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Two More Tools in the Tool-Kit

To reach the targets for extending home ownership especially to low- and moderate-income families, both Congress and the Administration were aware that two more avenues were open to them. Both were long-established. Both were originally part of the New Deal. One, the Federal Housing Administration, was part of a government department and the other, the Federal Home Loan Bank System, was a government-sponsored enterprise. Two more tools to be used.

The Federal Housing Administration (FHA)

The FHA was originally established in 1934 under the National Housing Act and was incorporated into the Department of Housing and Urban Affairs in 1965. Its function is to insure loans made by banks and other private lenders for house building and home purchase, and has insured over 34 million properties since it came into existence. A New Deal phenomenon which has probably outlived its usefulness, it came into being when a million construction workers were unemployed and most people were unable to obtain a mortgage. Mortgage terms then were limited to 50% of the property's market value, with a repayment schedule of three to five years, ending with a balloon payment.

As an agency within HUD, the FHA oversees two mortgage insurance programmes to insure lenders against loss from loan defaults by borrowers through the Mutual Mortgage Insurance/Cooperative Management Housing Insurance fund account (MMI/CMHI). Another account, the General Insurance/Special Risk Insurance Fund account (GI/SRI), covers more risky home mortgages, multifamily rental housing and an assortment of special-purpose loans for hospitals and nursing homes. Only the first fund is relevant here, providing insurance for mortgage loans backed by the "full faith and credit of the United States." Since the purchaser pays for the insurance as part of the monthly mortgage payments, and the proceeds are set aside in a separate account, which is used to operate the whole program, the insurance is regarded as self-financing and is designed to protect the lender from the losses incurred if the borrower defaults on the mortgage. The advantage of FHA loans from the borrower's point of view is that the required down payment is the high LTV, and there is greater flexibility in calculating household income and payment ratios.

This is the way in which HUD presents¹ the value of FHA-insured loans to would-be borrowers.

The FHA has traditionally been a major source of funding for first-time, low-income and minority home-buyers, but during the 1990s, substantial program and policy changes enabled it to extend that role. Between 1993 and August, 2000, the share of home purchase loans insured by the FHA and the VA (Veterans Home Loans Program) going to first-time buyers increased from 67% to 81%; that is, 4.2 million first-time buyers, especially minorities, have been assisted to buy their own homes, according to HUD. FHA-insured loans to African-Americans and Hispanics increased from 19.5% in 1993 to 34% by August, 2000. The share for all minorities rose from 22.5% in 1993 to 41.8% in the same period.

By contrast, the conventional conforming market funds low-income and minority borrowers and their neighborhoods at much lower rates than the FHA. Based on HMDA figures for 1999, African-American (minority) borrowers accounted for 14.6% of all FHA loans in metropolitan areas, compared with only 5.4% for the conventional conforming market. More than 40% of FHA loans financed properties in underserved neighborhoods, compared with only 26% of conventional conforming loans.

President Clinton saw the FHA as another way of achieving the aim of increasing home ownership. His 1998 Budget called for helping “hundreds and thousands of hard-working, middle-class Americans qualify as homeowners by raising home mortgage insurance limits used by the FHA. Despite record national home ownership rates, many Americans, including young, first-time home buyers, city center residents, and racial and ethnic minorities, are shut out of home ownership because they have difficulties in accessing mortgage credit.”² He asked for a single nationwide figure of £222,150, which would put FHA-insured loans on a par with the conventional loan limits set by Fannie Mae and Freddie Mac. The limit itself was well above the median price for houses in the USA, which ranged from \$148,000 in January 1998 to \$152,000 in December. This was not agreed; instead the limits for FHA single family loans continued to be set by county in accordance with the National Housing Act. The basic nationwide limits for single family units ranged from \$121,296 to \$219, 849 for high-cost areas in 2000, and from \$160,176 to \$290,319 in 2004.

Changes in FHA requirements

This “success story” was achieved by persuading Congress, whose responsibility it is to set the maximum and minimum loan terms as well as loan-to-value, to allow lower down payments. The National Housing Act was amended in 1999 (and extended in 2002) to allow the FHA to use a simplified formula for assessing the down payment for borrowers buying houses with FHA-insured loans.

The formula still seems quite complicated, but in effect it means that the down payment is about 3% of the appraisal price of the property. Borrowers also have to pay closing costs, prepaid fees for insurance and interest, escrow fees and property taxes, but the loan could be structured so that borrowers do not pay more than 3% of the total out-of-pocket funds, including the down payment. After this change, the FHA doubled the percentage of loans it insured with down payments of less than 5%, from 23% in 1998 to 44% in 1999, and increased its share of house purchase loans from 12% to 15%. It was setting lower underwriting standards with greater reliance on minimum down payments and increasing the total debt-income ratio to 41% and beyond on very low down-payment loans, and it had no minimum FICO score. Indeed, the FHA focused only on the borrower's last year to two-year credit history. With loans like this on offer, the FHA's market share rose from 11% to 15% in 1999–2000, but began to fall in 2001 and 2002 as it faced increased competition from the GSEs. By 2004, its share had fallen to about 3%.

HUD also persuaded Congress to increase the dollar loan limits on FHA mortgages in 1998. These had previously been set at 95% of the area median home sale price within a county, and ranged between a statutory minimum of 38% of the conforming loan limit for conventional loans purchased by Freddie Mac and Fannie Mae and a statutory maximum of 75% of the conforming limit, which could change annually with the general level of house prices. At HUD's request in 1998, Congress raised the respective statutory minimum and maximum limits to 48 and 87% of the conforming limit respectively, thus making FHA loans available more widely, especially to those in high-cost areas who could not use conventional mortgage products. By 2000 the loan limits for single units stood at a minimum of \$121,296 to a maximum of \$219,849.

Seller down-payment program

Underwriting guidelines were also relaxed: gifts could be used to cover the whole down payment in the seller-funded down-payment program; this was introduced in the 1990s and brought to an end in 2008, although loans from a family member will still be considered as cash for this purpose. Congress was also persuaded to authorize a simpler method of calculating the minimum down payment required so that an FHA borrower must put a minimum cash investment of 3% of the purchase price towards the acquisition cost of the home (price plus closing costs), together with whatever additional cash is required to achieve a maximum LTV that varies with loan size and whether the property is located in a state with high closing costs.

The seller down-payment program allowed non-profit consumer advocacy groups to “donate” the 3.5% down payment to low-income buyers seeking an FHA-insured loan.³ Having introduced the program, the FHA was extremely reluctant to abandon it, despite the concerns expressed by both HUD and the

FHA itself.⁴ In her written statement to Congress in June, 2007, for example, Margaret Burns, Director of the FHA's Single Family Program Development, admitted their concerns and refers to the "recently published rule" that the "funds cannot be derived from sellers or any other party that stands to benefit financially from the purchase transaction."⁵ Loans that rely on these "gifts" had higher foreclosure rates than other FHA loans, not necessarily because the buyers were riskier, but because seller-funded down payments were offered in weak real estate markets, often accompanied by property overvaluation. These were very popular loans, accounting for about 30% of FHA loans in 2005.⁶

Congressional reluctance to limit the seller down-payment scheme continued even after the Internal Revenue Service (IRS) issued a new ruling in 2006, for which the press release stated that funneling down-payment assistance from sellers to buyers through "self-serving, circular-financing arrangements is inconsistent with operation as a section 501(c)(3) charitable organization." The so-called "charities" were often set up by the builders, who covered their costs simply by increasing the cost of the home. They "contributed" the funds to the non-profit organization, which passed on the increased costs to the buyer. They were roundly condemned by the Chairman of the IRS as "scams" which "damage the image of honest legitimate charities." This weakness in lending standards cost the FHA some \$10bn according to the FHA's independent Actuarial Report, 2009; the report states that "if the FHA had not insured any loans with seller-funded down payment assistance, the net capital ratio today would still be above the statutory required 2%. FHA's estimated economic net worth would be \$10.4 billion higher today were it not for those loans."⁷ These "gifts" not only benefited the non-profits, but also house builders and many others, since the non-profit was at times a front for them. The program was often fraudulent as well.

Margaret Burns' statement also provided the examples of Ohio and Indiana, where, in 2006, more than 50% of FHA's purchase mortgage business was for borrowers who relied on non-profit seller-funded gifts, these being states in which house values have been stagnant or declining. Borrowers who face any kind of financial hardship and have no or negative equity slip into foreclosure fairly quickly. As a result, the high foreclosure rates in these communities contribute to additional decline in home values and a vicious cycle of property deterioration.

The seller down-payment program was regarded as being an extremely risky one. For example, HUD had proposed a series of reforms, which were incorporated into H.R. 5121, as passed by the House. An administrative provision in the bill the House passed would have amended the National Housing Act, raising the loan limits for low-cost areas from 48% to 65% of the Freddie Mac limit, and would have given the FHA authority to insure 100% mortgages, with HUD determining what, if any, down payment would be required based on the

likelihood of borrower default, with the insurance premium being based on the risk the borrower posed to the insurance fund.

Senate declined to include these provisions in its version of H.R. 5576, partly because it did not believe that the proposal included the reforms necessary to allow HUD to compete in the private market without increased financial risk to the FHA insurance fund, and without subjecting the proposal to significant fraud and abuse. Interestingly enough, the Committee was concerned that the proposals would move the FHA closer to becoming lender of last resort. Neither proposal was enacted by the end of the 109th Congress.⁸

Senators may have been fortified in their views by the 2005 Government Accountability Office (GAO) report on the risks involved in the seller down-payment programme.⁹ GAO noted that the risks had grown substantially over the previous few years, between 2000 and 2004 increasing from 35% to nearly 50%, with seller non-profit having reached about 30%. Involving a non-profit alters the transaction in a variety of ways:

- (i) When a home buyer receives assistance from a seller-funded non-profit, many require the property sellers to make a payment to the non-profit that equals the amount of assistance the home buyer receives plus a service fee after the closing. This requirement creates an indirect funding stream from property sellers to home buyers that does not exist in other transactions, even those involving some kind of down-payment assistance.
- (ii) GAO found from market participants and a HUD contractor study that the property sellers who provided down-payment assistance through non-profits often raised the price of the house so that they recovered the cost of the contributions to the non-profits. This meant larger loans for the purchaser and higher LTV ratios. The differences were significant, about 2% to 3% more than comparable homes without such assistance. The FHA requires lenders to inform appraisers of the presence and source of down-payment assistance, but does not require the lenders to identify whether or not the provider receives funding from the property sellers. Some mortgage lenders regard seller-funded non-profits as an inducement to a sale and so its use should either be restricted or banned. The FHA did not.
- (iii) The GAO report notes that examples of seller-funded non-profits that provide the most down-payment assistance to home buyers with FHA-insured mortgages include the Nehemiah Corporation of America, Ameridream, Inc. and The Buyers Fund, but all these require contributions from sellers. Examples of those which do not include, but still provide, the most down-payment assistance to buyers with FHA-insured mortgages include the Clay Foundation, Inc. and Family

Housing Resources Inc. It is the lender's responsibility to ensure that the gift meets FHA requirements.

- (iv) The GAO report relies on two studies conducted by the Office of the Inspector General, analysing the default rates of FHA loans with down-payment assistance: one sample included loans provided by Nehemiah, and the other did not. In the first study, the default rate was more than double for the loans with down-payment assistance provided by Nehemiah. In the second study (loans endorsed between 1997 and 2001), Nehemiah-assisted loans defaulted at the rate of 19.42% as compared with a rate of 9.7% for loans without assistance from this non-profit.¹⁰ GAO also refers to another report by the Homeownership Alliance of Nonprofit Downpayment Providers (HAND), whose survey based on endorsed loans from 1997 to 2001, evaluated in May 2003, found that the delinquency rates for loans with assistance from non-profits were about 11% higher than for loans with gifts from relatives.

GAO therefore recommended that the FHA should:

- (i) Routinely assess the impact that the widespread use of down-payment assistance has on loan performance; it should also target lenders with a high volume of such loans.
- (ii) Identify down-payment sources.
- (iii) Include the presence and source of down-payment assistance as a variable in the FHA's TOTAL Mortgage Scorecard during the underwriting process.
- (iv) Continue to include the presence and source of down-payment assistance in future loan performance models.

The GAO added that a program assessment, which was included with the 2006 President's Budget, showed that the FHA's Loan Performance Model was neither accurate nor reliable, because it consistently failed to predict the level of claims. This was a significant failure then, and was about to become more serious as the economic value of the fund fell dramatically in 2007. FHA's actuaries have also commented on the impact of down-payment assisted loans in the actuarial study of MMI for the fiscal year, 2005. Their conclusion was that the losses on such loans led to a decrease of almost \$2bn in the estimated economic value. The independent actuarial report for 2006 showed that the cumulative insurance claim rates for down-payment assisted loans represent a significantly greater risk to the FHA than "no gift" loans. For each origination year, the claim rates are much higher than the rates associated with no gifts.¹¹

It was for this and for the reasons cited above that HUD introduced a rule banning seller-assisted down payment, which came into force on October 31,

2007. All organizations providing down-payment assistance reimbursed by the seller “before, during and after” that sale must cease providing grants for FHA-insured loans by October 30, 2007. The Nehemiah Corporation was allowed an extension until April 1, 2008; Ameridream was also allowed to operate until February 29, 2008.

However, life for HUD was not going to be that easy. Nehemiah and several other organizations filed suit to block HUD’s implementation of this new rule, which led to the District Court of Columbia issuing a ruling on November 1, 2007, temporarily preventing HUD from implementing the ban. On March 5, 2008, the Court vacated the rule and remanded it to HUD for further processing in line with the Court’s opinion. It was, however, a Pyrrhic victory for Nehemiah and others, since the Housing and Economic Recovery Act, 2008 (enacted July 30) ended seller down-payment assistance. Nehemiah, by then, had invested in a for-profit marketing firm, Invision Marketing and Sales Inc., to help it reach real-estate agents, house builders and other industry professionals on the grounds that a for-profit company would perform better than a non-profit group because marketing representatives would work harder. It expanded nationally and became the largest provider of down-payment assistance.

The non-profits share part of the blame for the long period in which this program was allowed to flourish. At the start of 2008, when the FHA announced that such assistance was no longer allowed, it had been required to re-estimate its insurance fund by \$6bn due to the high default rate on such loans. It became clear at the beginning of 2009 that the FHA would have to request its first ever Congressional appropriation, if the program were to continue (given the Court ruling). The FHA announced that it was going to introduce risk-based pricing of mortgage premiums instead of its traditional “one-price fits all” approach. After the public comment period, the risk-based pricing approach took effect in mid-2008. Because some industry organizations did not support risk-based pricing (no doubt due to extensive lobbying), Senate placed a one-year moratorium on pricing its mortgage insurance premiums according to the risks of the borrower, even in the midst of the financial crisis.

The costs of the program continued to rise: the seller-assisted loans have claim rates that are three times those of other FHA single-family loans. In their 2009 report, the actuaries note that the net capital ratio would still have been about the statutory 2% if the FHA had never insured those loans, and its estimated net worth would have been \$10.4bn higher in 2009 without them. The actuarial estimate in 2010 is that these loans will have a net cost of \$13.6bn. The report adds that of the one million seller-assisted loans insured between 1998 and 2009, about 500,000 are still active, and an additional 145,000 were paid-off but re-entered the MMI as stream-lined refinance loans. Of these, 14,000, nearly one in ten, have already gone to claim. The effect of this program was dire and will continue to be so.

The report sums up the current situation as follows: “The sum of house purchase loans with the Seller assisted programme and refinance loans from that portfolio, account for \$157bn of actively insured loan balances today. That represents 17% of all active insurance in the MMI Fund ... [Of those] which are still active, 34% are in serious delinquency. Another 12% of the refinance loans are in serious delinquency. This suggests significant additional claims and losses will occur over the next two years. If one-in-three of these loans results in an insurance claim, with current loss-on-claim rates of 54%, the expected two-year losses could be an additional \$7.5bn beyond the \$6.1bn already incurred.”¹²

Congressional efforts to remove the down-payment requirement

But “Congressional efforts have yet to result in the FHA being permitted to offer better and more flexible financing options,” and continued to do so until the seller-assisted program was abolished on October 1, 2008. In fact, the Congressional efforts to which Ms Burn referred sought to deal with the problems of the seller down payment by an even riskier proposal, removing the necessity for a 3% down payment altogether. Brian Montgomery, Assistant Secretary for Housing, stated that the FHA wanted to remove the 3% down payment, and cited in support of his request the fact that 43% of first-time buyers purchased their homes with no down payment in 2006. That was to be balanced by a risk-based pricing approach to premiums charged for MMI insurance. In addition, the FHA wanted to increase the loan limits in high-cost areas.¹³ In so doing Brian Montgomery failed to understand the risks involved in such mortgages, despite the warnings received: the GAO had issued a number of reports on the inadequacies of FHA’s management and the risks of its portfolio, especially in its 2005 report.

Modernising the FHA proved controversial, and although various measures were introduced in Senate and the House, these stalled until 2008. One was introduced by Senator Jim Talent (Missouri): “The Expanding Home Ownership Act” was designed to eliminate the 3% down payment, create a risk-free premium structure, and increase and simplify FHA’s loan limits. It was welcomed by Alphonso Jackson, Secretary for Housing, but although it had bi-partisan support, it did not become law; it was re-introduced in 2007, but died again. These and other bills were introduced with a blithe indifference to or perhaps a total lack of understanding of the fact that such proposals simply increased the risks and in the longer run would do nothing for the recipients of the largesse.

A similar bill was introduced Senator Hillary Clinton, “The 21st Century Housing Act” (S. 1373). Its aim was to revise the National Housing Act to allow the FHA to offer zero down-payment loans and to increase multi-family loan limits to expand affordable rental housing production in high-cost

areas. The bill also proposed 50-year mortgages to reduce monthly mortgage repayments for low-income families: it was never debated in committee. In July of the same year, Senator Clinton introduced “The Federal Fair Housing Act” (which did not make any progress), designed to increase loan limits in high-cost areas. “Many people in New York cannot afford a home within two hours of where they work. If the FHA limits were higher, they could afford a home and we should make that happen.”¹⁴ Her legislative proposals were welcomed by the Chairman of the Mortgage Bankers Association in testimony before the Senate Banking Committee. “As mortgage bankers, we look to programs like the FHA to help us provide even more options to consumers and help bridge the affordability gap faced by many first-time buyers and minority and low-to-moderate income families ... S.3173 will make the changes necessary.”

Lender perspectives on the FHA’s declining market share

A survey of mortgage bankers published in 2006 shows the extent to which the FHA’s approach to lending had been adopted by the market as a whole.¹⁵ The survey was conducted during 2005 against the background of a precipitous drop in FHA’s share of single-family lending between 2000 and 2005. Between 2000 and 2004, for example, FHA’s share of single-family originations declined from 16% to 5%, whilst its share of total mortgage debt outstanding fell from 20% to 9%. Some of this can be accounted for by changes in the overall market: between 2000 and 2004, conventional prime loans (including private and Agency loans, Fannie Mae and Freddie Mac) as a share of total loans outstanding increased from 69% to 76%, while the subprime share increased from 2% to 11% defined as higher priced loans.

Another change was taking place: the conventional conforming market declined to 35% of total originations, from 62% in 2003, as the Alt-A market share increased to 12.5% in 2005 and the subprime market increased to 20% in 2005.¹⁶ The authors point out that the FHA’s market share tends to decline during refinancing waves such as took place in 1992–3 and again in 1998, and has increased during the times when home purchase was to the fore, due to the caps on the size of FHA mortgages and the FHA’s traditional appeal to first time-buyers. Contributing to the perceived increase in FHA risk were the rising FHA delinquency and foreclosure rates, when about 12% of the FHA book was delinquent in the third quarter of 2005 and about 2.5% was in foreclosure. In 2005, delinquency rates on FHA mortgages were about 7% higher on all loans, compared with a spread of 4% in 1998, that is, before the rules changed on down payments and the seller down-payment programs. Lenders also reported their dislike of higher delinquency rates, since these almost always meant higher servicing costs and the possibility of being called before the HUD Mortgage Review Board, which oversees compliance with FHA/HUD

requirements and has the power to impose sanctions, ranging from reprimands to civil penalties and ultimately to the lender's ability to originate FHA loans.

The lenders were most concerned about the FHA's lack of a zero down-payment product, regarding this as one of the most significant weaknesses in its existing product suite, which was then available in both agency and subprime markets. The loan limits were another, but less important, factor. The best way to improve FHA's market share would be to match the down-payment and equity requirements of other market offerings, including agency (that is, Fannie Mae and Freddie Mac) offerings.

Interestingly enough, the lenders surveyed regarded the appraisal process as another important obstacle to considering FHA loans. The appraisal process is usually based on a market-based approach; that is, an estimation of the value of the property for sale, based on recent sales of similar units ("comparables") in nearby areas. The FHA (until 2005) required a much more comprehensive review, involving a meticulously detailed assessment of the property, and required the seller to remedy various deficiencies, such as foundations and structural conditions, roofing, site hazards and nuisances, wood-destroying insects and so on. None of this would be considered in a conventional report. Real estate agents and lenders breathed a sigh of relief when this requirement was removed in 2005. Appraisers generally only sought to assess the market value, and were thought to have frequently inflated those values during the late 1990s and up to 2007, when house prices began to fall.

Undeterred by such concerns, respondents to the survey declared that they would still consider FHA loans if a zero down-payment product was on offer as well as a stronger refinancing product. The FHA had a cash-out refinancing product, and the loan amount was capped at 85% of the home's appraised value. That was about to change with an FHA Mortgagee Letter of 2005, which stated that the FHA would allow such an offer up to 95% of the appraiser's estimate of value, but as this came after the survey was almost completed, it did not affect the response. In respect of the zero option, respondents considered that recent market innovations had put the FHA at a disadvantage, rendering it less able to compete for more creditworthy business, and regarded this as an explanation for the decline in the performance of FHA loans.

The human cost of increasing home ownership

Successive Secretaries of State for Housing and Urban Development and Commissioners for the Federal Housing Administration presented their reports to Congress each year, emphasizing the increase in home ownership for low-income families and minorities. Their claims were not matched by reality, according to one of the community groups, National People's Action.¹⁷ The NPA pointed out that "HUD claims that foreclosures are lower than ever nationally ... The national default rate on FHA loans made between 1996 and

2000 was 6.4%. However, a closer look reveals the startling reality of families losing their homes and communities plagued with abandoned buildings. This situation is most severe in low-income and minority neighbourhoods.” NPA argued that the result was increased crime, drug trafficking, prostitution and disinvestment. The examples given include the low-income neighborhoods of Baltimore, where 21% of FHA loans between 1996 and 2000 went into default, as did over 25% of FHA loans made by Los Angeles’s third largest lender, and over 20% of the loans made by Cleveland’s top FHA lender in minority neighborhoods, statistics which, it is claimed, applied to many other cities. The FHA continued to do business with the majority of these lenders; in fact, it paid out over \$5.6 bn to lenders in insurance claims on foreclosed properties. In addition, NPA argued that HUD-approved lenders, realtors, and appraisers often work together to deceive home-buyers by overvaluing homes, selling shoddy properties to unsuspecting borrowers, or promising repairs or loan deals that never materialized. HUD’s response under Secretary Mel Martinez was described as being “lukewarm.”

The true costs of FHA’s mortgage insurance

According to the federal budget accounting rules as specified in the Federal Credit Reform Act of 1990 (FCRA), the subsidy cost of the FHA’s insurance program, Mutual Mortgage Insurance, is negative. Indeed, the program’s activities are estimated to produce a net gain to the government, excluding administrative costs. The President’s budget for the fiscal year, 2007 estimates a net income of 3 cents for each \$100 of guaranteed loans. This is why using the FHA to meet the affordable housing objectives appealed to politicians: increase home ownership for minorities and low-income families at no cost to the taxpayer.

Unfortunately, an analysis provided by the Congressional Budget Office (CBO) in 2006 shows that this is not the case. This is partly because budget accounting understates the subsidy cost of credit programs by excluding the cost of market risk and displaying administrative costs separately. It is also because the FHA’s Mutual Mortgage Insurance Program imposes costs on the government and taxpayers of between 2% and 5% of the amount of insured loans. The CBO compared the cost of single-family mortgage insurance with that of private mortgage insurance in a highly competitive market, suggesting that the quoted prices are good approximations of the minimum cost of providing such insurance. It is that comparison which provides the basis for the estimated subsidy of between 2% and 5%.

MMI provides lenders with protection against defaults and increases the availability of funds for the kind of higher-risk borrowers whom the FHA insures. Current law allows an up-front fee of up to 2.25% of the loan and an annual fee of 0.55% of the unpaid balance, but the present premium is 1.5%

with an annual fee of 0.5%, which ceases when the loan is reduced to 78% of the initial amount. In 2005, the FHA insured about \$58bn in new loans, down sharply from \$147bn in 2003, part of the long-term decline in its share of single-family mortgages since the mid-1980s, when the agency insured 15% of all mortgages. The FHA is also limited in the kind of mortgages it insures: 30-year and 15-year mortgages of a limited size with a 3% down payment.

Private mortgage insurers, on the other hand, have noted especially rapid growth in coverage for mortgages with less than 97% LTV, larger mortgages than the FHA amount, deferred principal payment or interest-only mortgages, and adjustable-rate mortgages in which the borrower has an option only to pay a portion of the amount due each month. Eight insurers were providing mortgage coverage, but perhaps more important, a large number of mortgage lenders compete by not selling mortgage insurance directly but by providing equivalent services through second mortgages or home equity loans. Such mortgages for no more than 80% of the purchase price do not need insurance; the second mortgage borrowers take out will finance the remaining 20%, and that will cover the risk of default.

However, the rules under the FCRA, although they include the cost of expected losses from defaults, do not calculate these in the way in which markets do, that is, including the costs of uncertainty and risk. The budget costs only average losses rather than a range of losses, which does not recognize any compensation due to the taxpayers for taking on those risks. A careful analysis of the costs of FHA mortgage insurance with private insurance and the price actually charged to FHA borrowers indicates a subsidy of about 3.5% of the amount of the insured mortgages. Allowing for the uncertainty of the adjustment to the costs of FHA insurance so that the annual net cost is 36 and 76 basis points less than the cost of private insurance, the subsidy costs become between 2% and 5% of the amount of the insured mortgages. If the FHA insures \$60bn in new single-family mortgages per year, with a subsidy rate of 3.5%, then the program costs \$2bn annually in the form of bearing risks to maintain its activities.¹⁸ The extent to which the risk applied to the inability to meet the rising costs of foreclosures from the capital would cost the taxpayer more than the subsidy for mortgage insurance. The other cost was the encouragement to extend home ownership by increasingly risky loans, in which the FHA played its part as well.

This was revealed in the 2009 independent actuarial report, which showed (for the first time) the extent of risky lending, as defined by those with low FICO scores of 620 or below.¹⁹ Mortgage lenders generally regard scores of 620 and below as ineligible for prime mortgages; scores of 500 and below as extremely risky and liable to default.²⁰ The FHA was largely squeezed out of the mortgage lending boom between 2003 and 2007, partly because it could not compete with the 100% LTV others were able to offer. However, in 2009, the FHA guaranteed more than \$360bn in single-family mortgages, partly due

to an increase in refinance activity as interest rates fell from about 6.5% in 2008 to close to 5% in 2009. That represents a 75% increase over activity in 2008, and more than four times the volume of insurance commitments made in 2007.

Even in those boom years, the FHA managed to provide low-income families with mortgages; for each year between 2005 and 2008, the agency recorded high proportions of fully underwritten loans with credit scores of below 620, ranging from 40.57% in 2005 to 46.90% in 2007, and even 33.56% in 2008 of its 1.1 million single-family loans for that year. As for underwriting standards, FHA Commissioner David Stevens in his written testimony to Congress pointed out that 6.2% of the entire loan portfolio had been issued to home buyers with FICO scores of below 500, that is, some 360,000 loans, which are four times more likely to be seriously delinquent than loans above the guidelines. These loans “currently demonstrate a seriously delinquent rate of 31.1%.”²¹ In the same testimony, Commissioner Stevens pointed out that the FHA assisted 450,000 families in keeping their homes out of foreclosure, but by the first quarter in 2010, 67% of these modified FHA mortgages were in foreclosure again.

It was HUD’s responsibility to oversee the activities of the FHA and its lending practices, the dilatoriness in dealing with the issue can be seen from the failure to respond to the recommendations made by the Government Accountability Office (GAO) in 2005. Their report pointed out that almost half the single-family home-purchase mortgages the FHA had insured in 2004 had down-payment assistance, with about 30% of the non-profits receiving at least part of their funding from the sellers. Sales with such assistance were appraised and sold for about 2–3% more than comparable homes bought and sold without it, and these loans were characterized by higher delinquency rates. The GAO’s series of recommendations did not include abolition of the practice, but required much stricter oversight of the program, noting that mortgage-industry participants restricted such assistance. The Secretary of HUD took little action apart from requiring more information from the FHA in its quarterly reports until the scheme was finally closed.

Such delays in essential reforms have to be seen in the political context in which both HUD and the FHA operated. Indeed, in view of all the problems in the down-payment program, it is surprising to see that the FHA resisted development of an outright prohibition on seller-funded gifts, and instead tried to obtain an “alternative FHA financing arrangement for borrowers lacking the funds for a down payment.” It is true that any such ban may have been prone to loopholes in the rules, such as the Nehemiah Housing Corporation exploited, but the FHA abandoned the attempt in view of strenuous opposition rather than any drafting problems. The agency wanted to eliminate its own 3% cash down-payment requirement: to “offer cash poor, but creditworthy borrowers a safer, more affordable alternative to seller-funded Gift programs,”

but “Congressional efforts have yet to result in FHA being permitted to offer better and more flexible financing offers.”²²

The FHA to the rescue?

Momentum for FHA reforms grew as the downturn in the housing market worsened in 2008. By then, the fall in house prices, the continuing rise in foreclosures and the meltdown in the mortgage market meant that politicians turned to the FHA as an instrument to add some stability to the mortgage market. Modernizing the FHA became part of the Housing and Economic Recovery Act of 2008 (HERA), which was enacted on July 30 of that year. Title I of Division B of HERA is in fact the FHA Modernization Act, but it does not follow all of the proposals contained in Congressional debates, such as zero down payments. It increased the down-payment requirements to 3.5%, although family loans may be included, or, if the borrowed amount is secured by a lien, then this must be subordinate to the mortgage, and together they must not exceed 100% of the appraised value of the property. Loan limits were increased in relation either to HUD-approved limits or to the Freddie Mac conforming loan limits. Insurance premiums were increased, but these were linked to whether or not the borrower had received counseling.

The FHA Modernization Act sets out significant changes to the law governing the MMI Fund, including: (i) establishing that HUD has the fiduciary responsibility to ensure that it remains financially sound; (ii) that there is an independent actuarial study of the Fund; (iii) that quarterly reports are provided to Congress on the status of the Fund; (iv) that adjustments are made to the insurance premiums when needed; and (vi) that operational goals are established for the Fund. By 2008, the whole tenor of the legislation had changed, as the enormity of the housing crisis had begun to hit home.²³

Both the independent auditors' report and the independent actuarial report of November 2010 showed the impact of the FHA's past and continuing policies of providing affordable home ownership options for those who would otherwise be unable to purchase their own homes, either as single- or multiple-family units, as well as the costs. Between 2003 and 2007, FHA-insured loans constituted only about 2–3% of the market, but when private capital withdrew at the end of 2008, would-be purchasers turned to the FHA for the insurance that would enable them to borrow. The FHA then insured 30% of purchases and 20% of refinances. From January 2009 to September 2010 the agency helped nearly 3 million Americans to either purchase a home or to refinance into more stable, affordable mortgages.²⁴ In the fiscal year, 2009, the FHA re-emerged as the primary source of credit guarantees both for home buyers and for home owners wishing to refinance as interest rates fell from around 6.5% to 5%. In 2009, the FHA guaranteed over \$360bn in single-family mortgages, a 75% increase over 2008 and four times the

volume of commitments made in 2007. In 2010, the FHA served over 1.1 million home buyers, helping 882,000 first-time buyers, which was only the second time that the FHA had helped so many home buyers, the first time being in 1997, when it insured 740,000 single-family mortgages, of which 76% were first-time buyers. In other words, the FHA appears to be retrieving its position in the market between 1986 and 1990, when it was the largest insurer of single-family mortgages.

The immediate cost was that the secondary reserves fell to 0.53% of the total insurance-in-force, below the 2% level required by legislation, according to the 2009 Independent Actuarial Report. The 2010 report found that the MMI Fund remains actuarially sound, but that there are significant risks to the near-term financial outlook, with the capital ratio standing at 0.50%²⁵, once again below the mandated level. Shaun Donovan, Secretary for Housing and Urban Development (responsible for oversight of the FHA and MMI) noted in his assessment of the actuarial reports that “this has precipitated significant administrative actions at HUD to both protect the ratio from falling below zero, and to assure that a 2% ratio can again be achieved in a reasonable amount of time.”²⁶ HUD argued that the loan book of 2010 was of a much higher quality than in previous years, with credit scores of 680 or over being 12% higher, a dramatic decrease in the share of loans with scores between 600–639, and a virtual disappearance of loans with credit scores below 600. This once again demonstrates the level of credit scores the FHA had been prepared to accept in the past.

One of the highest costs, and likely to continue as such, turned out to be the seller-funded down-payment assistance loans (SFDPA). These proved a disaster, with insurance payments totaling over \$5.5bn having been paid out by 2010 and the 2010 actuarial estimate being \$13.6bn. The FHA reported a further loss of \$600m on subsequent refinance loans for such mortgages, totalling \$6bn. The exposure in 2010 of SFDPA mortgages together with refinancing accounted for \$157bn of the actively insured loans in that year. With continuing high unemployment in the USA, it is likely that further losses will occur. The failure to understand the risks of such loans, or the unwillingness on the part of Congress to recognize the risks, cost the taxpayer dear; even when the risks of seller down-payment were presented, politicians produced a flurry of bills with a view to the introduction of 100% loan to value mortgages for those with the kind of poor credit ratings that the FHA was willing to accept. The 2009 actuarial study observed that the net capital ratio would still be above 2% but for the SFDPA loans.

Once again the FHA promised a series of significant administrative actions and changes in lending criteria, both to protect the ratio from falling below zero and to ensure that a 2% ratio could be achieved in a reasonable time period. A Chief Risk Officer was appointed in 2009, the first in the FHA's history, and insurance premiums were increased. David Stevens, FHA Commissioner until

later that year, when he became Chairman of the Mortgage Bankers Association, reported to Congress. He set up a Mortgagee Review Board, meeting monthly, and no doubt was shocked to find the extent of violations of the FHA's origination and underwriting requirements, including false certifications and failures to verify the borrower's income and creditworthiness. This led to the suspension of well-known FHA lenders and withdrawal of FHA approval from a further 1,500.²⁷

Its new guidelines on LTVs and minimum credit scores took effect in October 2010, raising the minimum credit score for those requiring maximum financing to 580 or higher. Those with a credit score of between 500 and 579 are limited to an LTV of 90%, those with a sub-580 FICO score have to make the 10% down payment on a purchase transaction, and those with a FICO score of 500 and under would be refused an FHA loan. These criteria now apply to all single-family mortgages, except for reverse mortgages (home equity conversion mortgages) and Hope for Homeowners. At present, few banks are willing to lend on such low credit scores, even for FHA loans, but that could change when the economy eventually recovers and FHA lending will once again be risky.

Furthermore, it is unlikely that the proposed administrative changes will have any significant effect, despite HUD's repeated assurances to Congress. In November 2010, the auditors reported on the results of their analysis of the FHA's financial management and information system, noting that it was composed of many aging systems developed over 30 years and integrated with the FHA Subsidiary Ledger introduced in 2002. However, little work was undertaken in the intervening years and bringing the system up-to-date will take several years and hundreds of millions of dollars. It is clear from the auditors' assessment that the system has prevented the FHA from carrying out fraud mitigation and counterparty risk-management initiatives, and from acquiring business intelligence. In particular, the current structure of the actuarial model might lead to understatements of the near-term claim levels, especially given the quantum change in the housing market.²⁸

The report of HUD's Office of the Inspector General (OIG) for September 2010 illustrates graphically what this meant in practice in its review of HUD's controls over its automated underwriting process. HUD implemented changes to the FHA's Technology Open to Approved Lenders Scorecard review rules without assessing the risks and documenting changes. "As a result, loans valued at more than \$6.1bn were automatically approved for FHA insurance despite having debt ratios that exceeded average thresholds for automated underwriting." The Inspector General then adds, "OIG recommended that HUD conduct a risk analysis to determine the appropriate front-end and back-end ratios for the Scorecard's review rules and institute appropriate changes. OIG determined that the full contents of this report would not be appropriate for public disclosure and released a redacted version to the public."²⁹ The general observations and assessments are followed by several

pages of fraudulent activities on the part of lenders, mortgage brokers and counselors in the Single Family Program, which came to light in part because of Operation Watch Dog.

Can the FHA rescue the mortgage market?

The prospects do not look too hopeful, given so many aspects of extensive and all-pervasive mismanagement, the fact that some programs were open to fraud, which went unchecked, and the poor quality of the loans the FHA continues to insure. Add to that the fact that the the agency failed to introduce new rules, even after repeated warnings, and did not seem to appreciate the risks of the mortgages it would insure when it wanted to include zero down-payment mortgages as the market was clearly deteriorating. None of this inspires confidence.

In its report on the financial condition of the FHA's Mutual Mortgage Insurance Fund, issued shortly before the actuarial report of 2010, the GAO noted that "a weakening in the performance of FHA insured loans has heightened the possibility that the FHA will require additional funds to help cover the cost of insurance issued to date."³⁰ The GAO report contains a number of proposals for improving the actuarial assessment of the Fund's financial condition, including a wider range of economic forecasts as opposed to a single one, so that the variability in future house prices and interest rates that the Fund may face is taken into account. The failure to do so may well lead to an overstatement of the Fund's economic value. The 2010 report reflects a movement in that direction in that it relies on more than one scenario as produced by Moody's Analytics, but does not provide a stochastic simulation, which may explain why the 2010 projections are cautiously optimistic. The projections for house prices in 2012 (HIS Insight, July 2010 and Moody's Analytics, July 2010) suggested house price increases of 7% in 2012; by the summer of 2011 that seemed unlikely, given the overhang of repossessed houses which the banks have to sell and the uncertainties of the economic situation.

In a statement before the Subcommittee on Housing and Community Opportunity in 2009, Edward Pinto outlined some of the factors leading to the likelihood of a bail-out. These include the fact that the FHA (and the Veterans Administration) now account for over 90% of all the high LTV loans being made. The total high LTV lending in the first six months of 2009 was equal to 23% of all originations by lenders, up from 17% in 2006, which was thought to be the peak of risky lending. The FHA's dollar volume in 2009 was four times its volume in 2006, so that FHA- and VA-insured loans comprised 10% of all outstanding first mortgages by the end of 2009. Millions of new ultra-low down-payment loans are being added to a mortgage market that already has vast numbers of borrowers with low or negative equity.

The loan limit was raised to \$729,750, a large increase, and now covers areas such as California, which were badly hit by the crisis. Wells Fargo and Bank of America are the two largest FHA lenders with a combined share of 46%, and their combined share of FHA loans in such fragile markets was 10% in 2009. Finally the FHA has a long history of fraud, and its inability to monitor, control and discipline its lenders is a source of additional risk. The agency added thousands of new lenders to its approved lists between 2007 and 2009, but by the time it is able to track them and assess their quality, it may be too late.³¹

By January 2011 the FHA had insured over 6.8m mortgages with an outstanding balance of \$947.8bn (HUD, 2011). The 2009 report estimated that the FHA would not require any government support; that has been criticised on the grounds that it underestimated the number of borrowers who had negative equity and were subject to economic shocks, such as unemployment, especially from “streamline” re-finances. These are a modification of an existing loan into a lower interest rate and extended term: what the actuarial report did was to treat them as though the original loan had been paid off and the refinance was a fresh loan, and this procedure, it has been argued, is subject to significant selection biases in the estimation.³² The 2010 report corrects for some, but not all, of these criticisms, and concludes that the Fund is still solvent. The income from loans made in 2010, when house prices had stopped falling, the quality of the average FHA borrower was higher and the FHA had raised its premiums.

The future of the MMI is uncertain at best. The FHA’s insurance in force has doubled over the past two years and is expected to approach \$1.5 trillion over the next five years.³³ At present, the FHA is thought not to require any further government support, but that will depend to a large extent on whether house prices decline again in 2012 and on the economic outlook, neither of which look particularly promising at present. It will also depend on further information about the quality of FHA loans.

The White Paper sees a “reformed and strengthened FHA” having a key role in the future, and so that can be achieved, the Administration “will explore ways to further reduce the risk exposure of FHA ... the FHA will consider other options, such as lowering the maximum LTV more broadly. In considering how to apply such options, the FHA will continue to balance the need to manage prudently the risk to the FHA and the borrower with its efforts to ensure access to affordable loans for lower and middle-income Americans.”³⁴ The temptation is to add: not much change there, then. It is the latter aim which cannot be reconciled just with “managing risk;” the reforms would have to be “root and branch” to deal with all the management issues, and would require resources for new systems and highly qualified staff, which would not be removed when successive Administrations needed to reduce federal expenditure. Continuing the traditional role of the FHA in insuring mortgages should be approached with great caution, bearing in mind that many countries have a mortgage market which functions without a state mortgage insurance agency.

The Federal Home Loan Bank (FHLB) System

Origins of the system

The Federal Home Loan Bank System was created in 1932³⁵ as a collection of wholesale banks, co-operatively owned by its member commercial banks, thrifts, credit unions and insurance companies, designed to restore liquidity to a housing market which had collapsed following the Great Depression. The “System” is still composed of the original 12 Federal Home Loan Banks (FHLBs), where membership of the FHLB was confined to the relevant financial institutions headquartered in the distinct geographical area that the FHLB was originally assigned to serve. Each FHLB is a separate legal entity with its own management, employees, board of directors and financial statements. The function of each FHLB is still to provide reliable long-term funding to specialized mortgage lenders, known to its members as “advances”. Thrifts and certain insurance companies were obliged to be members until the collapse of hundreds of thrifts in the late 1980s led to the introduction of the Financial Institutions Recovery, Reform and Enforcement Act of 1989 (FIRREA). Although that Act brought significant changes to the FHLB, the System retained its privileges.³⁶ Some of its Charter provisions combined with past government actions have given rise to the perception that its obligations are implicitly guaranteed by the federal government; this allows the FHLBs to finance their activities by issuing debt on more favorable terms than any AAA-rated private corporation. Their “advances” or loans to lenders generally have as their collateral mortgage-backed securities and whole loans, US Treasury and Federal Agency securities. In addition to the explicit collateral and a member’s capital subscription, the FHLBs also have priority over the claims of depositors and almost all other creditors (including the Federal Deposit Insurance Corporation, FDIC) in the event of a member’s default; this is often described as a “super lien” and explains why the FHLBs argued that they would not suffer losses.

Changes following the 1989 Act

The resolution of the Savings & Loans crisis of the late 1980s brought about enduring changes in the FHLB system. The Act made membership voluntary, open to all depository institutions with more than 10% of their portfolios in residential mortgage-related assets. This allowed many commercial banks and credit unions to join the FHLB System for the first time, resulting in an increase in membership from 3,200 in 1989 to over 8,000 in 2005, and 8,075 by the end of 2007; this despite the decline in the number of thrifts, still legally obliged to be members until 1999. Commercial banks accounted for 70% of all System members by 2005.

The 1989 Act also obliged members to pay 20% of their net earnings to cover a portion of the interest on the Resolution Funding Corporation bonds which were used to finance the clean-up of the thrifts, after the

Savings & Loans crisis. Another 10% was set aside for the “Affordable Housing Program,” the largest source of private-sector grants for housing and community development, which is disbursed on the basis of advice provided by a 15-member Affordable Housing Advisory Council for guidance on regional and community development issues.

Emerging concerns about the system and the Gramm-Leach-Bliley Act

However, although FIRREA was credited with strengthening the thrift industry and the System in the early 1990s, concerns emerged later in that decade about its capital structure. In particular, it was noted that, since commercial banks could remove stock from FHLBs with six months’ notice, the System’s commercial stability could be affected. The Gramm-Leach-Bliley Act (GLBA, 1999) created a more stable and risk-based capital structure for the System. This Act established that FHLB membership was voluntary for thrifts as well, but also that those who decided to become members had to invest more permanent stock in their “FHLBank.” FHLBanks can issue Class A stock, which can be redeemed with six months’ notice; Class B stock, which can be redeemed with five years’ notice; or both. To ensure that capital did not dissipate due to redemption in times of stress, the FHLBank, if following the redemption, would not meet the minimum capital requirements.³⁷ Following the implementation of the Act, each FHLB had to submit a capital plan to the regulator, the Federal Housing Finance Board (FHFB), for review and approval: all had been approved by 2002, and 11 had implemented their capital plans. The regulator noted that 10 of the 12 capital plans relied entirely on Class B stock and just two included Class A stock. As part of the implementation process, the FHLB required the FHLBs to submit plans for modeling interest rate risks and related procedures for managing those risks.

Lenders see the benefits of the system

FHLB advances are usually regarded as an attractive source of wholesale funds. Advance interest rates are set by the individual FHLBs and reflect a mark-up to the cost of Federal Agency debt funding secured by the Office of Finance. Then the “advances” are structured in a variety of ways to suit each member’s funding strategy. To qualify for these advances, a member pledges high-quality collateral in the form of mortgages, government securities or loans on small businesses, agriculture or community development; they must also buy additional stock, usually between 2% and 6% of the advance, in accordance with the FHLB’s capital plan. Once the FHLBank approves its member’s loan requests, it advances those funds to the member. Advances increased rapidly in the late 1990s and the early 2000s following the entry of commercial banks;

from the end of 2005 to mid-2007 the level of outstanding FHLB advances was within the range of \$620bn to \$640bn, but suddenly increased by 25% to \$824bn in August and September and ended the year at \$875bn, equalling 6.2% of US GDP. This was due to the development of liquidity pressures during the third quarter of 2007, so that FHLB appeared to be an attractive source of funding in terms of pricing and investors turned to the security of federal guarantees (explicit or implicit).

The increase in the proportion of residential mortgages on the FHLB System's combined balance sheet began with the introduction of the Chicago FHLB's Mortgage Partnership Finance Program in 1997. They continued to purchase fixed-rate mortgages on single-family properties under various programs in which, generally speaking, the seller guarantees most of the credit risk, whilst the interest rate risk is handled by the FHLBs together with mortgage-backed securities. The interest rate risk from these assets requires careful management because changes in interest rates affect borrower prepayment behavior with consequent effects on the life of the mortgage assets. This led to the FHLBs having to manage an increasing amount of interest rate risk, including embedded call options linked with mortgage prepayment.

The composition of FHLB membership changed as the banking system in America changed, and developed throughout the 1990s and from 2000 onwards. The top depository institutions were also the largest users of FHLB advances, even though they had access to various wholesale borrowing mechanisms, as well as having national or regional branch networks. Many of these institutions maintained charters in more than one FHLB area, thus having many channels into the System. These trends have both heightened the competitive pressures within the co-operative and led to the growth in size, complexity and risk in this institution.

Exposure to risk has also increased in that the FHLBanks are jointly and severally liable for their combined obligations, so that if any individual FHLBank was not able to pay a creditor, the other 11 would be required to step in and cover that debt. Joint and several liability for payment of consolidated obligations was taken to give investors confidence that System debt will be paid. In addition, the FHLB System also provides letters of credit for bond issuances guaranteed by members and mortgage programs, thus passing through their triple-A rating to member institutions, while pledging to be a credit backstop. The mortgage programs provide competitive alternatives to the secondary market by taking the interest rate risk of mortgage loans, while members retain the credit risk and customer relationship.

A chance to play the system

However, the structure of banking has changed so much that it appears that large banks, and especially holding companies with mortgage subsidiaries which

are members of more than one FHLB district, could play the system. The GAO identified about a hundred such companies in their 2003 report, and noted significant differences in advance-term pricing among the 12 FHLBanks. It also pointed out that the opportunity existed for holding companies to obtain advances from the FHLBank which offered the most favorable terms, and reported that it had been informed by some FHLB officials that holding companies tried to play one bank off against another by creating competition within the System over advance-term pricing. "However, we also found that the FHFB had not identified any material safety and soundness issues related to FHLBanks' advance-term pricing;" identifying and dealing with such issues as they may give rise to unsafe and unsound practices was the responsibility of the FHFB.³⁸

The FHLB System developed new programs, such as the direct purchase of mortgages from member institutions, which led to increased interest rate and credit risk, where the former is the potential for loss due to fluctuations in interest rates, while credit risk is the potential for loss from a borrower or counterparty failure to perform on an obligation. By holding mortgages on their books, they increase both types of risks.

The program began with the Chicago FHLB in 1997, not without controversy. It was a pilot program at first, in which the member institutions originated loans that would close in the name of the FHLB, which would then hold them in portfolio. The pilot was obviously successful, since it was supported by all but one of the FHLBs, FHLB San Francisco, where it was subject to a number of threatened but unsuccessful lawsuits.³⁹ The mortgage purchase program (MMP) was inaugurated and rapidly got underway: total FHLB System whole mortgage assets nearly tripled, from \$16bn at the end of 2000 to \$47bn by September 30, 2002.⁴⁰ As it turned out, the FHLBs found it difficult to manage the risks involved and at first were not in a position to supervise them effectively.

The FHLB System has weak constraints against over-lending, and indeed against extending its purchases of mortgages. Its purpose is to ensure that its members are in a position to make loans, and the FHLBs are lending to their owners, the member banks. The FHLBs do not monitor the loans or the lenders, since that is the role of their borrowers' primary regulators, but they were regulated by the FHFB until October 2008, when the Federal Housing Finance Authority (FHFA) became their regulator.

The regulatory structure

The Board of the FHFB consisted of five directors, four of whom were appointed by the President and confirmed by the Senate; the fifth director was the Secretary for Housing and Urban Development, with the directors serving staggered seven-year terms. No more than three members could be members of the same political party. The criteria for appointment included

extensive experience in housing finance or training in that area, together with a commitment to providing specialized housing credit. Another requirement was that at least one appointed director must be from an organization with more than a two-year history of representing consumers or consumer interests in banking services, credit needs, housing or consumer protection.

The FHFB was also responsible for appointing public interest directors to the boards of the 12 banks, a duty which it considered increasingly difficult owing to the conflicts of interest involved: as the then chairman of the Federal Housing Finance Board put it, “the regulator should not appoint the regulated.”⁴¹ The FHFB appointed at least six directors to serve on the boards of the FHLBanks, each of whose boards consist of at least 14 members. A minimum of two of the public interest directors are designated as community interest directors, due to their strong ties with the local community. Members of each of the 12 FHLBanks elect the remaining directors. The selection of independent directors of the FHLBanks, stated Chairman Ronald Rosenfeld, would be subject to a new process “by which we can assess the individual needs of each Bank and select public interest directors, who not only have the desire to serve for relatively low compensation and potentially increased liability, but who also possess the requisite qualifications, knowledge and skills necessary to satisfy the needs of the Bank’s board.”⁴²

This was not the only problem encountered in the appointment of public interest or “outside” directors. The GAO’s Review of FHFB Operations⁴³ showed that 50 of the 75 public interest directors appointed for the first time from January 1, 1998 through to May 8, 2002 made one or more political contributions in the eight-year period prior to their initial appointments. They then analysed the available data to cover the tenures of the three FHFB chairmen in office when the FHFB made public interest director appointments during 1998 to 2002: namely Bruce Morrison, 1995–2000; William Apgar, July to December 2000; and John T. Korsmo, December 2001 to the present. During that period just over half the directors had made between one and ten separate donations, and 22% had done so 11 or more times. The amount given varied from a median of \$3,250 for the five appointments made during Apgar’s tenure, and \$8,364 as the median during Korsmo’s tenure until he resigned from the chairmanship following the revelation that he had not told the truth about support given to a fundraiser for a Republican congressional candidate. None of the directors who were appointed gave contributions exclusively to the party of the chair of the FHFB, apart from the brief tenure of Apgar, when the three appointed gave exclusively to the party of the chair.

Problems also arose with the FHFB Board itself, partly due to the fact that the legal framework of the agency gives the chair more power to make key administrative decisions, such as the power to appoint and remove officials and to reorganize the agency without recourse to the board. These powers, in the view of the GAO, have “contributed to the sometimes bitter conflicts that have

periodically characterized relations amongst board members over the past eight years.”⁴⁴ However, when the issue was discussed with the members of the board at the time, it was agreed by the majority of the then board members that the delegation of certain powers to the Chairman is the most efficient way of managing the agency’s operation, and that board members can state their views under the delegation with two or more members calling for a vote on the actions taken.

From the accounts summarized in the GAO report, it seems the problems with the management of the board had much to do with its political composition, and the fact that the members of the board were political appointees. The FHFB was finally abolished on July 30, 2008 and the FHLB System is currently regulated by the Federal Housing Finance Agency. The FHFA has appointed a board of directors consisting of the presidents of each of the 12 banks and five independent directors, who now have to meet certain strict criteria as well as the minimum requirements for independence. The directors were selected from a slate of at least five candidates, each of whom was identified in consultation with the FHLBanks.⁴⁵

Problems at Seattle and Chicago

These disputes may also have hindered the effectiveness of the FHFB as a regulator. The GAO reports that it first identified weaknesses in the examination program as far back as 1998, but it was not until August 2002 that the FHFB announced plans that would significantly improve the program by more than doubling the number of examiners and revising the examination program. By 2003, it was too early to assess its effectiveness. In 2004, the agency became aware of risk-management deficiencies in both the Seattle FHLB, one of the smallest, and Chicago, the third largest, especially in their mortgage purchase programs, and sought to rectify these deficiencies by entering into written agreements with both banks. Chicago had led the way in the introduction of the mortgage purchase program.

The written agreement with Seattle dealt with its shortcomings in corporate governance, risk management, capital management and financial performance. For several years, the Bank had been seeking growth and profitability by purchasing a portfolio of mortgage loans, agency debt securities, and mortgage-backed securities to supplement earnings for its advance business, without paying due attention to risk management. In 2002, it had decided to change its portfolio structure by substituting mortgage assets for advances by raising interest rates on the latter.

Washington Mutual, the largest borrower from Seattle, decided to move its advance borrowings to other FHLBs in which its affiliates had members. The low-interest-rate environment of 2003 and the mortgage refinance wave, together with poor quality hedging, resulted in a marked decline in Seattle’s

market value. Seattle then reduced its mortgage purchases but sought to boost returns by investing some \$8bn in callable FHLB System debt obligations funded largely with shorter-term, non-callable instruments, and then was caught by the flattening of the yield curve in 2004, resulting in additional market losses of some \$260m.

This transaction apparently took place without the full knowledge of the board and senior management, and was perhaps the reason (rather than the efficiency of the examinations⁴⁵) why the banks' regulators stepped in, leading to the written agreement in 2004. As a result of the independent reviews of the board's oversight and risk-management processes, which the regulator had ordered them to carry out, Seattle had developed an acceptable three-year business and capital management plan in 2005. By 2007, the bank seemed to have recovered, with advances at record levels and a \$70.7m profit for the year. That may have been due to general market conditions, because it seems that the basic problems had not been solved: as the financial crisis developed, by July 2009 Seattle had accumulated \$247m in net losses, mainly due to its investments in mortgage-backed securities issued by Washington Mutual, the Bank of America and others, in which it had invested some \$5.6bn. The Bank's financial condition was weakening; its governance was unsatisfactory and its credit risk high and increasing, according to the FHFA.⁴⁶

The path of the Chicago FHLB was a troubled one, even after its agreement with the FHFB as announced in 2006 in its bulletin, "The Chicago Balance Sheet." Following the identification of serious risk-management deficiencies, it was required to submit a three-year business plan. Rectifying the deficiencies included a restatement of its financial results for 2003 and placed limits on its mortgage purchase program until its risk-management practices improved.

The Bulletin for 2005 stated that the Bank would reduce its voluntary stock owned by members from 58% in December 2004 to 43% by the end of 2007, and would delay implementation of the new capital structure until December 2006 (or until a time mutually agreed with the FHFB). The Bank also planned to find other methods of capitalizing and funding its mortgage finance partnership program and reduce its quarterly dividends below 5.5% on an annualized basis.⁴⁷ However, by late 2005 it had halted the redemption program and in the following year, in June, the Finance Board allowed the Chicago FHLB to issue \$1bn of ten-year subordinated debt (for which the Bank is the sole obligator) and to use that to purchase excess shares. The FHFB treated excess stock as equity for the purpose of assessing compliance with the minimum capital requirements. The implications of this are difficult to determine. Flannery and Scott Frame point out that "one interpretation of this transaction is that it allowed the Chicago FHLB to increase its risk by substituting debt for equity. However, FHLB excess stock itself has debt-like features, and the lack of market pricing for these claims limits their value as market discipline tools."⁴⁸

By 2007, this approach became unsustainable as the Finance Board announced a “cease and desist” order affecting the redemption and repurchase of capital stock and stated that any increases in dividends by any of the FHLBs required its approval. In October the Chicago Bank announced in its “Balance Sheet” that the Board had decided on a voluntary basis not to declare a dividend in “recognition of projected earning pressure in the fourth quarter and in 2008.” In August, it announced that it was discussing a possible merger with the Dallas FHLB, an unprecedented move. The merger talks were abandoned in April 2008, when the Chicago Bank announced the resignation of its President and CEO, Mike Thomas, and a return to a more traditional FHLB business model and capital structure. Regrets for past business were perhaps reflected in its decision in 2010 to file complaints against several defendants, such as Wells Fargo and Citigroup, with regard to the private label MBSs sold to them between 2005 and 2007, on the grounds that the quality of the loans was inconsistent with the description in the pre-purchase documents prepared by the underwriters and the issuers, leading the FHLB to believe that they were purchasing higher-quality instruments than turned out to be the case.

By November 2008, the FHLB of Atlanta reported its first quarterly loss (\$47.1m qtr 3) in two years to the SEC, a decline of \$179m from the same period in 2007. This was unusual, as the Atlanta FHLB with \$213bn in assets was one of the financially strongest in the System. This was especially true when the Chicago FHLB reported large losses in recent years and almost merged with the Dallas FHLB. Atlanta’s loss was primarily attributed to a \$170m reserve against credit losses from the Lehman Brothers Special Financing Ch 11 bankruptcy filing on October 3, 2008 and an \$87m impairment charge for certain mortgage-backed securities. The MBS investments created the largest problems for the Bank, as during the first nine months of 2008, the securities that were downgraded or put on the watch list by the ratings agencies for a potential credit reduction increased from \$637m on January 1 to \$2.2bn on October 29 in the same year. The Bank recorded net total assets of \$213.7bn that year, due to the fact that advances increased by \$21.4bn (some 15%) during this period, and also due to the sale of federal funds and held-to-maturity securities.⁴⁹ It is interesting to note that the demand for loans continued to increase in 2008, but the lenders may have used the funds for other purposes besides mortgage lending.

Another risky federal agency

In an interesting paper produced in 2005, the authors put the question: “Should the FDIC worry about the impact of the Federal Home Loan Bank Advances on the Bank Insurance Fund?” The question turned out to be much more prescient than they may have thought at the time.⁵⁰ The first point in their argument is that the FHLBs do not face any credit risk because of their GSE status and monopoly position; they also require collateralization far

in advance of that required by other insured creditors. Finally, they have access to confidential commercial bank examination reports, so they are aware of the deterioration in a member's loan portfolio before other creditors, although the events outlined below suggest that they did not make proper use of such information. If a member bank did fail and the collateral prove insufficient, then the FHLB, as noted earlier, can assert its legal lien priority on other assets before all unsecured creditors. "Because of this protection, no FHLBank has ever lost a penny on an advance. So banks can take the risks with advances, keep the upside, and shift the downside to the FDIC."⁵¹

The authors sought to model the impact on the FDIC, but concluded that "our estimation of resolution costs suggest that FDIC exposure from advances ranges from modest to large depending on the assumptions. But those figures may still understate potential losses ... and [in 2005] US banks held record levels of capital ... High levels reduce expected Bank Insurance Fund (BIF) losses by deterring risk-taking and absorbing losses from any level of risk-taking. Reversion of capital ratios to historical norms would increase both default probability and loss-given default."⁵²

They note that the current pricing structure for BIF (the Bank Insurance Fund as part of the FDIC) does not differentiate between different advance levels, but with similar supervisory ratings and capital protection pays the same premiums, and suggest that the FDIC should charge for increases in expected losses arising from advances. That suggestion, which may have required legislative changes, is perhaps one which Sheila Bair, Chairman of the Federal Deposit Insurance Corporation, came to regret in 2008, when she realized that the FHLBank funding provides an easier escape than insured deposits, as the latter are expensive to obtain and the supply is relatively inelastic (which partly explains the attractiveness of such funding). In an interview in the November issue of *Bloomberg Markets Magazine*, she said "we really get a double whammy," adding that the FDIC has "a beef with excessive reliance on FHLB advances." Earlier that year, Bair had stated that the FDIC was developing a plan to raise insurance premiums for the coming wave of bank failures.

The extent of the use of the "advances" can be seen from the cases of Countrywide and Indymac Bank Corps. The latter had increased its advances by 500% between the end of 2004 and early 2008, and had outstanding loans of \$10bn, about one-third of its liabilities, when it collapsed on July 11, 2008. That bank failure cost FDIC \$9bn to sort out. Similarly, Countrywide's CEO agreed to borrow \$51bn from FHLB Atlanta, but even this did not save it, as the Bank of America acquired Countrywide to rescue it from failure in June 2008.

The role of the FHLBanks was upheld by the then Treasury Secretary as a means of ensuring liquidity for their members, the lenders, in his announcement at a press conference on September 7, 2008. But he was careful to point out what had gone wrong. "Prior to the crisis, the FHLBs suffered from inadequate

regulatory oversight, and were allowed to build up large investment portfolios that subjected them to excess risk, while providing concentrated funding to banks engaging in unsound business practices. Today, eight of the twelve banks are under regulatory orders with respect to their capital or have voluntarily suspended dividends or the repurchase of excess stock.”⁵³

The US Treasury extended a secured credit facility to the FHLBs, allowing them to borrow until the end of 2009. But as James Lockhart, then Director of the Federal Housing Finance Agency, which had become their regulator at the end of July that year, pointed out, they were “very unlikely” to need to use the program, as they had larger capital reserves than Fannie Mae and Freddie Mac and all but one of the regional lenders are profitable. The System is the largest US borrower after the federal government, with \$1.34 trillion of assets on June 30, 2008, mostly eligible collateral for the lending program, and \$1.25 trillion of debt, according to the Finance Office, which manages their collective debt sales.⁵⁴ The US Treasury terminated its short-term credit facility, which had been created under the Housing and Economic Recovery Act, 2008 but had never in fact been used.

FHA and FHLB contributions to the total subprime and Alt-A exposure

By June 2008, about 83% of FHA loans consisted of high LTV loans (over 90%) and about 70% had a FICO score of 660 or less. Given these percentages, it is highly likely that at least 90% of FHA-insured loans have one of these two characteristics. Similar data is not available for VA and rural housing loan programs, but it is reasonable to assume that at least 60% of these loans have one or more of the two characteristics. FHA loans have an average loan balance of \$103,300, which would give a total loan balance of \$394bn, and for the VA, the average may be \$150,000, which gives a loan balance of \$143bn. This gives a total of \$537bn (including VA and rural loans).⁵⁵

As regards the FHLB, at the end of 2008, the various FHLBs were reported as holding \$76bn in private MBSs.⁵⁶ Moody’s commented that, based on market prices in the third quarter of 2008, the banks’ total private label MBS portfolio was valued at \$62.7bn, thus representing a \$13.5bn write-down, which was felt to be unlikely, but it did mean that under the worst-case scenario only four of the 12 FHLBs would remain above the capital minimum. Taking the year end value of the private MBSs, it would be reasonable to assume that 66% of the total or \$50bn would be backed by Alt-A and sub-prime loans. This in turn is based on an average loan amount of \$160,000 (blended average used for Fannie and Freddie’s holdings of private MBSs and Alt-A

private MBS results in 0.13 loans). What this means is that there are more sources of risk in the mortgage finance system than successive governments have been prepared to admit, even today.⁵⁷ The FHLB has been weakened by these purchases and also by the continuing fall-out from its inability to manage interest rate risk from their mortgage purchase programs with FHLB members. It has managed to remain solvent, but leaning on the FHLB may turn out to be leaning on a broken reed.