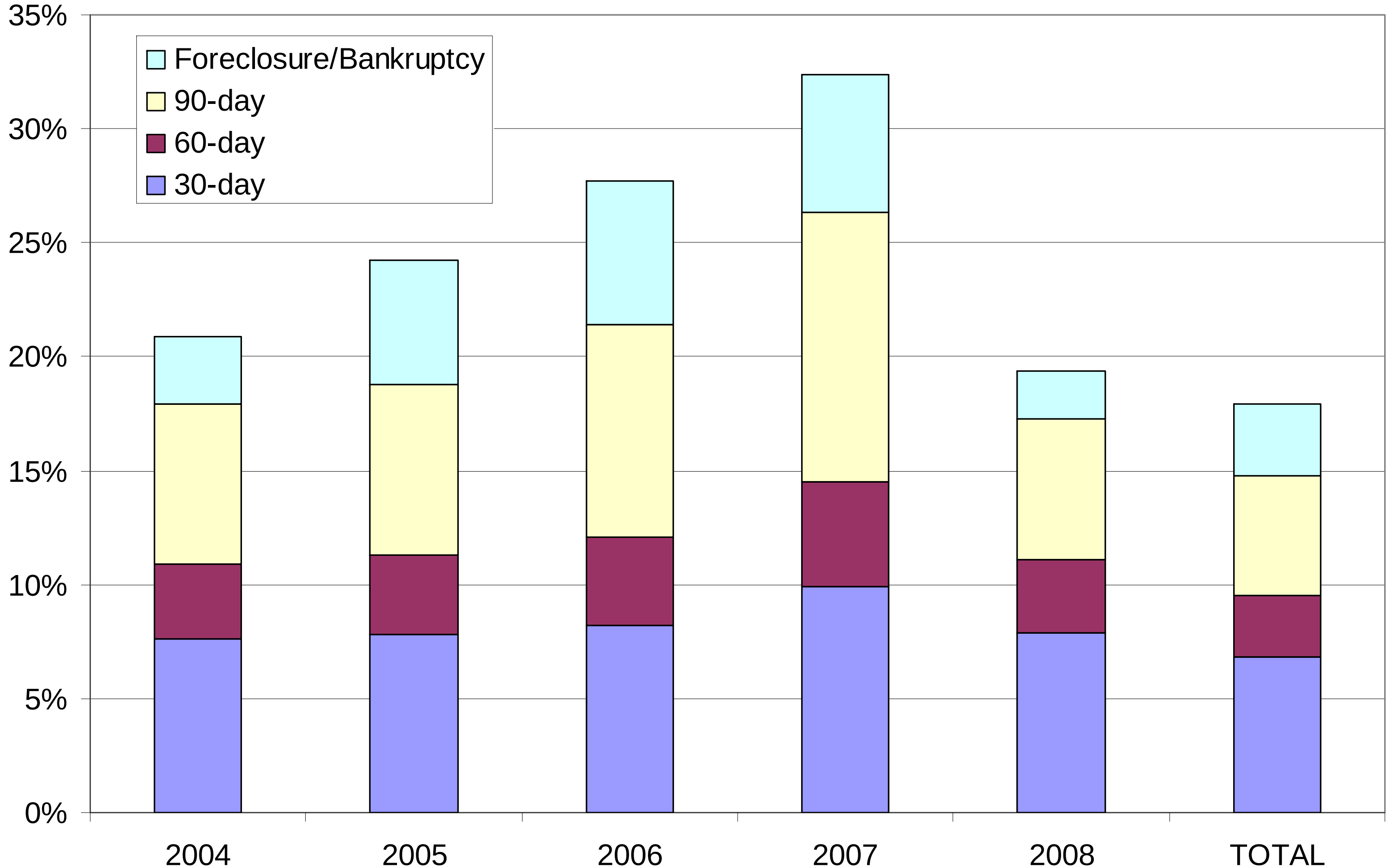
FHA's Loan Book Is a Rapidly Growing Disaster

17.9% of Loans Are in Some Stage of Default; For 2007 Loans, It's 32.4%; Even For Recent 2008 Loans, It's 19.4%

T2 Partners LLC



	2004	2005	2006	2007	2008	TOTAL
Insured loans	**351,736**	**315,916**	**290,030**	**372,380**	**1,095,472**	**5,391,876**
% of total	**6.5%**	**5.9%**	**5.4%**	**6.9%**	**20.3%**	**100%**

Source: HUD/FHA, through August 31, 2009.

Recent Signs of Stabilization Are Likely the Mother of All Head Fakes

T2 Partners LLC

Rather than representing a true bottom, recent signs of stabilization are likely due to six factors that are (or are likely to be) short-term:

1. Ultra-low interest rates
2. More middle- and upper-end homes defaulting, which has the effect of raising the price at which the average home is sold – but the spread of defaults from the low end to the mid- to high-end is *very* bad news for mortgage holders
3. Home sales and prices are seasonally strong in April-July due to tax refunds and the spring selling season
4. The $8,000 tax credit for first-time homebuyers
   – This expires on November 30th, but will likely be renewed and perhaps expanded to all new home buyers
   – Current cost: $30 billion/month
5. A temporary reduction in the inventory of foreclosed homes
   – Shortly after Obama was elected, his administration promised a new, more robust plan to stem the wave of foreclosures so the GSEs and many other lenders imposed a foreclosure moratorium
   – Early this year, the Obama administration unveiled its plan, the Homeowner Affordability and Stabilization Plan, which is a step in the right direction – but even if it is hugely successful, we estimate that it might only save 20% of homeowners who would otherwise lose their homes (it's 12% so far)
   – The GSEs and other lenders are now quickly moving to save the homeowners who can be saved – and foreclose on those who can't
   – This is necessary to work our way through the aftermath of the bubble, but will lead to a surge of housing inventory later this year, which will further pressure home prices
   – "For now, the delays have led to what is probably a temporary drop in the supply of bank-owned homes in California and other places where investors and first-time home buyers have been competing for bargains. In Orange County, Calif., the number of bank-owned homes listed for sale dropped to 322 in early September from 1,404 in November 2008, according to Altera Real Estate. But the number of foreclosures is expected to increase in the fourth quarter as mortgage-servicing companies determine who is eligible for a loan modification and who isn't. 'We are going to see a spike from now to the end of the year in foreclosures as we take people out of the running' for a loan modification or other alternatives, says a Bank of America Corp. spokeswoman. 'Foreclosure sales had dropped to 'abnormally low' levels in response to government efforts to stem foreclosures, she adds.' – WSJ, 9/23/09
6. The FHA is providing massive support to the housing market, in part by doing extremely risky lending
   – FHA's market share has risen from 2% in 2005 to 23% of all mortgages, in part because of lax lending standards: only 3.5% down for people with 600 (subprime) FICO scores and 10% down for people with 500 (deep subprime) FICO scores
   – Thousands of shady subprime mortgage lenders rebranded themselves and are now doing FHA-backed business. Approved FHA lenders grew from just over 9,600 at the end of FY07 to nearly 14,000 today, according to HUD
   – FHA has very poor systems and controls – there's not even a Chief Risk Officer!
   – It's no surprise, therefore, that defaults are skyrocketing – 17.9% of all FHA-guaranteed loans are now in some stage of delinquency
   – HUD's audit for FY08 (which ended 9/30/08) showed that the FHA capital ratio declined dramatically from 6.4% to 3.0%, but projected that it would remain above its statutory minimum of 2% going forward – this is highly unlikely
   – FHA will likely need additional funding from Congress in the near future – and a condition of this might be a requirement of tighter lending standards, in which case it's highly unlikely that any other lender would step in to fill the gap; it's possible, however, that Congress might decide to continue the subsidy to help stabilize the housing market