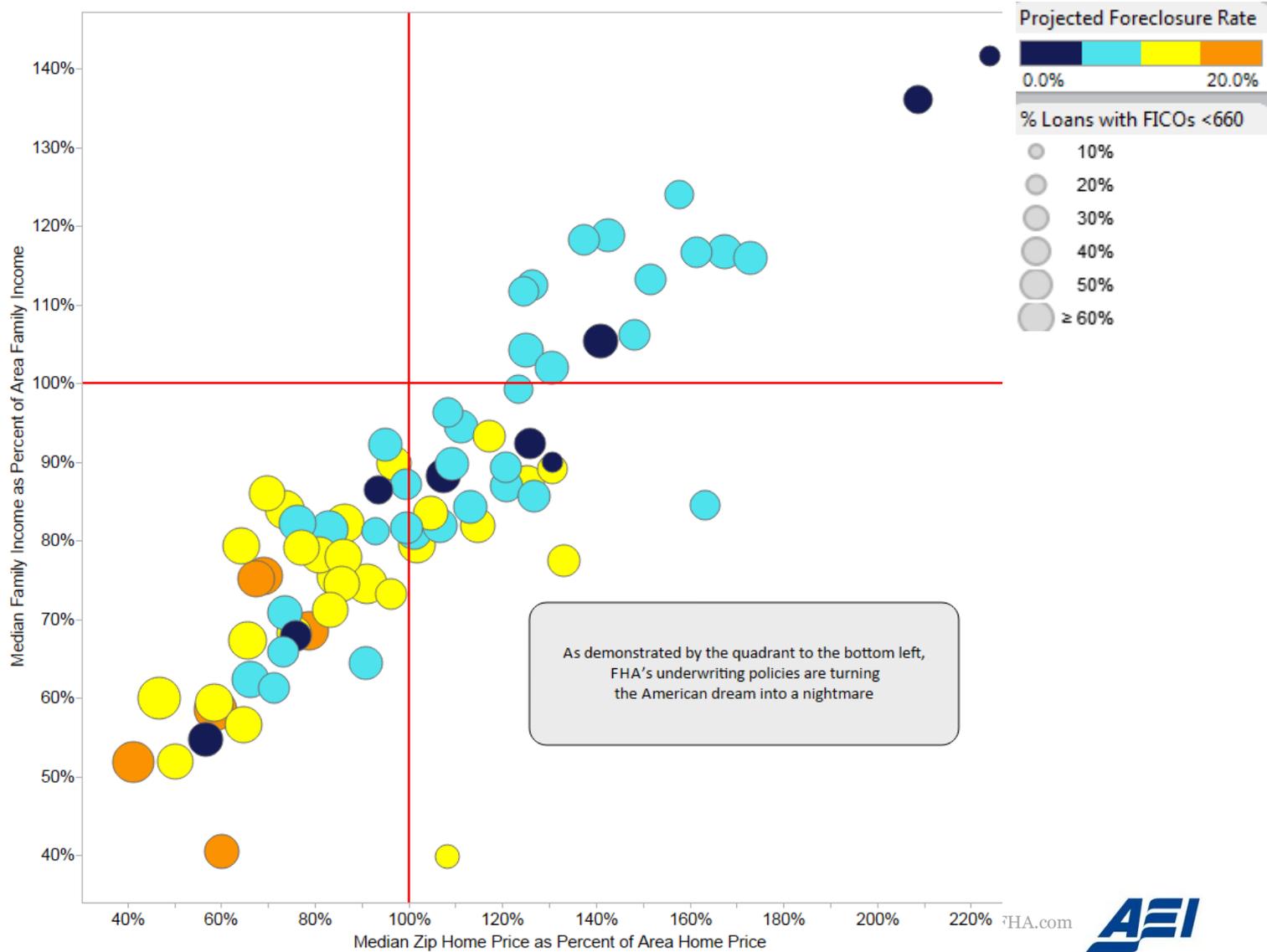


# Cincinnati: Projected Foreclosure Rate

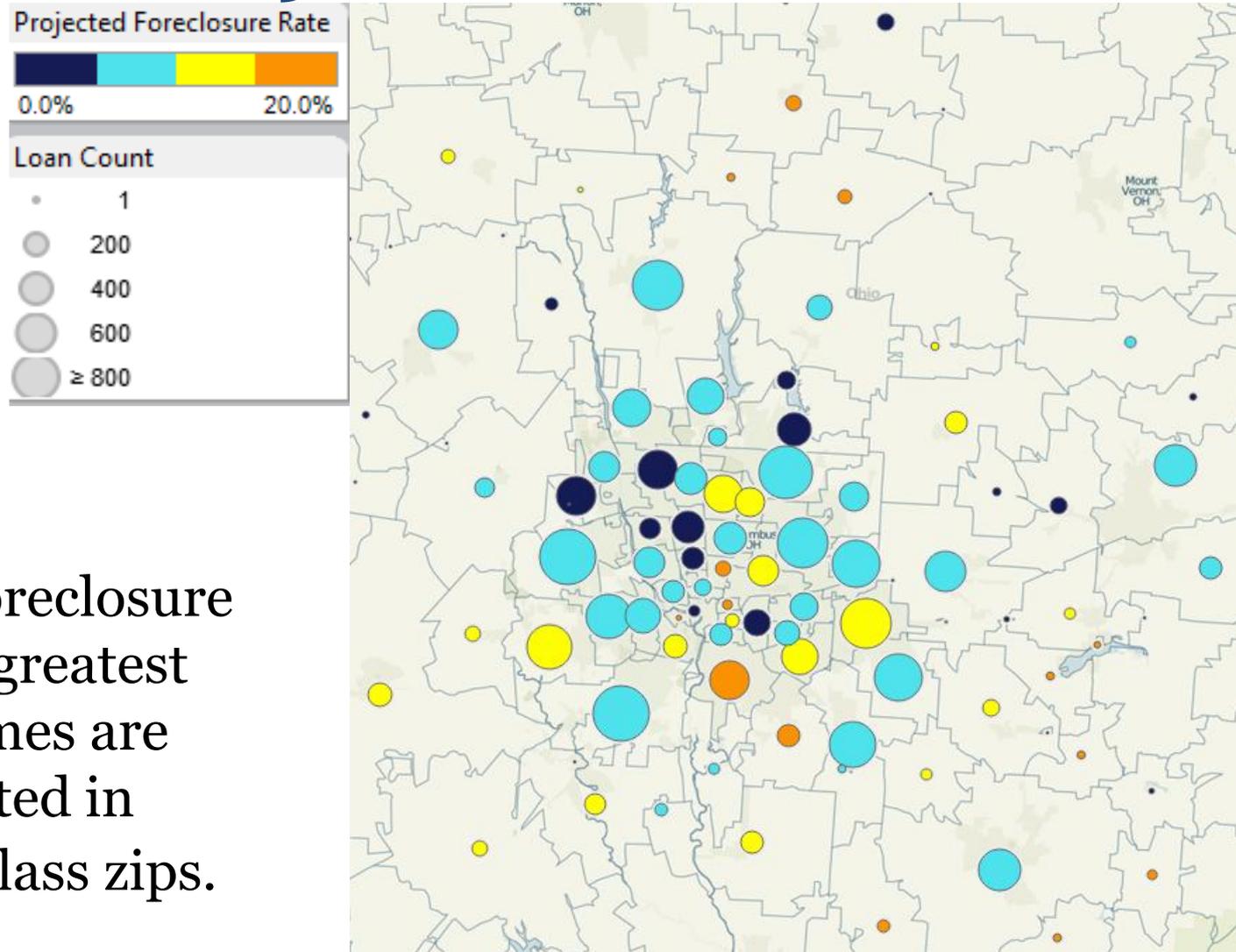


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# Quadrant of Doom - Cincinnati

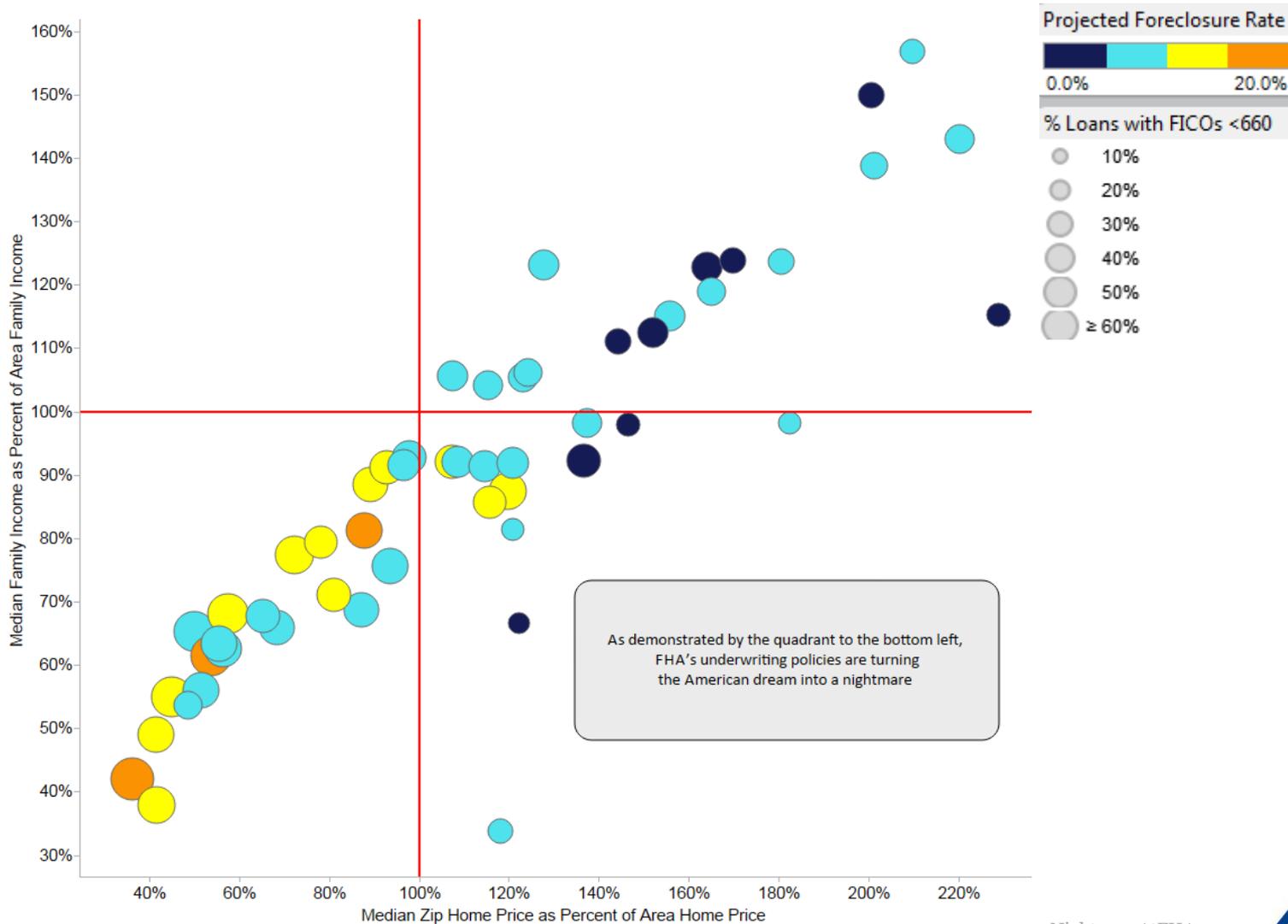


# Columbus: Projected Foreclosure Rate

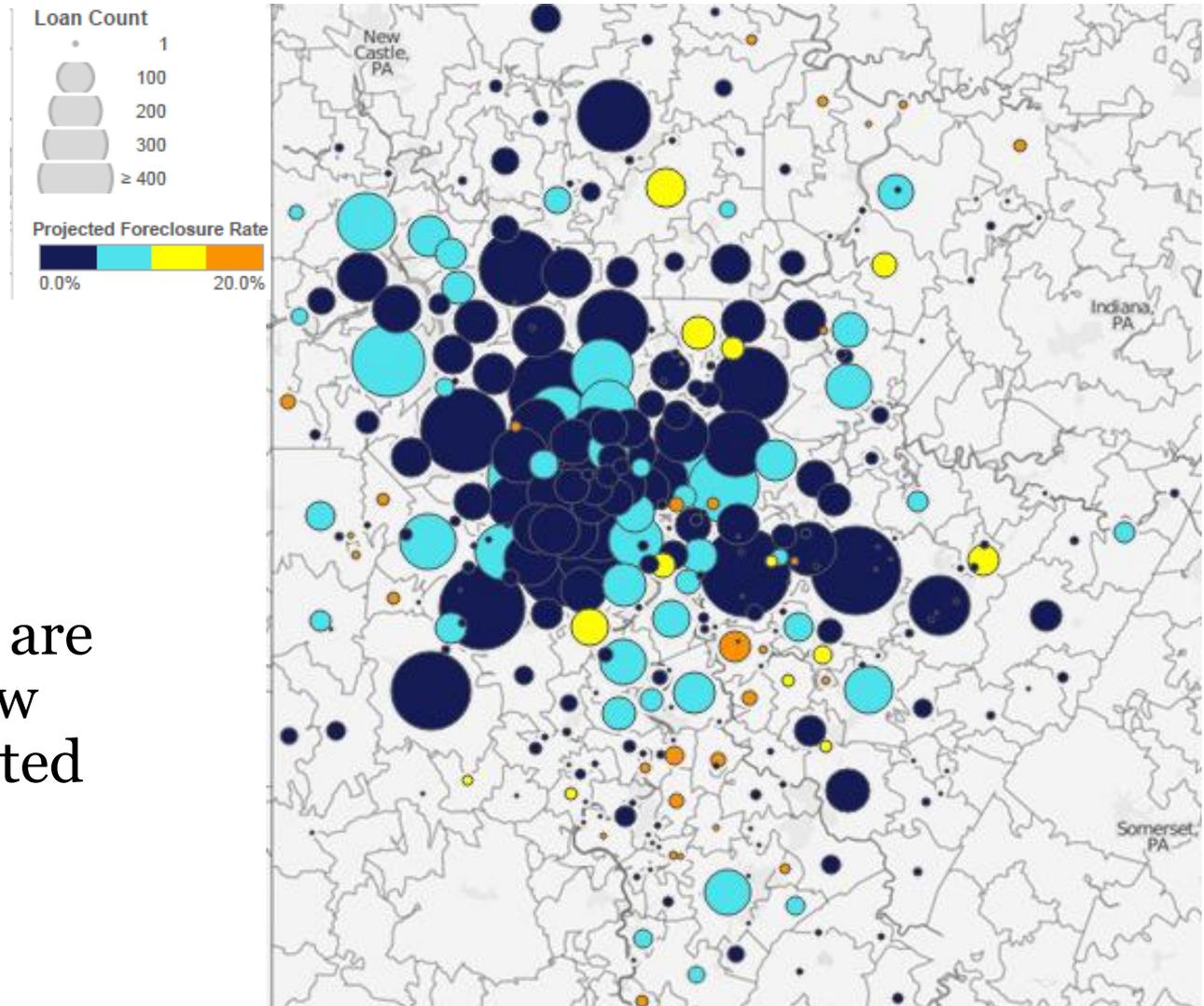


Highest foreclosure rates and greatest loan volumes are concentrated in working-class zips.

# Quadrant of Doom - Columbus



# Pittsburgh: Projected Foreclosure Rate

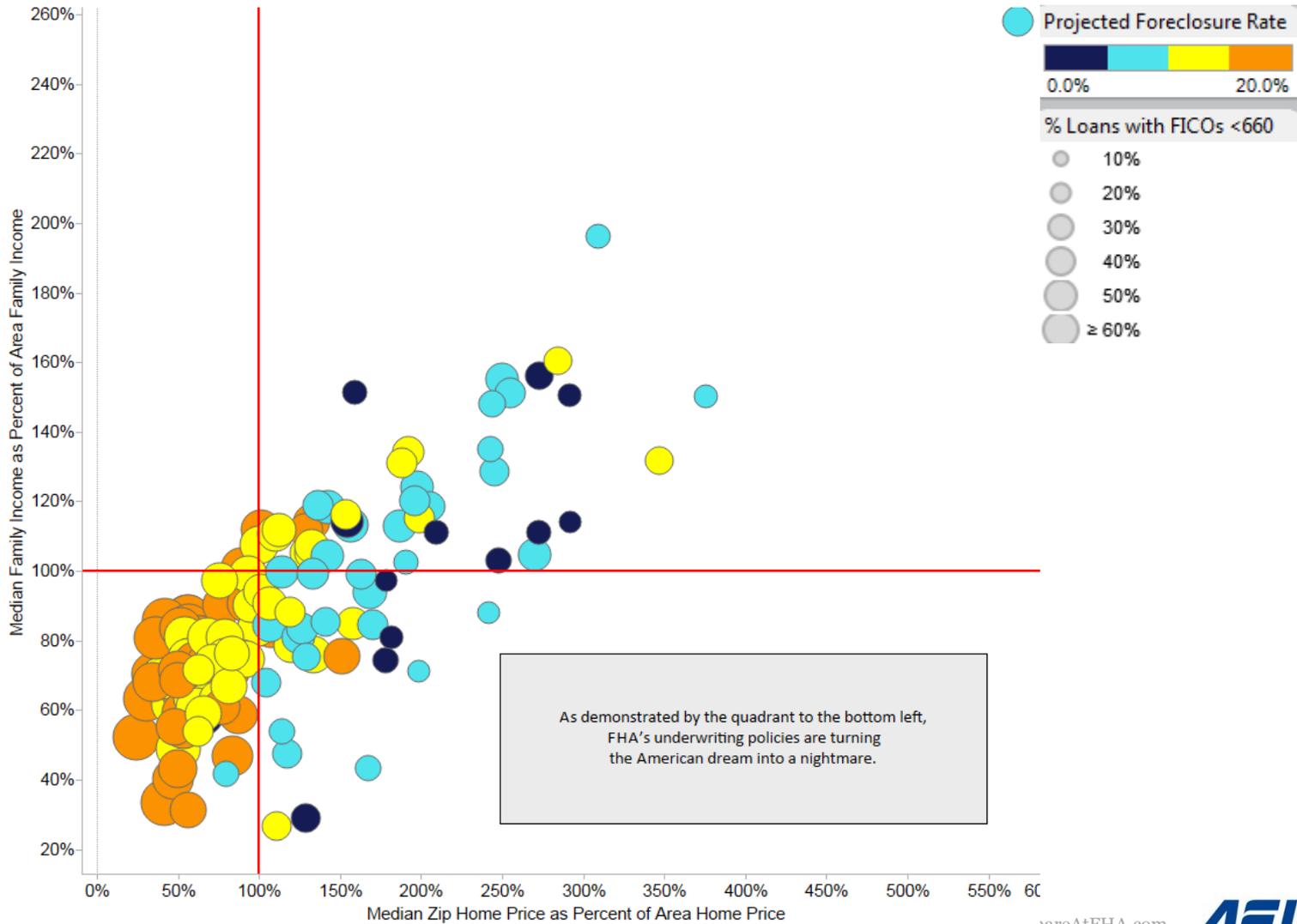


Pittsburgh's foreclosure rates are comparatively low and well distributed across income groups.

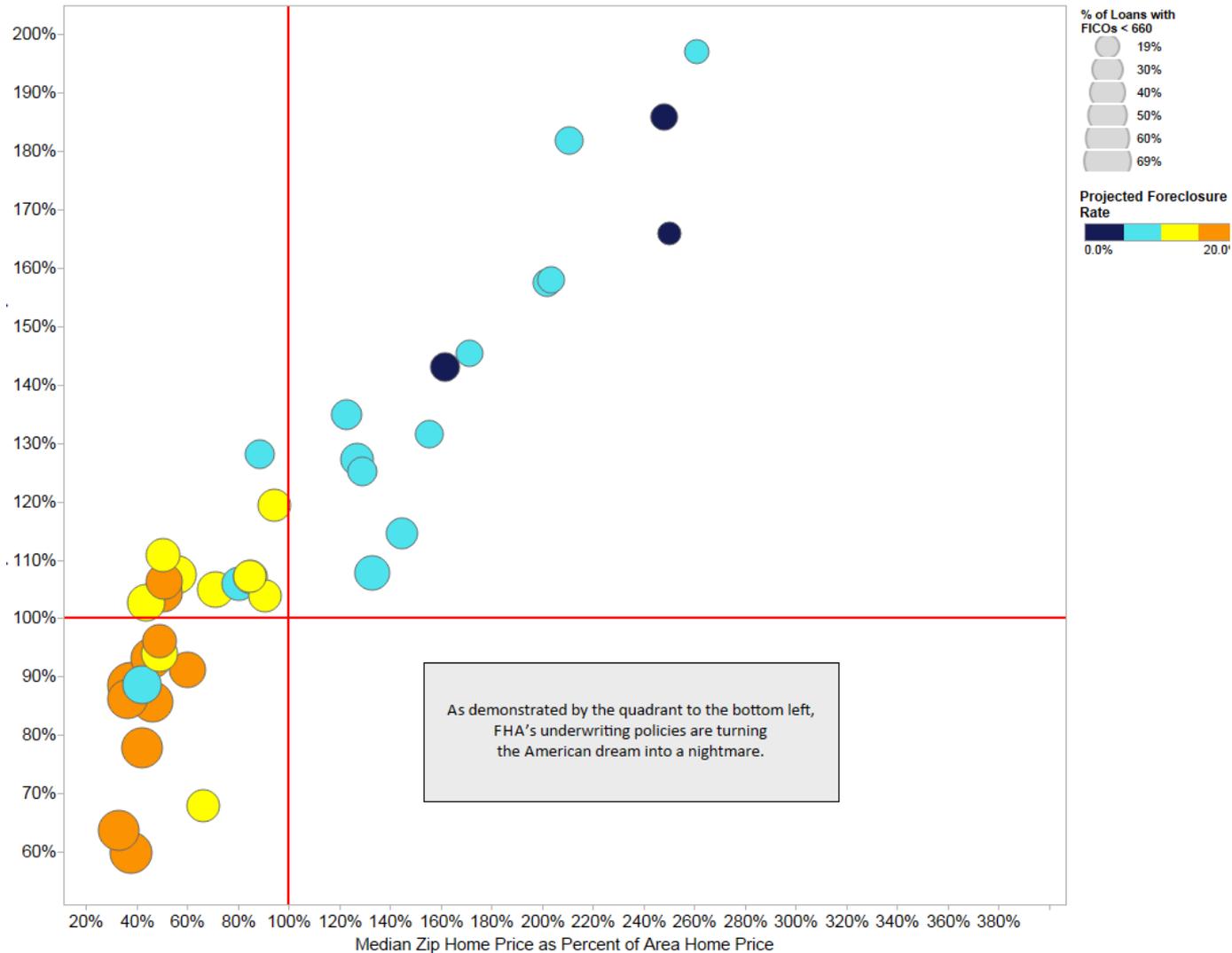
# Pittsburgh Is an Exception



# Quadrant of Doom - Atlanta



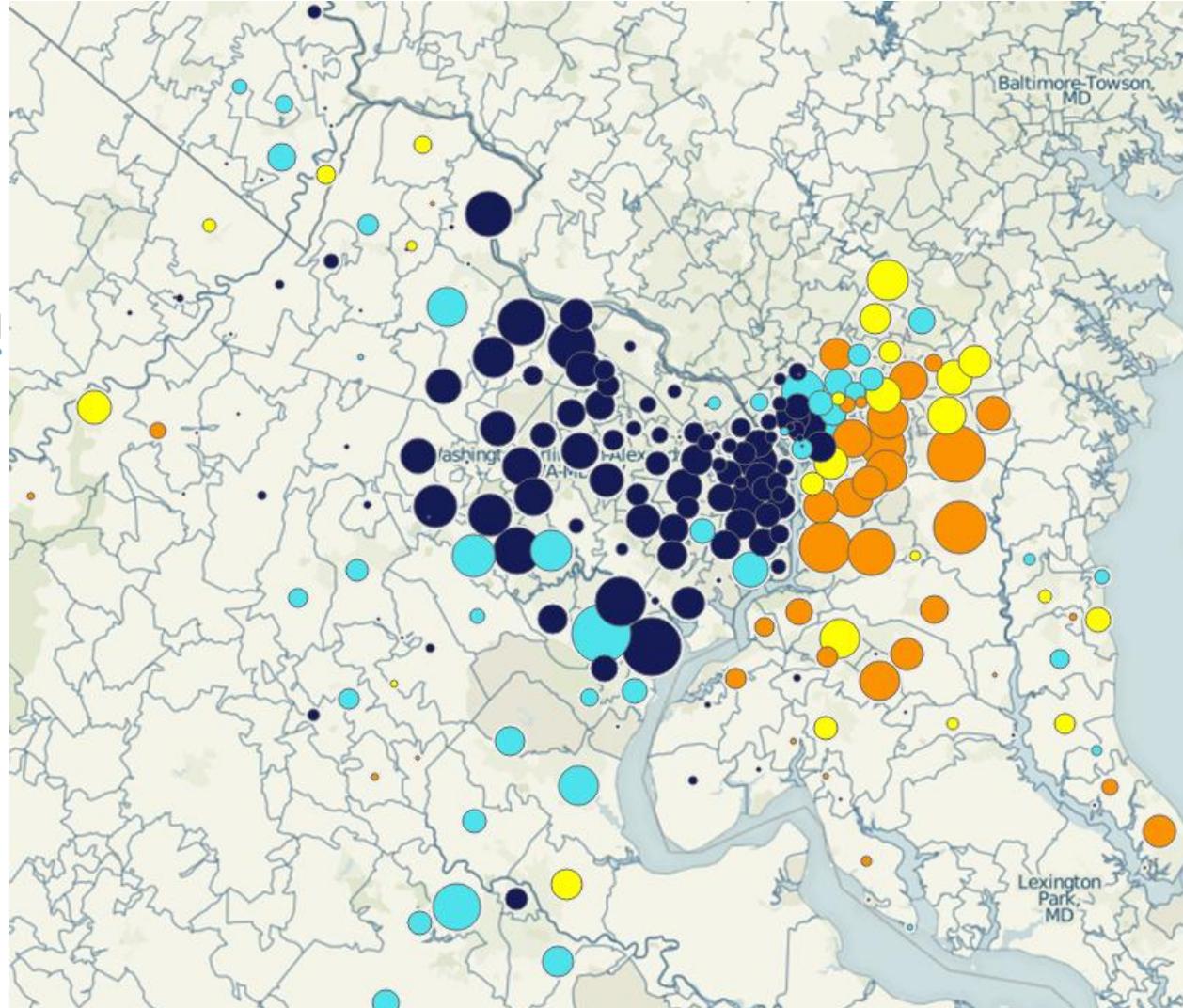
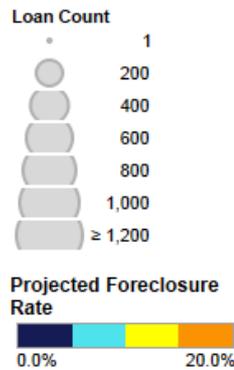
# Quadrant of Doom - Detroit



# Quadrant of Doom - Newark

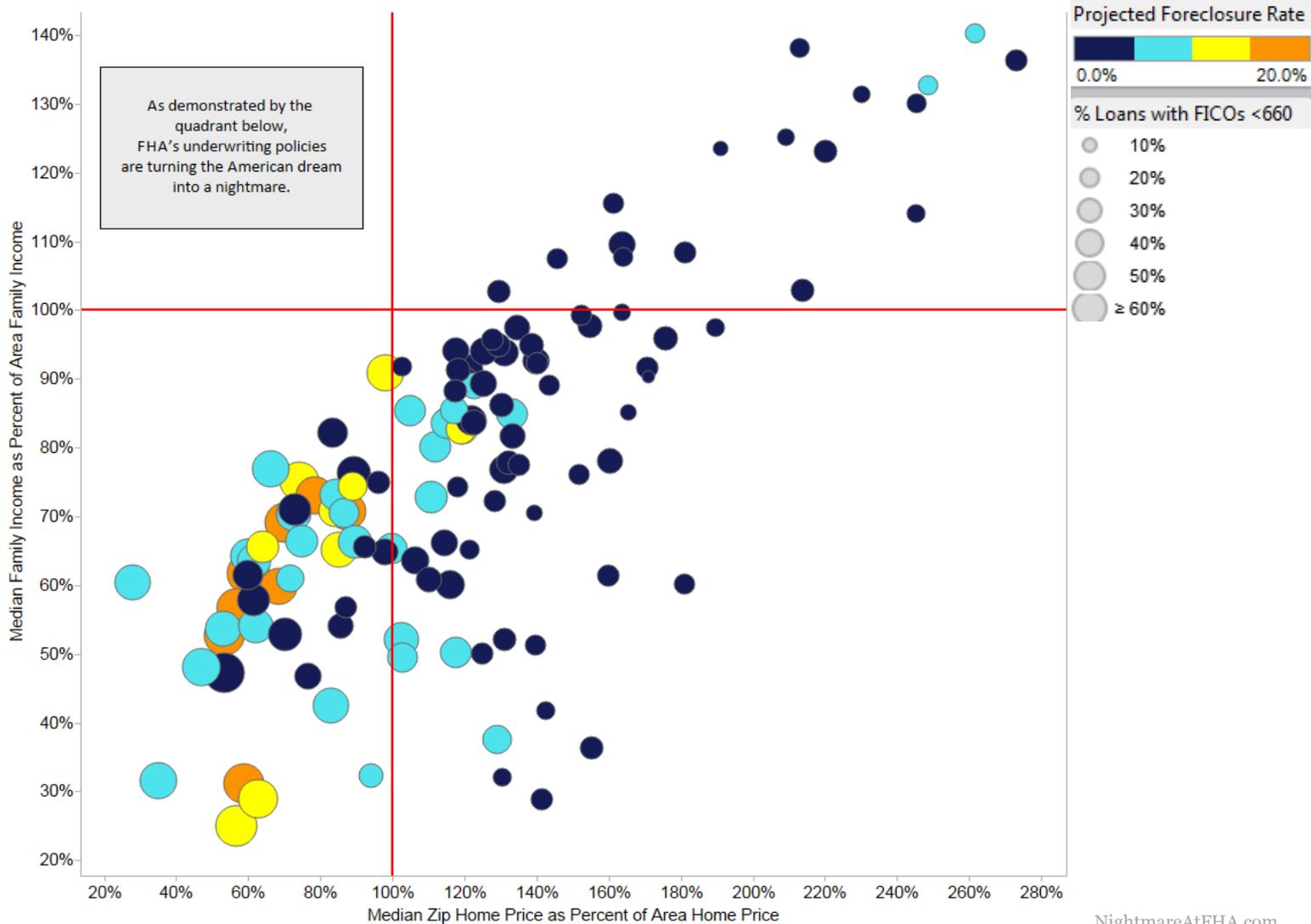


# Washington, DC: Projected Foreclosure Rate

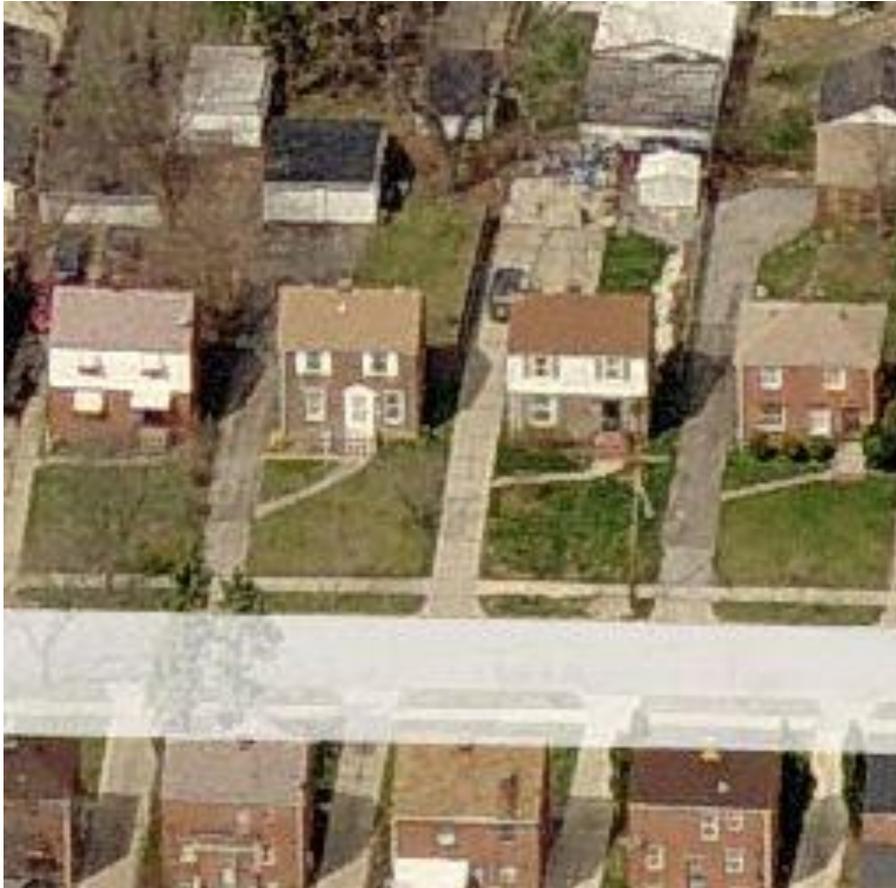


Highest foreclosure rates and greatest loan volumes are concentrated in working-class zips.

# Quadrant of Doom - Washington, DC



# Financing Failure, Zip by Zip



This is Cleveland, OH zip code 44128. With a 21.8% projected foreclosure rate for 2009-2010, one in five families may well lose their homes.

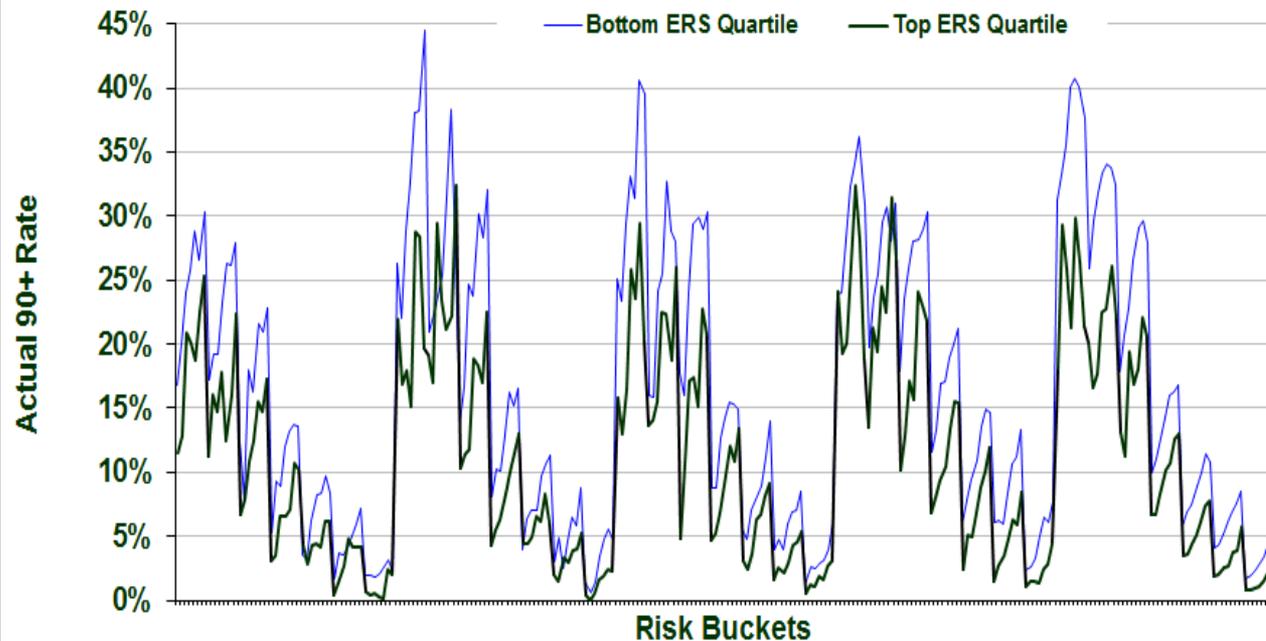
In 2009, the FHA or VA guaranteed two-thirds of home purchase loans in that zip code.

Zillow Home Price Index Aug. 2012:	<b>\$58,600</b>
City:	<b>CLEVELAND</b>
Loan Count:	<b>125</b>
Median Family Income as Percent of Area Family Income:	<b>65%</b>
Median Zip Home Price as Percent of Area Home Price:	<b>54%</b>
Percent of Loans with FICOs < 660:	<b>57%</b>
Projected Foreclosure Rate:	<b>21.8%</b>
Zip Code:	<b>44128</b>

Image Source: [www.Zillow.com](http://www.Zillow.com)

# Disproportionate Impact on Working-Class Communities

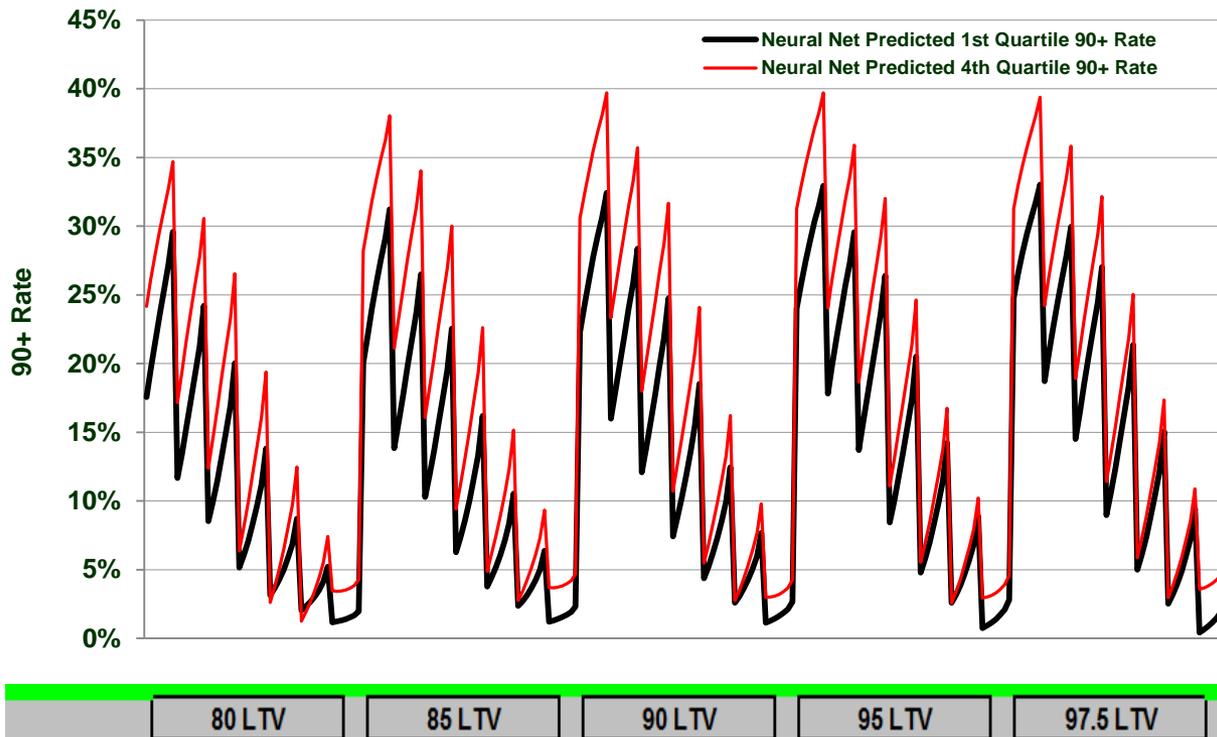
*Actual 90+ Rates by Risk Bucket  
For Loans In Zip Codes In 1st & 4th Quartiles Of Average ERS*



From a study showing that an FHA borrower living in a zip code in the fourth quartile (those with a mean Equifax Risk Score of 519 to 673) had an average 45 percent higher likelihood of being 90+ days delinquent compared to a borrower with the same risk characteristics (measured across 245 risk buckets) living in a zip code in the first quartile (with mean Equifax Risk Scores of 721 to 826).

# Disproportionate Impact on Working-Class Communities

Neural Net Predicted 90+ Rate By Risk Bucket  
1st & 4th Interthinx Risk Index Quartiles



Loans to FHA borrowers in zip codes with a higher fraud risk score (FRS) perform worse than loans in zips with a lower FRS, even when borrower risk factors such as FICO score, down payment, and DTI ratio are held constant across 245 risk buckets. An FHA borrower in a zip code in the 4<sup>th</sup> quartile (the 25% of the zips with the highest FRS), on average, had a 31% higher likelihood of being 90+ days delinquent compared to a borrower with the same risk factors living in a zip in the 1<sup>st</sup> quartile (the 25% of the zips with the lowest FRS).

# WORKING CLASS COMMUNITIES DESERVE COMMON SENSE REFORM

- Reduce coverage below 100 percent (Section 234 of the Protecting American Taxpayers and Homeowners Act of 2013 (PATH))–Appendix C;
- Advise consumer as to foreclosure risk based applicant’s risk profile (Section 236 of PATH);
- Limit seller concessions to 3 percent (Section 263 of PATH)–Appendix D;
- Utilize residual income test (Section 267 of PATH)–Appendix E;
- Reinstitute vetted appraisal panels with rotational assignment–Appendix F;
- Introduce countercyclical stress test and countercyclical LTV ratios–Appendix G;
- Underwrite for risk – balance down payment, loan term, FICO, and debt-to-income (DTI to achieve meaningful equity–Appendix H; and
- Support accumulation of meaningful equity by prohibiting second mortgages and cash out refinances and by requiring any rate reduction on a rate and term refinance to be dedicated to faster amortization.

# The relevant public policy question

- What is the tolerance for failure for loans under such a government program?
- What is the tolerance for failure given the concentration of failure that occurs with respect to working class families and neighborhoods?
- Answer: These common sense reforms will allow FHA to reduce its cycle default rate to 6-7%.

# Appendix A: Needy Families Deserve FHA's Full Attention

Category	% in 580-675 FICO*	Ratio to Non-Hispanic white
Non-Hispanic white	20.5%	1:1
<b><u>Black</u></b>	<b><u>38%</u></b>	<b><u>1.9:1</u></b>
<b><u>Hispanic</u></b>	<b><u>30%</u></b>	<b><u>1.5:1</u></b>
<b><u>Low-income census tract (&lt;50% of median)</u></b>	<b><u>33.5%</u></b>	<b><u>1.60:1</u></b>
<b><u>Moderate-income cen. tract (&gt;49% &amp; -&lt;80% of median)</u></b>	<b><u>29.75%</u></b>	<b><u>1.45:1</u></b>
<b><u>Minority population &gt;=80% for census tract</u></b>	<b><u>33.75%</u></b>	<b><u>1.65:1</u></b>
<b><u>Age: &lt;30 years</u></b>	<b><u>31.1%</u></b>	<b><u>1.5:1</u></b>
<b><u>Age : 30-39 years</u></b>	<b><u>28%</u></b>	<b><u>1.35:1</u></b>
Urban census tract	23%	1.1:1
Rural census tract	23.8%	1.16;1
All	23%	1.1:1

\* Estimates based on [www.federalreserve.gov/boarddocs/.../creditscore/creditscore.pdf](http://www.federalreserve.gov/boarddocs/.../creditscore/creditscore.pdf)

# Appendix B: Credit Score Impact Distribution by Demographic Groups

	Fed study interest rate	Fed study credit score distribution	Fed study default rate	FHA serious delinquency rate	Non-Hispanic white	Black	Hispanic
Credit score band							
<580	9.56%	11%	30%	30%	8%	33%	17%
580-619	8.94%	8.50%	18%	20%	7%	20%	13%
620-659	7.30%	10.50%	14%	11%	9%	15%	16%
660-719	6.40%	19%	5%	2%	20%	17%	24%
>719	6.10%	51%	1%		55%	16%	30%
Some results interpolated to standardize across credit score bands							

Source: Federal Reserve, *Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit*, May 2007,  
[www.federalreserve.gov/boarddocs/rptcongress/creditscore/creditscore.pdf](http://www.federalreserve.gov/boarddocs/rptcongress/creditscore/creditscore.pdf).

# Appendix B continued: Credit Score Impact of Financial Distress

## Mortgage Delinquency Impact To FICO® Score



	Consumer A	Consumer B	Consumer C
Starting FICO Score	~680	~720	~780
FICO® Score after these events:			
30 days late on mortgage	600-620	630-650	670-690
90 days late on mortgage	600-620	610-630	650-670
Short sale / deed-in-lieu / settlement (no deficiency balance)	610-630	605-625	655-675
Short sale (with deficiency balance)	575-595	570-590	620-640
Foreclosure	575-595	570-590	620-640
Bankruptcy	530-550	525-545	540-560

Source: FICO® Banking Analytics Blog. ©2011 Fair Isaac Corporation

# Appendix B continued: Credit Score Recovery from Financial Distress

## Estimated Time For FICO® Score To Fully Recover



	Consumer A	Consumer B	Consumer C
Starting FICO Score	~680	~720	~780
FICO® Score after these events:			
30 days late on mortgage	~9 months	~2.5 years	~3 years
90 days late on mortgage	~9 months	~3 years	~7 years
Short sale / deed-in-lieu / settlement (no deficiency balance)	~3 years	~7 years	~7 years
Short sale (with deficiency balance)	~3 years	~7 years	~7 years
Foreclosure	~3 years	~7 years	~7 years
Bankruptcy	~5 years	~7-10 years	~7-10 years

Source: FICO® Banking Analytics Blog. ©2011 Fair Isaac Corporation

# APPENDIX C

## REDUCE COVERAGE BELOW 100%

- VA pays up to an average of 25%, averaging 25% while FHA pays up to 100% of the claim amount, averaging 63%.
- FHA's loss rate is an estimated 5 times the VA's (2 times the incidence and 2.5 times the severity).
- The VA charges 1/3 FHA's premium (present value basis).
- VA Issuers absorb 1.6 times the overall loss rate compared to FHA issuers for the same fee.

# APPENDIX C CONTINUED

NightmareAtFHA.com

## VA'S 25% COVERAGE

- Did not deter ability to play a countercyclical role.
  - VA's volume tripled from 2007 to 2009.
  - In 2009 the VA's median FICO score was 705, similar to the FHA's median of 694.
- Did not deter ability to serve underserved borrowers in a sustainable manner.
  - In 2005, 43% of the VA's originations had a FICO between 600-679, virtually identical to FHA's 44%.
- VA has experienced substantially lower serious delinquency rates than the FHA for decades and are currently half the FHA rate (2001-2012).

# APPENDIX D

## Excessive Seller Concessions

- In July 2010, FHA Commissioner Stevens proposed eliminating seller concessions  $>3\%$ .
  - FHA allows up to a 6% seller concession vs. 3% for conventional market:
  - The incidence of concessions and the average concession is highest for loans  $< \$180,000$  (lowest loan size for which FHA provided data).
    - When concession is  $>3\%$ , default rate 1.9 times that of loans where 0%  
(1/3 of FHA loans below \$180,000 have a 0% concession.)
    - When concession is  $>3\%$ , default rate 1.3 times that of loans where  $>0\%$  and  $\leq 3\%$ .

# APPENDIX E

## Utilize Residual Income Test

- VA requires underwriters to identify and verify income available to meet:
  - The mortgage payment
  - Other shelter expenses (includes utilities and maintenance)
  - Debts and obligations (includes job related expenses such as child care)
  - Family living expenses
  - Residual income needs
- The resulting debt-to-income ratio (DTI) is secondary to residual income as an underwriting factor.



# APPENDIX F

## Reinstitute Vetted Appraisal Panels

- Achieves Alignment of incentives:
  - Panel selected based on experience and geographical competence (VA)
  - Size: 4500 (VA) vs. 55,000 (FHA). VA did 40% of the FHA's volume (2012)
    - Reopening of local panel based on need, additions based on competence (VA)
    - 2012: goal of increasing VA panel size from 4600 to 5800 , now at 5200
  - Assignment based on rotation (VA) vs. lender selection (FHA)
  - Three benefits of appraiser panels merit special mention:
    - Appraiser independence takes away a tool from unscrupulous parties.
    - Appraiser independence results in greater identification of needed property repairs and shortcomings.
    - "Tidewater Initiative"
  - Quality control (VA)
    - VA staff appraisers or designated lenders
    - Minimum of 10% of work is field reviewed

# APPENDIX G: Countercyclical Policies Designed to Lean Against a Boom

- Countercyclical capital stress test:
  - A risk-based capital model to determine the amount of capital that is sufficient for the FHA to maintain adequate capital to cover all credit losses which are projected to occur at the higher of the rates determined as follows:
    - Consistent with a nationwide economic recession of average severity based on nationwide economic recessions since 1950 or
    - The result of house prices reverting to their long term value trend. Long term value trend shall be determined over a multi-decade and shall utilize fundamental trend values such as replacement costs, rents, household income, or consumer prices

# APPENDIX G: Countercyclical Policies Designed to Lean Against a Boom

- A Countercyclical Loan-to-Value ratio (CCLTV) reflecting the underlying sustainable lending value trend.
  - The standard for the CCLTV shall consider the sustainable lending value based on long-term trends, in addition to the current price, thus creating a standard for a countercyclical loan-to-value ratio.
  - The sustainable lending value trend shall take into account the result of house prices reverting to their long term value trend.
  - Long term value trend shall be determined over a multi-decade and shall utilize fundamental trend values such as replacement costs, rents, household income, or consumer prices.

# Appendix H: Underwrite for Risk

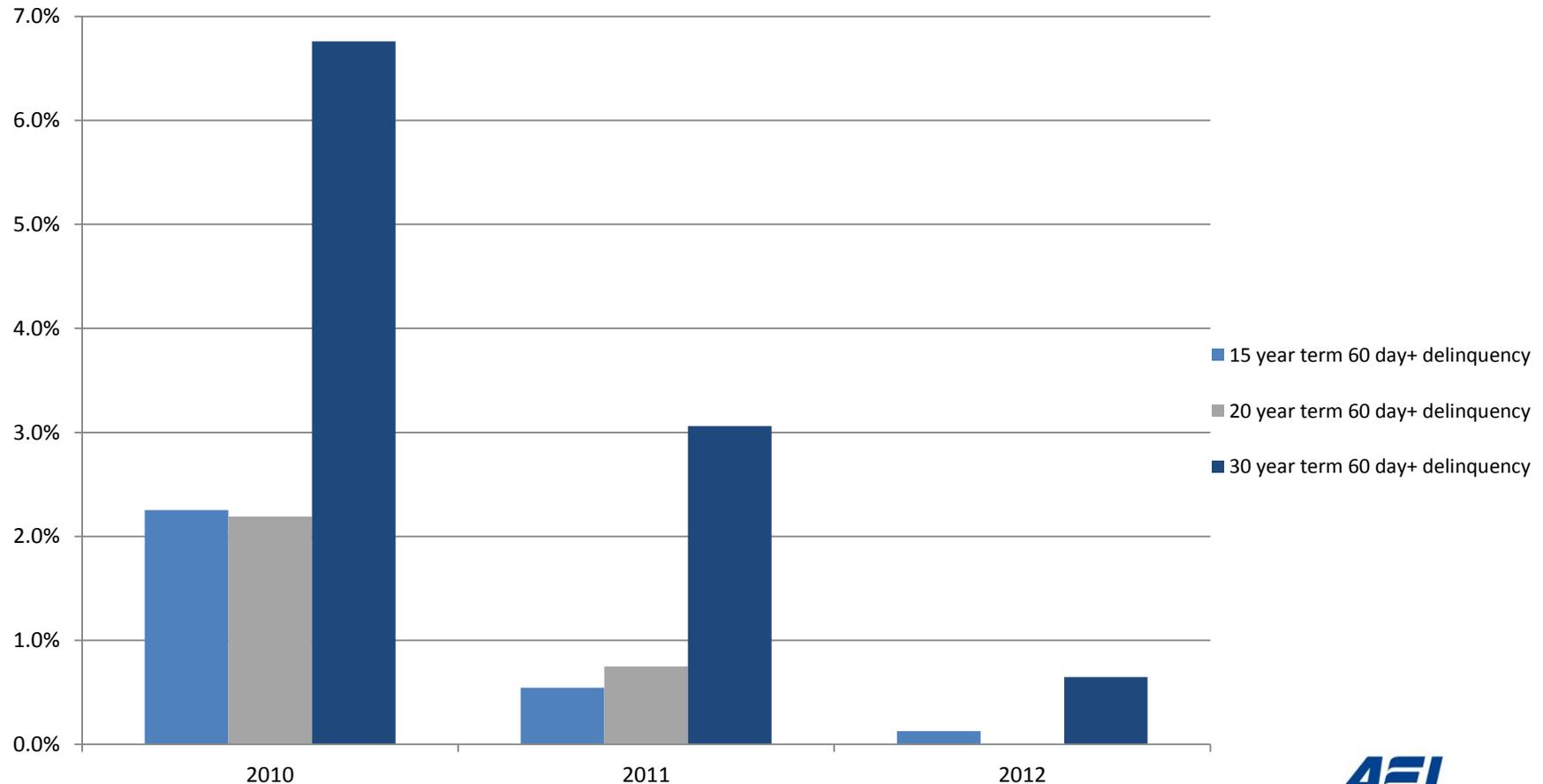
## Balance Risk to Achieve Sustainability

Balance down payment, loan term, FICO, and debt-to-income ratio to expand access to borrowers with lower FICO scores, reduce expected defaults, and achieve meaningful equity. Lenders originate few FHA loans with FICOs below 640 because the likely cycle failure rate is 20-25%.

FICO	Maximum LTV limit	Maximum loan term	Maximum total DTI	Equity after 4 years	MIP Upfront/annual
580+	97.25% (current)	30 years		8%	30 yr.: 1.75%/1.30-1.35% 15yr.: 1.75%/0.45-0.70%
660-675	95.5% (proposed)	30 years	<50%	10%	30 yr.: 1%/1.50%
620-659	95.5%/90% (proposed)	20/30 years	<50%/40%	16%/15%	21 yr.: 1%/1.50% 30 yr.: 1%/1.50%
580-619	92%/85% (proposed)	15/20 years	<45%/40%	26%/25%	15 yr.: 1%/1.50% 20 yr.: 1%/1.50%

# Appendix H: Underwrite for Risk

## 15 and 20 Year Terms Perform Well



# Appendix H: Better Performance for 15 Year Term across All FICO Bands - 2010

