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What If There Were No FHA

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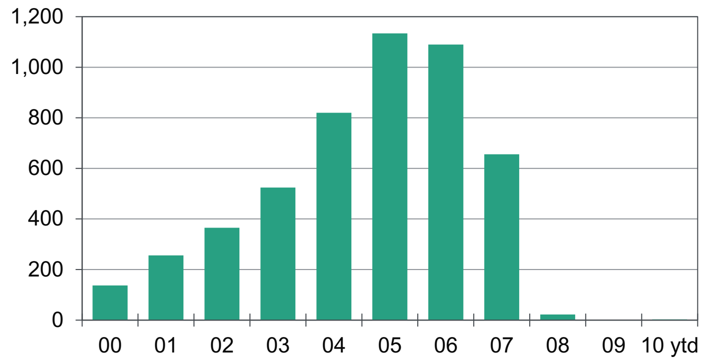
The nation's housing market has suffered an epic crash. Since housing activity peaked nearly five years ago, home sales have been cut in half, housing construction is about one-fourth of what it was, and house prices have fallen by a stunning over 30%. The market remains under severe pressure given the extraordinary overhang of vacant homes and the millions of mortgage loans that are in foreclosure and clearly headed in that direction.

The collapse in the housing market and resulting foreclosure crisis would have been measurably more severe if not for the unprecedented government response to stem the free fall. This response includes a wide range of efforts, including most notably putting Fannie Mae and Freddie Mac into conservatorship; the Federal Reserve's aggressive monetary easing, which involved the direct purchases of GSE debt and mortgage securities; three rounds of housing tax credits; a significant increase in conforming loan limits; and large programs to facilitate the modification of distressed mortgage loans and the refinancing of mortgages of underwater homeowners.

Arguably the most important policy response to the housing crash has been the dramatic expansion of Federal Housing Administration lending. During the height of the housing boom in the mid part of the last decade, the FHA accounted for very little of the purchase mortgage loan volume. The FHA was nearly completely supplanted by private lenders originating subprime, alt-A and option-ARM loans. This aggressive private lending and the millions of bad loans that were originated are, of course, the fodder for the subsequent housing crash, financial panic and Great Recession. Private lending has since all but dried up, with the exception of some very modest jumbo mortgage lending. Into this breach has stepped the FHA, accounting recently for nearly one-half of all purchase mortgage lending (see Charts 1 and 2). Fannie Mae, Freddie Mac, and the mortgage insurance industry account for the

Chart 1: Private Mortgage Market Has Collapsed…

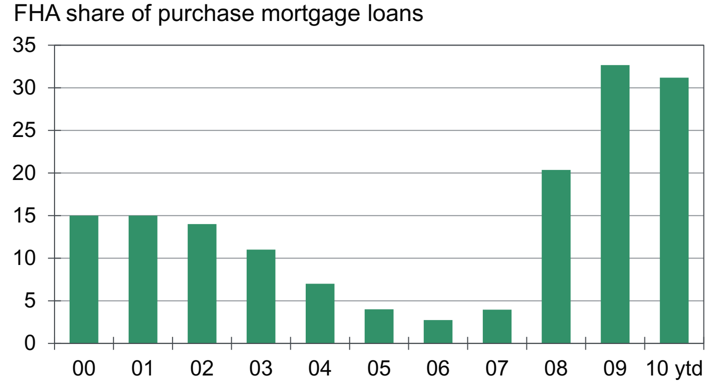
Private label residential MBS issuance, $ bil, annualized



Source: Dealogic

Chart 2:…And the FHA Has Filled the Void

FHA share of purchase mortgage loans



bulk of the rest of the lending. It is clear that without the expanded FHA activity, current conditions in the housing market and by extension the broader economy would be measurably worse.

While the FHA has been important to supporting the housing market and economy, there are reasonable concerns that its role has become too large. Even though the quality of FHA borrowers has steadily improved, as is evidenced by the steady rise in their credit scores, future credit losses may put taxpayers at risk. Some vocal critics have even argued that the FHA should cease operations.

To evaluate the impact of a FHA shutdown on the housing market and economy, Moody's Analytics has simulated its macroeconometric model of the U.S. economy assuming that the FHA is prevented from guaranteeing loan originations without warning on October 1, 2010. The Moody's model has been used for forecasting, scenario analysis, and quantifying the impact of policies on the economy for nearly 20 years. A large number of nonfinancial corporations, financial institutions, regulators and government bodies use the model regularly for these purposes. The Congressional Budget Office and the Council of Economic Advisers also derive their impact estimates for policies such as the fiscal stimulus using similar models and approaches. The Moody's model is in the mainstream of econometric models currently being used to address practical business and policy problems.

The principal lever used in the model to generate this "No FHA" scenario is mortgage rates. Rates would quickly jump as Fannie Mae, Freddie Mac, and the mortgage insurance industry would not be able to quickly fill the void left by the lack of FHA activity. The MI industry would be the most serious constraint as mortgage insurance would be required on most of the additional lending, and the MI industry is currently very thinly capitalized. This is despite the industry's success in raising additional capital during the past year. A survey of private mortgage insurers' premium rate sheets indicates that insurers are currently willing to offer insurance to borrowers with credit scores above 680 and loan-to-value ratios below 95%, no more than 20% of the FHA's credit guaranty portfolio. The MIs do not have sufficient capital at this time to adequately handle a substantial expansion of their activities.

Based on simulations of the Moody's model, fixed mortgage rates would have to immediately increase by about 800 basis points to sufficiently ration the mortgage credit that is available from Fannie, Freddie, the MIs, and jumbo mortgage lenders. The Freddie Mac fixed loan rate would thus rise from its current record low of just over 4% to nearly 12% in the fourth quarter of 2010. Mortgage rates would soon drift lower as private capital would flow into the MI industry to meet the increased demand for credit, but rates would ultimately settle about 100 basis points above where they would if the FHA had remained a substantial participant in the mortgage market. This long-term rate impact is based on the assumption that the MI industry would need to charge higher insurance premiums than the FHA in order to get the 15% return on capital that they have historically enjoyed. It is also assumed that it takes two years for rates to move down to their new long-run level, as it would take that long for the MIs to raise sufficient capital to meet the greater demand for their insurance.

The fallout of the cessation of FHA activity and the consequent surge in mortgage rates on the housing market and economy would be severe. Housing starts would plunge, totaling just 300,000 in 2011 compared with more than 800,000 units expected in the baseline outlook in which FHA activity continues on as is. Key housing market and economic statistics for the baseline outlook, the No FHA lending scenario, and the difference between the two scenarios are shown in Table 1. New- and existing-homes sales total about 4 million units in 2011 compared with 6 million in the baseline, and median existing-home prices fall a stunning almost 25% in 2011 compared with less than 5% in the baseline. With housing in free fall again, the economy suffers a double-dip recession. Real GDP declines 1.8% between the third quarter of 2010 and the new bottom in the economy in the second quarter of 2011. Nearly 3 million more payroll jobs are lost and the unemployment rate peaks near 12% during the second half of 2011.

Exacerbating the housing and economic fallout from the cessation of FHA activity are conditions that are already very fragile. Even under the baseline, the housing market is weak and though the recovery remains intact, growth is slow. Unemployment drifts back into double digits in early 2011. The collective psyche is also on edge. It does not seem as if it would take much to send already very low consumer, business and investor confidence tumbling. Given the difficulties of quantitatively capturing how sentiment would respond to a shock such as that generated by an abrupt ending in FHA activity, it is very likely the housing market and economic impacts presented here understate the actual negative impacts that would ensue in such a scenario.

TABLE 1: DIFFERENCE BETWEEN NO FHA AND BASELINE SCENARIOS

	Units	10Q3	10Q4	11Q1	11Q2	2010	2011	2012	2013	2014
Gross Domestic Product	bcw$	-0.1	-120.8	-359.1	-491.8	-30.2	-504.5	-410.8	-105.0	37.3
Change	*%AR*	*0.0*	*-3.6*	*-7.2*	*-4.0*	*-0.2*	*-3.6*	*0.9*	*2.3*	*1.0*
Federal Budget	$ bil	0.0	-8.4	-41.4	-94.4	884.1	584.9	337.3	436.7	497.3
Total Employment	mil	0.0	-0.5	-1.8	-3.2	-0.1	-3.6	-4.5	-1.8	0.0
Change	*%AR*	*0.0*	*-1.5*	*-4.1*	*-4.4*	*-0.1*	*-2.7*	*-0.6*	*2.2*	*1.3*
Unemployment Rate	%	0.0	0.2	0.8	1.4	0.0	1.6	2.0	0.8	0.0
Light Vehicle Sales	mil, SAAR	0.0	-0.4	-0.9	-1.4	-0.1	-1.6	-1.4	0.2	0.6
Residential Housing Starts	mil, SAAR	0.00	-0.34	-0.41	-0.48	-0.08	-0.52	-0.55	-0.36	-0.05
New Home Sales	mil, SAAR	0.00	-0.24	-0.35	-0.46	-0.06	-0.49	-0.45	-0.18	-0.08
Existing Home Sales	mil, SAAR	0.00	-1.25	-1.75	-1.75	-0.31	-1.90	-1.77	-0.48	-0.16
Median Existing-House Price	ths $	0.0	-46.0	-48.4	-42.5	-11.5	-40.8	-29.8	-18.2	-7.4
Change	*%YA*	*0.0*	*-26.7*	*-28.0*	*-24.6*	*-6.7*	*-18.7*	*9.3*	*9.8*	*7.9*
Consumer Price Index	%AR	0.0	-0.1	-0.4	-0.4	0.0	-0.2	-0.2	-0.5	-0.4
Federal Funds Rate	%	0.0	-0.1	-0.1	-0.1	0.0	-0.1	-1.3	-3.4	-2.3
Fixed Mortgage Rate	%	0.00	8.00	8.00	7.40	2.00	6.72	2.29	1.00	1.00
Treasury Yield: 10-Year Bond	%	0.00	-0.31	-0.53	-1.05	-0.08	-1.26	-1.69	-0.25	0.10
Baa Corp. - 10Y Treasury	DIFF	-5.6	-4.6	-4.7	-5.3	-6.1	-5.7	-9.1	-9.6	-9.3
Corporate Profits With IVA & CCA	bil $	0.0	-31.7	-125.6	-208.2	-7.9	-200.9	-144.7	-15.2	27.5
Change	*%YA*	*0.0*	*-2.2*	*-8.0*	*-12.9*	*-0.6*	*-12.1*	*5.9*	*8.4*	*2.1*
S&P 500	1941=10	0.0	-253.8	-416.1	-524.9	-63.5	-468.2	-159.1	0.0	0.0
Change	*%YA*	*0.0*	*-23.3*	*-36.9*	*-46.2*	*-6.7*	*-37.9*	*47.6*	*14.8*	*0.0*

About the Authors

Mark Zandi

Mark M. Zandi is chief economist of Moody's Analytics, where he directs economic research. Moody's Analytics, a subsidiary of Moody's Corp., is a leading provider of economic research, data and analytical tools. Dr. Zandi is a cofounder of Economy.com, which Moody's purchased in 2005.

Dr. Zandi's broad research interests encompass macroeconomics, financial markets and public policy. His recent research has focused on mortgage finance reform and the determinants of mortgage foreclosure and personal bankruptcy. He has analyzed the economic impact of various tax and government spending policies and assessed the appropriate monetary policy response to bubbles in asset markets.

A trusted adviser to policymakers and an influential source of economic analysis for businesses, journalists and the public, Dr. Zandi frequently testifies before Congress on topics including the economic outlook, the nation's daunting fiscal challenges, the merits of fiscal stimulus, financial regulatory reform, and foreclosure mitigation.

Dr. Zandi conducts regular briefings on the economy for corporate boards, trade associations and policymakers at all levels. He is on the board of directors of MGIC, the nation's largest private mortgage insurance company, and The Reinvestment Fund, a large CDFI that makes investments in disadvantaged neighborhoods. He is often quoted in national and global publications and interviewed by major news media outlets, and is a frequent guest on CNBC, NPR, Meet the Press, CNN, and various other national networks and news programs.

Dr. Zandi is the author of *Paying the Price: Ending the Great Recession and Beginning a New American Century*, which provides an assessment of the monetary and fiscal policy response to the Great Recession. His other book, *Financial Shock: A 360º Look at the Subprime Mortgage Implosion*, and *How to Avoid the Next Financial Crisis*, is described by the New York Times as the "clearest guide" to the financial crisis.

Dr. Zandi earned his B.S. from the Wharton School at the University of Pennsylvania and his PhD at the University of Pennsylvania. He lives with his wife and three children in the suburbs of Philadelphia.

Cristian deRitis

Cristian deRitis is a director in the Credit Analytics group at Moody's Analytics, where he develops probability of default, loss given default, and loss forecasting models for firms and industries; contributes to forecasts and analysis for CreditForecast.com; and writes periodic summaries of the consumer credit industry. His commentary on housing and mortgage markets, securitization, and financial regulatory reform often appears on the Dismal Scientist web site and in the Regional Financial Review.

Dr. deRitis' recent consulting work has included an evaluation of the efficacy and cost of the federal government's Home Affordable Modification Plan, and he is frequently consulted on credit risk modeling and measurement as well as housing policy. He helped develop the company's models to forecast the Case-Shiller and FHFA metropolitan house price indices and is a regular contributor to the firm's Housing Market Monitor. Dr. deRitis also gives frequent presentations and interviews on the state of the U.S. housing, mortgage and credit markets.

In his previous work at Fannie Mae, Dr. deRitis supervised a team of economists who developed models of borrower default and prepayment behavior. He has published research on consumer credit and credit modeling as well as on the costs and benefits of community mediation. He received a PhD in economics from Johns Hopkins University, where he focused on the impact of technology on labor markets and income inequality. His bachelor's degree in economics is from the Honors College at Michigan State University.

About Moody's Analytics
Economic & Consumer Credit Analytics

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Moody's Analytics added Economy.com to its portfolio in 2005. Now called Economic & Consumer Credit Analytics, this arm is based in West Chester PA, a suburb of Philadelphia, with offices in London, Prague and Sydney. More information is available at www.economy.com.

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