GSE Activity Report

Thursday, November 16, 2017

FHA Wants Its Banks Back

Summary

Although it's of course newsworthy – if not at all surprising – that the Trump Administration plans to retain current FHA premium levels, not adopt the Obama reduction, the annual report to Congress is more illuminating than the actuarial report on the future of FHA. With non-bank origination now accounting for a startling 86% of FHA originations and FHA acknowledging the credit-availability challenges we highlighted, we expect significant near-term change in premium and indemnification-risk aspects of FHA designed to lure back the big banks. We note also the report's discussion of recent refi volume – an early warning that HUD will shift refi policies before the predatory-lending accusations now sweeping over VA also taint FHA.

Impact

It's worth quoting the report to Congress in detail on non-bank lenders:

> The composition of FHA's new endorsements by type of lender has been undergoing an impactful transformation. In FY 2017, 85.8 percent of insurance endorsements were on mortgages originated by non-depository lenders, up from 56.3 percent in 2010. Depository institutions have decreased their FHA participation for a number of reasons, including perceived enforcement risk.
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> Reduced participation by depository institutions may reduce opportunities for borrowers to access FHA-insured mortgages. While meeting FHA requirements, non-depository lenders typically hold less capital than depository institutions participating in FHA and are subject to different regulatory regimes.

It is, as FHA says, "impactful" that the agency recognizes the different risk presented to banks versus non-banks by potential indemnification demands. As noted in the FedFin report cited above, this risk is particularly costly to the largest banks, which have thus exited FHA origination. We note a new Fed paper documenting how the departure of big banks adversely affects LMI credit availability, a point we also go into in detail in a recent post in our *Economic Equality* blog. That FHA now recognizes this not only puts it in sharp contrast to the Obama Administration's insistence on False Claims Act liability, but also signals a significant policy shift that may encourage banks to come back to FHA and thus cut into GSE market-share.

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On to refis, again quoting from the report to Congress:

> In FY 2017, cash-out refinance transactions represented 38.9 percent of all FHA refinance transactions, an increase from the FY 2016 level of 26.1 percent. The increase in cash-out refinance activity include both an increase in the number of endorsements where the borrower's prior loan was an FHA loan, as well as an increase in the number of endorsements where the borrower previously had a conventional loan. An additional 11.4% of FHA insured refinance transactions are loans refinancing into an FHA-insured mortgage from the conventional market without taking cash out, which was a slight decrease from 11.9% in FY 2016. FHA will continue to monitor both the trends of the increasing volume of cash-out refinances and the utilization of FHA-insured refinancing by borrowers with conventional mortgages.

Note that the cash-out refi share of all refinancings grew almost 50% over just one year. Rising house prices are of course part of this, but it's likely also attributable to the same kind of aggressive non-bank marketing that not only boosts endorsements, but also all too often encourages cash-out refis early in the loan term. This type of equity extraction of course generates fees, but puts borrowers at still greater risk of negative equity in even a minor downturn (one now being predicted in numerous cities cited by analysts as house-price hot spots). VA is already experiencing considerable strain and resulting political risk; that FHA sees it coming suggests to us near-term, like-kind action to limit cash-out refis and perhaps all refis before a mortgage has seasoned for at least a year.

Outlook

FHA's premium decision is forced by astonishing HECM losses, losses likely to mount given the portfolio concentration in a comparative handful of states – California, Florida, and New York – as well as a 20% increase in its total maximum claim amount during just the last fiscal year. Although HECMs are only $73 billion out of FHA's total $1.3 trillion book, their projected losses took the MMI Fund down from a capital ratio of 3.3 percent for forward loans to the final 2.09 percent capital ratio reported yesterday.

The recent Trump Administration-mandated HECM reforms met with Democratic and industry outrage, with these changes taking affect in FY18. Given these results, we expect no let-up in HECM discipline and, quite likely, more changes to come that sanction HECMs instead of simply moving reverse mortgages back into their own capital calculation to mask the government's total FHA-related risk profile. Indeed, the fact that this year's report highlighted both the historic high average HECM maximum claim amount ($320,000) and the single nationwide HECM maximum claim limit ($636,150)—versus FHA's usual area adjusted loan limits—suggests some program adjustments are already being contemplated.

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