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Lifting the Fog around FHA Lending?

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With all of the focus in recent weeks on the housing finance reform effort under way in the Senate, an important development in housing policy has slipped largely under the radar. In the rollout of its budget last week, the Administration requested $30 million to help fund a "quality assurance" effort at the Federal Housing Administration (FHA), explaining that the money would be used for "expanding [the FHA's] capacity to more effectively monitor loans and transform its business processes."[1] A few weeks prior, Wells Fargo announced that it is reducing its minimum credit score for FHA lending from 640 to 600.

Each move generated a ripple of attention, but few observers seemed to catch the larger relevance of either of the steps—or their connection. They both arise from an ongoing effort by the FHA to tackle a problem that has led most lenders to offer credit only to the least risky FHA applicants. This has constrained access to credit, particularly for first-time homebuyers, slowing demand in the housing market and frustrating economists and policymakers alike.[2] Below I'll explain the problem the FHA is struggling to address and how it is trying to address it.

The Connection between the FHA's Indemnification Rules and Access to Credit

Today, the FHA imposes a minimum credit score of 580 for most borrowers. Yet few borrowers with a 580 are able to get a loan backed by the FHA, because most lenders apply their own minimum credit score well above what the FHA imposes.

On the surface, this is a curious phenomenon. After all, the government has agreed to take on the credit risk of these borrowers. So, why would lenders shy away from offering them a loan because of their credit risk?

The answer, in part, is that lenders are concerned that when they purchase FHA insurance, the agency may nonetheless make *them* bear the cost if the loan goes into default.

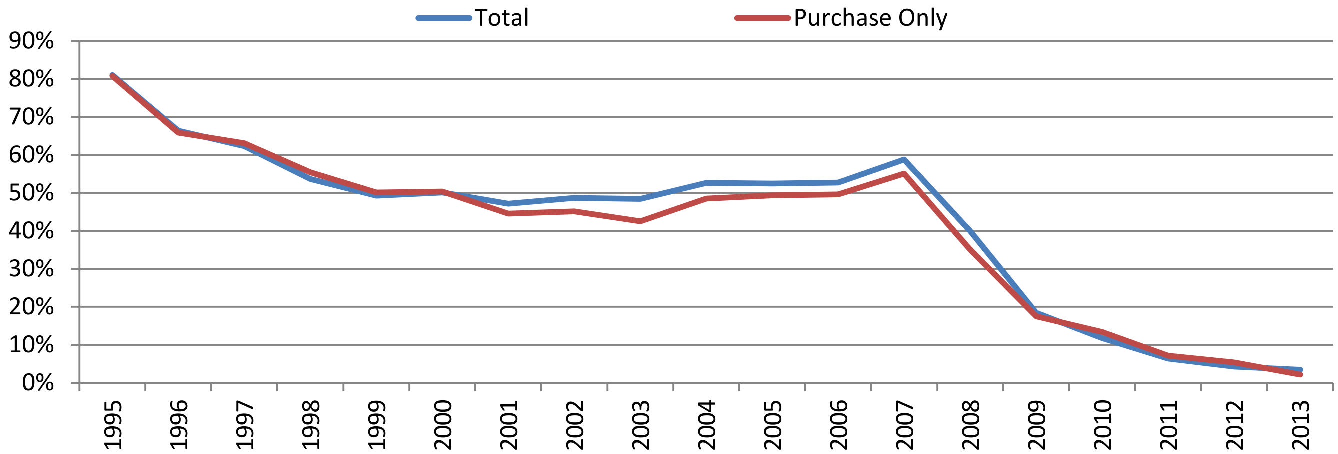
This isn't because the FHA is willfully ignoring its obligations. The FHA has the right to force lenders to indemnify the agency for any insurance claims they pay out if the FHA later finds mistakes in the lender's underwriting of the loan. This, of course, makes sense, as the FHA shouldn't be forced to insure loans that don't fit the characteristics it agreed to cover. The problem is that lenders are unclear about the rules that govern when and why the FHA will require indemnification, leaving them unable to manage their risk simply by improving their underwriting.

So instead they manage it by lending only to lower risk borrowers. Indeed, most lenders apply a minimum credit score of 640 on their FHA lending, causing lending to FHA borrowers below that threshold to plummet, as shown in Figure 1. This means that borrowers with a credit score between 580 and 640 are unlikely to find lenders willing to make them a loan, *even when the government has agreed to take on their credit risk*.

The impact of this is significant. There are 13 million borrowers with credit scores between 580 and 640.[3]

It should be said that there is some dispute between the FHA and lenders about whether the rules are, in fact, unclear. At the end of the day, however, the dispute is largely beside the point: If lenders don't find the rules clear and refuse to lend because of it, then policymakers who care about access to credit are faced with a problem.

Table 1: Percent FICO <640 over Time



Source: CoreLogic Prime Servicing Data and Urban Institute Calculations.

How the FHA Is Trying to Address the Problem

In describing how the FHA is grappling with the problem, it helps to lay out the main sources of uncertainty at issue. There are at least three:

- In its underwriting rules the FHA attempts to give the lender the manufacturing risk—that is, the risk that a loan is not underwritten properly—and the FHA the credit risk. However, there are areas where the two kinds of risk are entangled and thus it is unclear who bears the cost when a loan defaults. For instance, if after applying for a loan the borrower suffers a loss in income (typically considered a credit risk), rendering their file inaccurate (typically a manufacturing risk), who bears the cost if the borrower ultimately defaults?
- Lenders also have to make judgment calls in applying certain FHA rules, calls that later can be second-guessed should a loan go bad. What if shortly after being approved for an FHA loan a borrower begins renting the house out, calling into question whether they ever intended to occupy the house, as required by the FHA? Is the lender obligated to indemnify the FHA if the loan defaults?
- Last, it is unclear which kinds of mistakes rise to the level of a put-back. Given that each loan file is several hundred pages long, with thousands of pieces of information, this leaves the lender with a prohibitive level of possible risk.

There are then two factors that exacerbate these sources of uncertainty. First, the FHA has traditionally focused its quality-control reviews almost entirely on loans that have already gone into default. While understandable, as those are the loans for which the lender has filed an insurance claim with the FHA, it inevitably creates a bias in favor of finding mistakes. Imagine if an insurance company only decided whether those who had purchased its insurance had properly filled out all their application paperwork when they actually needed to be paid out. It would inevitably create a very different kind of "approval" process, because that process would determine who ultimately bears an actual cost. Something like this dynamic is at work with the FHA now, as its reviews take place in the context of a failed loan, the cost of which no one wants to bear.

Second, different authorities with jurisdiction over lenders making FHA loans interpret the rules differently, and some of these authorities can levy penalties well above indemnification. There is variation within the FHA because different regional FHA centers charged with enforcing the rules in their areas interpret these rules differently, and there is variation between the FHA, the HUD inspector general, and the Department of Justice, the latter of which can seek triple damages for mistakes under the False Claims Act. This variation magnifies the uncertainty, and the threat of severe penalties beyond indemnification increases significantly the effect of that uncertainty on lender behavior.

To address the challenge, FHA Commissioner Carol Galante began meeting with a half dozen or so lenders of various sizes to better understand the uncertainties driving them to add credit overlays to their FHA lending. Lenders were able to share their processes and perspectives, and the FHA their intentions and interpretations.

After six months of discussions, Commissioner Galante and the FHA decided that the best way to address the concerns raised is to replace the current indemnification guidelines, which are contained in a hodgepodge of hundreds of mortgagee letters released over the past decade, with a single set of guidelines. The effort is not intended to change the rules so much as simplify and clarify what is expected under them. Most relevant to the uncertainties driving the credit overlays, the new guidelines will be designed to do the following:

- Define more clearly which party—the FHA or the lender—holds which risk at each step in the manufacturing process.
- Narrow the range of areas over which there are judgment calls required of lenders.
- Clarify what kinds of penalties rise to the level of an indemnification claim.
- Perform quality reviews earlier in the process, in order to provide lenders with a clearer picture of how the FHA is interpreting the rules and to ensure that at least some are performed before loans go into default.

It will be a significant feat to accomplish these objectives given the volume of rules involved and the complexity of the matters they cover. But it is the right set of objectives, and to the degree that they accomplish them, the FHA will go a long way in addressing the main areas of uncertainty. That would, in turn, likely limit the variation in interpretations that others apply to these rules, since that variation feeds off of the uncertainty in the rules themselves. Although the FHA does not control its inspector general, or the Department of Justice, one would assume that rules that are more concise, coherent, and clear will lead to rulings that are more predictable.

Prospects for Success

The FHA is months away from implementing these changes, but the announcement last month by Wells Fargo that it will reduce its minimum credit score is at least one early sign that the FHA may be headed in the right direction.

Other lenders remain guarded, however, withholding judgment until they see the guidelines that the FHA ultimately releases. After all, everything turns on what sort of clarity the FHA provides. If it chooses to maintain maximum optionality—retaining the right to second-guess judgment calls by lenders, say, or keeping wide discretion in how it determines what constitutes a material default—then it will merely swap the inadvertent uncertainty of poorly drafted rules for an uncertainty consciously chosen. If that happens, not only will the market not follow Wells Fargo's lead, but Wells Fargo will no doubt put its stronger credit overlays back in place.

And if either the HUD inspector general or the Department of Justice interprets the rules in ways that leave lenders uncertain how to manage their risk in FHA lending, then, again, the effort will fall short and the overlays will remain a problem.

So the challenge before the FHA is daunting, but it is one well worth taking up. As the step by Wells Fargo makes clear, industry remains highly sensitive to the uncertainty that surrounds the risk associated with FHA lending. If policymakers can address that uncertainty, then we can expect to see others follow Wells Fargo's lead and, with that, the very expansion of access to credit that economists and policymakers alike have been calling for for months.

Endnotes

[1] http://portal.hud.gov/hudportal/documents/huddoc?id=FY2015BudgetPresFINAL.pdf

[2] For a discussion of the implications of the issue, see http://www.urban.org/UploadedPDF/412910-Opening-the-Credit-Box.pdf.

[3] Equifax and Moodys Analytics.

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