Mortgage risks underestimated, economists conclude

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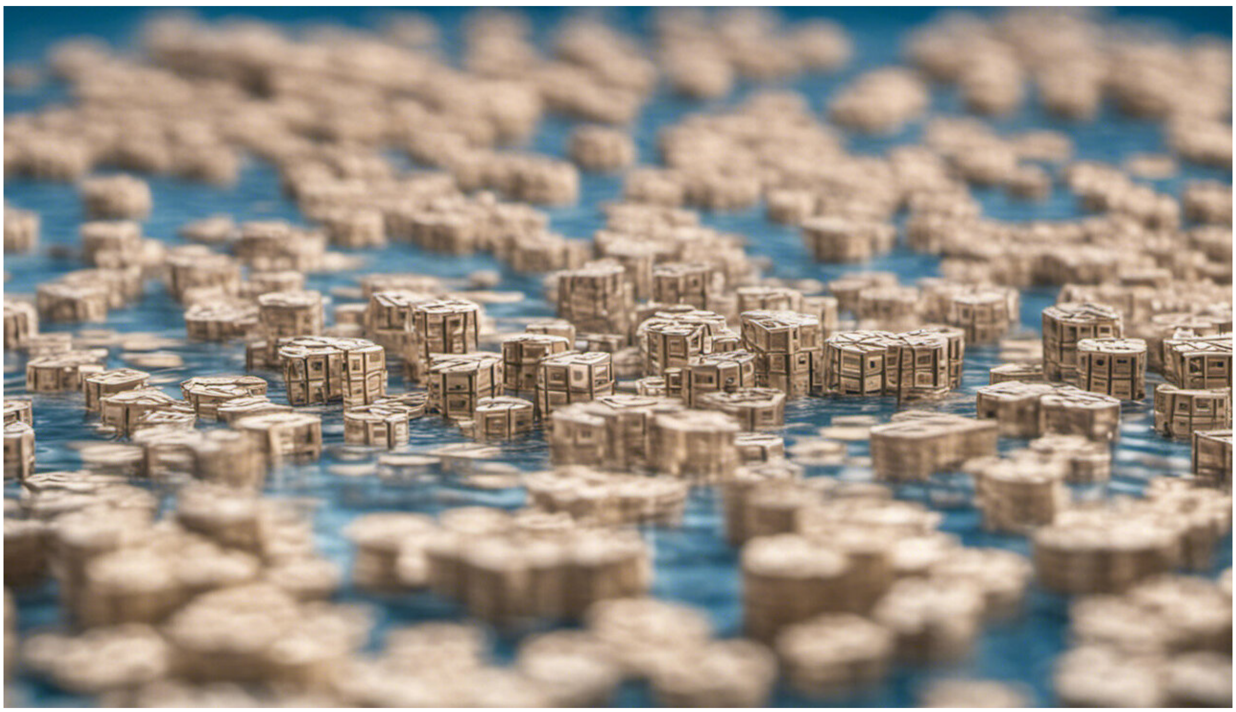

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(Phys.org)—The Federal Housing Authority (FHA) underestimates the risks of defaulted mortgages, NYU economist Andrew Caplin concludes in a new study co-authored with economists at the Federal Reserve Bank of New York.

Their research, which examined mortgages granted by the FHA, finds that the federally banked lenders miscalculate the risks of default because their assessments are based on mortgages rather than on individuals. That is, it counts refinanced mortgages as paid off, even though the same individuals still hold these mortgages and many of these homeowners remain at risk of defaulting on their home loans. Moreover, many of these homes, even after refinancing, are "underwater"—the value of the home is worth less than the amount of the loan.

"Since many of the FHA borrowers refinancing are underwater, it will be difficult for them to exit the FHA system by either selling the house or refinancing into a non-FHA mortgage," the authors write. "As such, these borrowers may remain at risk of default for many years."

The study's other co-authors were Anna Cororaton, an economist at the Federal Reserve Bank of New York, and Joseph Tracy, an executive vice president at the bank.

The authors point out that FHA mortgages that undergo an internal refinance are treated no differently than FHA mortgages that are fully paid off by the borrower, which removes any further credit risk to the FHA.

"So a borrower who defaults after internally refinancing is treated by the FHA as creating one success (termination of the first mortgage) and one failure (default of the second mortgage)," they write. "In fact, the borrower has nothing to show for their 'success' in refinancing, and taxpayers face a large bill."

Caplin and his colleagues conclude that "the current mortgage-based approach is inappropriate for the study of sustainability. Instead, one must focus on the borrower. Specifically, one must construct the borrower experiences by linking together strings of consecutive mortgages taken out by the same borrower and secured on the same property."

In assessing the borrower's likelihood of default, they examined FHA loans refinanced by the federal authority, then tracked the likelihood of default and prepayment—in which the loan is paid off earlier than the original life of the mortgage. This measure allowed the researchers to track multiple mortgages under a single borrower.

Their results indicated that only 6.4 percent of borrowers under FHA loans since 2007 have successfully paid off their mortgages. They also found than 15 percent of these borrowers have already been 90 days or more delinquent on their loans.

These findings stand in stark contrast to FHA's results, which track only mortgages, not their borrowers. Using that metric, the payoff rate is three times as high at 19.4 percent, reflecting the fact that a majority of terminated mortgages have immediately been refinanced back into new FHA mortgages.

"The FHA uses an outmoded econometric model that leads it to underestimate delinquency risk to borrowers and financial risks to taxpayers," the authors write. "Fannie Mae and Freddie Mac use this same outmoded model. More accurate estimates would serve the cause of transparency and help policy-makers to determine these organizations' appropriate roles in the U.S. housing finance markets of the future."

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