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Accessible Credit, Sustainable Credit and the Federal Housing Administration

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By David Reiss

The secondary mortgage market stands on three legs. The first leg, created in the early 1930s, is made up of government instrumentalities like the Federal Housing Administration (the FHA) and the Government National Mortgage Association (Ginnie Mae). The second leg, created in the 1930s, but taking off in the 1970s, is made up of public/private hybrids like the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). The third leg, created in the 1970s, but taking off in the 1990s, is the "private-label" market, which is made up of private companies that package mortgage-backed securities that have no guaranty, explicit or implicit, from the federal government. Each of these legs buckled during the Great Recession. This article primarily addresses the buckling of that government leg, but in broad historical context.

Today's FHA suffered from many of the same unrealistic underwriting assumptions that have done in so many lenders during the 2000s. It had also been harmed, like other lenders, by a housing market as bad as any seen since the Great Depression. As a result, the federal government announced in 2013 that the FHA would require the first bailout in its history. At the same time that it faced these financial challenges, the FHA has also come under attack for the poor execution of some of its policies to expand homeownership. Leading commentators have called for the federal government to stop employing the FHA to do anything other than provide liquidity to the low end of the mortgage market. These arguments rely on a couple of examples of programs that were clearly failures but they fail to address the FHA's long history of undertaking comparable initiatives. This article takes the long view and demonstrates that the FHA has a history of successfully undertaking new homeownership programs. At the same time, the article identifies flaws in the FHA model that should be addressed in order to prevent them from occurring if the FHA were to undertake similar initiatives in the future.

Notwithstanding the problems it has faced since the financial crisis, the FHA has a storied history. The *New York Times* noted in 1934, the year that the FHA started up, that there "is no New Deal agency which is being more widely discussed behind the scenes in Washington these days than the Federal Housing Administration. It is no secret that President Franklin Delano Roosevelt holds the highest hopes for this housing program . . . ."[1] Nearly 50 years later, a Commission on Housing appointed by small-government-proponent President Ronald Reagan, praised the FHA even while calling for extensive reforms:

> Few pieces of social invention from the 1930s have reverberated so loudly through the corridors of time as the FHA-insured, level-payment, self-amortizing, long-term mortgage. Supplemented by VA [Veterans Administration] mortgage guarantees after the war, this piece of paper and its acceptance-first by homebuyers and banks, later by insurance companies and an organized secondary market-made homeownership possible for tens of millions of Americans who would otherwise have lived out their days in rented quarters.[2]

With this background in mind, this article brings together the scholarly literature regarding the history of race and housing policy as well as the economics literature regarding the role that down payments play in the appropriate underwriting of mortgages in order to give a more detailed picture of the federal government's role in housing finance for low- and moderate-income households.

This article provides a basic introduction to the FHA and provides an overview of the way it is viewed by scholars and policy analysts. It concludes that the FHA can responsibly address objectives other than the

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provision of liquidity to the residential mortgage market. It proposes that FHA homeownership goals be more explicitly tied to a rational underwriting process, one that is designed to make sure that people can afford their mortgages over the long-term. This would both protect the financial health of the FHA and ensure that new homeowners are able to afford their homes for the long term — that is, to become sustainable homeowners.

Introduction to the FHA

The FHA provides mortgage insurance on mortgage loans on single family and multifamily homes, and "is the largest government insurer of mortgages in the world."[3] Mortgage insurance is a product that is paid for by the *homeowner* but that protects the *lender* if the homeowner were to default on the mortgage. The insurer pays the lender for the losses that it suffers from any default and foreclosure by the homeowner.

As with much of the federal housing infrastructure, the FHA has its roots in the Great Depression. The private mortgage insurance (PMI) industry, like many others, was decimated in the early 1930s. Its companies began to fail as almost half of all of the mortgages in the nation defaulted. The PMI industry did not revive until the 1950s. The idea for a government alternative to private mortgage insurance came from the National Emergency Council as part of its proposal to address a broad array of problems in the real estate sector.

One of the key programs to arise from this proposal was a system of federally financed mortgage insurance, the FHA. The FHA proposal was incorporated into the National Housing Act. The FHA was

> charged with the duty of encouraging improvement in housing standards and conditions by making improved credit facilities available to the owners and prospective owners of homes and other property. In accordance with the National Housing Act, it extends Government support by means of credit insurance covering private credit transactions. Hence, in achieving the desired results, chief reliance is placed upon private capital and initiative.[4]

The FHA's first full year of operation was 1935. The FHA's goals for insuring residential mortgages were to make "a sounder investment for the lender" and to extend "the practicable range of borrowers and of home-mortgage loans."[5] Over time, Congress gave the FHA a variety of additional policy mandates that were intended to help the federal government achieve other policy goals. These goals ranged from supporting the war effort during World War II to increasing the number of minority homeowners during the early 2000s.

Although conventional wisdom says that the FHA had one goal during the Great Depression — increasing liquidity — it actually had many. After its second full year of operation, the FHA set forth the following nine:[6]

(1) To expedite recovery in the building and allied industries
(2) To aid and encourage private capital investments in the home-mortgage field
(3) To secure a more uniform flow and wider distribution of home-mortgage funds
(4) To secure a lower and more uniform interest rate on home-mortgage securities
(5) To improve mortgage-lending practices
(6) To raise building standards
(7) To protect the owners of small homes
(8) To encourage the creation of private limited-dividend companies to finance housing developments for person[s] of low income
(9) To develop essential statistical and economic data on real estate and housing

These goals ranged broadly from the oft-cited liquidity rationale, to supporting industries relating to housing, to consumer protection. The FHA's role in reducing systemic risk was also explicitly acknowledged early in its history. In the FHA's second annual report, the administrator notes that it was initially designed to "help stabilize the whole real-estate market; to give warning of the periods of inflated prices when many families are apt to purchase homes with small equities; and to help maintain an orderly home real estate market during periods of depression."[7]

The FHA has also had many other missions over the course of its existence and a varied legacy to match. Beginning in the 1950s, the FHA's role changed from serving the entire mortgage market to focusing on certain segments of it. This changed mission had a major impact on everything the FHA did, including how it underwrote mortgage insurance and for whom it did so.

Over its lifetime, the FHA has insured more than 40 million mortgages, helping to make home ownership available to a broad swath of U.S. households. The overwhelming portion of its resources is devoted to one- to four-unit houses. And indeed, the FHA mortgage was central to the U.S. transformation from a nation of renters to homeowners. The early FHA really created the modern U.S. housing finance system, as well as the look and feel of post-war suburban communities.

The Failures of the FHA

The FHA is an understudied topic despite having a massive impact on the built environment of the United States. This is particularly unfortunate because it has had some serious failures that mar its long history of success as a provider of liquidity for, stability in and access to the residential mortgage market. Due to these failures, the leading commentators on the FHA have adjudged its initiatives to encourage homeownership to be failures. The absence of a vibrant and balanced scholarly exchange regarding the FHA stands in the way of responsibly charting its future course.

Robert Van Order and Anthony Yezer, the authors of the *FHA Assessment Report*, write that "[T]he lesson that we should take away from" the FHA's recent history of underwriting standards is that the "FHA, as currently organized, should not be used as an experimental program to encourage homeownership."[8] They argue that this is nonetheless unavoidable because "[T]here are powerful political forces willing to push FHA to allow very unsound lending practices."[9] Given that Yezer is the co-author of one of the handful of comprehensive studies of the FHA, this is a damning assessment indeed.

The few policy analysts who make a close study of the FHA agree in the main with Yezer and the other scholars who have given the FHA their sustained attention. The American Enterprise Institute's Edward Pinto, the author of the *FHA Watch,* writes that, "Government insurance programs suffer from three fundamental flaws: (1) the government cannot successfully price for risk; (2) government backing distorts prices, resource allocation, and competition; and (3) political pressure and congressional demands for a quid pro quo inevitably arise, politicizing the programs."[10] Housing economist Joseph Gyourko is more succinct, but equally pessimistic: The FHA "has failed by any reasonable metric."[11]

There is much to support these characterizations of the FHA, but I demonstrate that they cherry pick from the historical record to make their case, focusing on disastrous policies in the early 1970s and the 2000s. By failing to address the FHA's other initiatives over its 80 years of operation, these commentators fail to make a convincing case that the FHA's history is a one of failed government action.

Commentators are greatly concerned that the FHA will face high losses because of its supposed divergence from its original mission. These losses have been measured in the billions of dollars in recent years. Van Order and Yezer's policy prescription for the FHA is "that over time the FHA should revert to its previous role: helping first-time and low- to moderate-income homebuyers purchase homes, allowing the private sector to shoulder more of the risk associated with insuring larger loans."[12] Van Order and Yezer, like other commentators, tend to focus on just one aspect of the FHA's original mission — providing liquidity to a frozen market — and bestow it with an essential quality: *This is what the FHA truly is about*. But the historical record is much more complicated, both at the FHA's origin and over the course of its long history.

This is not to say that concerns about the FHA are unfounded. There is great reason to be concerned for the financial health of the FHA. Empirical studies bear this out. Gyourko demonstrates that the FHA's reserves became precarious soon after the Great Recession. In 2011, Gyourko wrote:[13]

> For the past two years, it has been in violation of its most important capital reserve guideline, under which it is supposed to hold sufficient reserves against unexpected future losses on its existing insurance in-force. To be barely compliant with this rule would have required just over a $12 billion capital infusion in fiscal year 2010, and that presumes that future losses are not being underestimated by FHA. This report suggests that they are by many tens of billions of dollars, so that the recapitalization required will be at least $50 billion, and likely much more, even if housing markets do not deteriorate unexpectedly.

Another study by Diego Aragon and others was consistent with Gyourko's findings. It found that the Mutual Mortgage Insurance (MMI) Fund's rapid growth since

2007 led to major losses, with its reserves dropping from $15.8 billion to $2.73 billion from 2008 to 2009. The same study estimated that absent "new revenues from future books of business, the recent annual audit estimates that the [FHA's] capital ratio is down to 0.53 percent, below its required 2 percent level."[14] The Aragon study identified various warning signals that indicated that funding will in fact be necessary.

Although the FHA denied that it would need additional funding after the Gyourko study was released, the critics turned out to be right. The FHA received a nearly $1.7 billion infusion from the U.S. Treasury in 2013. Also, the FHA's single-family mortgage guaranties made between 1992 and 2012 will have a net cost for the federal government of about $15 billion. Indeed, actuaries have estimated the economic value of the main FHA program to be *negative* $13.5 billion in 2012. This estimate was expected to improve over time, and in fact it has, but this was a financial low for the FHA. There is no question that these policy critiques and budgetary concerns must be addressed to chart a responsible course for the FHA going forward.

The Role of the FHA in the Residential Mortgage Market

The FHA's role in the mortgage market can best be understood as "a specialized insurance company that guarantees the payment of mortgages made by private lenders (banks and other mortgage lenders) who provide loans to developers and homebuyers."[15] The FHA was created in 1934, at a time when the mortgage market for one- to four-family homes was split among individuals and other non-institutional lenders; commercial banks; mutual savings banks; savings and loan associations; and life insurance companies. Although savings and loans had a significant share of the market and attractive terms, other types of lenders offered much less consumer-friendly products. Commercial lenders, for instance, required a loan-to-value (LTV) ratio of 50 to 60 percent of the property's market value, with a term of three to five years. These mortgages required a large balloon payment at the end of the term, a payment that almost always required the borrower to refinance. But even savings and loans required relatively low LTV ratios and relatively short terms.

The housing markets faced problems in the Great Depression that were similar in kind to those faced in the late 2000s. These problems include rapidly falling housing prices; widespread unemployment and underemployment; rapid tightening of credit; and, as a result of all of those trends, much higher rates of default and foreclosure. The FHA noted in its second annual report that the "shortcomings of the old system need no recital. It financed extensive overselling of houses at inflated values, to borrowers unable to pay for them . . . ."[16] The same could be said of our most recent housing bust.

The FHA had an explicit mission of providing "a thorough reform in the home financing structure."[17] In fulfilling that mission, it helped to make a consumer-friendly single-family mortgage mainstream during the Great Depression. This type of mortgage combined a small down payment with a long-term and a fully amortized payment schedule — and this type is now dominant in the residential mortgage market.

The FHA touted many other benefits for lenders and homeowners. The FHA believed that lenders also benefited from its mortgage insurance system because:

(1) It protected them from credit risk, the risk that borrowers would not repay their loans;
(2) It made illiquid mortgages very liquid such that they could be sold or used as collateral; and
(3) It standardized due diligence for mortgages because the FHA itself vetted them before agreeing to issue insurance.

The first benefit is quite dramatic, as credit risk is historically the most important of all risks that lenders face.

The second benefit of mortgage insurance for lenders was that it allowed lenders to sell their mortgages to secondary mortgage market investors. To advance this even further, the federal government created Fannie Mae in 1938 to create a secondary market for FHA mortgages.

Fannie Mae spun off Ginnie Mae in 1968 to securitize FHA mortgages while Fannie went on to securitize mortgages that were not insured by the federal government. Ginnie Mae is a wholly owned government corporation that is situated within the Department of Housing and Urban Development (HUD), as is today's FHA. Ginnie Mae insures mortgage-backed securities that are secured by FHA and other government-insured or guaranteed mortgages like those of the VA. Ginnie Mae mortgage-backed securities are the only mortgage-backed securities (MBS) that are explicitly backed by the federal government's full faith and credit.

The federal government's guaranty makes Ginnie Mae mortgage-backed securities attractive to investors who are willing to pay a premium over comparable mortgage-backed securities from other issuers. This premium thus reduces the interest rates paid by homeowners on the mortgages underlying Ginnie Mae mortgage-backed securities. The attractiveness of the guaranty to investors also creates an extraordinarily liquid market for Ginnie Mae securities. Thus, because of the federal government's guaranty, Ginnie Mae can continue to provide liquidity even when credit is drying up elsewhere in the credit markets. This has been readily apparent during the Great Recession.

At the same time that the FHA touted its benefits to lenders during its early years, it also promoted itself as a protector of consumers. For instance, it heralded standardization as "essential in the first real major offensive in the history of our people against an impracticable mortgage lending system unsuited to actual conditions and too often unsafe for the inexperienced borrower who merits security and protection in his dealings."[18]

Homeowners would benefit from a standard mortgage form, one that would protect "the borrower against ambiguous or 'trick' clauses...."[19] The FHA designed its procedures to "prevent borrowers from attempting to buy beyond their means. In the past, many persons have lost their savings because they lacked knowledge of the expenses involved in home ownership, if they had been better informed they could have succeeded in owning more modest homes."[20] Thus, the FHA was designed from the outset with consumer protection, along with liquidity, stability, and standardization, as core values. The FHA's original underwriting requirements also mandated that borrowers' ability to repay be documented notwithstanding the fact that the home provided sufficient security. This was to ensure that the loan would be repaid, thereby barring equity-based lending, a type of abusive lending.

Early on, the FHA took credit for a qualitative change in the housing market that resulted from its policies and practices: "In view of the low monthly payments required to amortize a long-term mortgage, it appears that the single-mortgage system has brought new homes within reach of many families previously unable to acquire them."[21] Although the FHA's assessment of its own performance is not always merited, it was in this case.

In order to move away from the unsustainable practices that preceded it, the FHA initially set the maximum term for a mortgage that it would insure at 20 years and the maximum LTV ratio at 80 percent. At its creation, the FHA served a broad swath of the residential mortgage market, given that it could insure mortgages with principal amounts as high as \$16,000 (meaning that a home could be valued as high as \$20,000 with a maximum LTV of 80 percent) when the median price for a house in the United States was a bit more than \$5,000. Interest rates were capped in order to equalize rates among local markets and to limit the effects of restricted capital.

The Role of Mortgage Insurance

Mortgage insurance is typically required for borrowers with limited funds for down payments. Lenders, not borrowers, are the direct beneficiaries of mortgage insurance. Depending on the insurer, mortgage insurance pays some or all of a lender's loss upon default or foreclosure of the loan. The FHA has long been the dominant mortgage insurer. Other significant providers are the Department of Veterans Affairs (VA) and private companies, known as private mortgage insurers (PMIs).

Mortgage insurance works as follows. When a borrower purchases a home with a small down payment, the lender may require that the borrower purchase mortgage insurance at the same time to protect the lender, *not* the borrower, from a default. The lender may do this to transfer some of the risk of loss to the insurer but also to make the loan eligible for purchase by Ginnie Mae, Fannie Mae, or Freddie Mac. These entities can then securitize pools of mortgages and insure the owners of the securities against late payments and nonpayments. If the borrower does default and the property is foreclosed upon, the lender can look to the insurer to make up some or all of the difference between the foreclosure sale price and the outstanding amount due on the loan (consisting of unpaid principal and interest as well as all of the other costs that may be due under the mortgage, such as those relating to the foreclosure itself). By doing this, the lender has offloaded some or all of the risk of default to the insurer. If there were no mortgage insurance, that entire credit risk would remain with the lender or its successor.

Mortgage insurers charge a premium to the borrower for the insurance. PMIs generally charge an annual premium. The VA guaranty fee is an up-front charge but it can be financed as part of the mortgage. FHA charges an up-front premium that can be financed as part of the mortgage in addition to an annual premium. These premiums are intended to allow the FHA to be self-funded, that is, it requires no funds from the federal government to maintain its operations.

Mortgage insurance products from the various insurers differ from each other as to the:[22]

(1) Maximum mortgage amounts and LTV ratios allowed;
(2) Underwriting standards for borrowers, such as the income-to-expense qualifying ratio requirement;
(3) Funds required at loan closing for such items as down payment and closing costs; and
(4) Dollar amount or percent of loss that each organization will pay lenders to cover the losses associated with foreclosed loans.

The FHA generally insures a lower maximum principal amount than private insurers. FHA insurance stands out from other forms of mortgage insurance for protecting the lender from nearly all of the losses from a loan that has gone through foreclosure whereas other insurers, both government and private, only insure a portion of the potential losses.

The amount insured by the VA has been changed by Congress over time but has never been as high as that of the FHA. PMIs usually insure a much smaller proportion of the losses, from 20 to 35 percent. Although the FHA and the VA insure or guarantee "loans with effective loan-to-value ratios that exceed 100 percent (due to the financing of closing costs or other fees)," PMIs typically required at least a 3 percent down payment[23] although that loosened up during the Subprime Boom of the early 2000s.

Homeowners choose FHA over PMI mortgages for one or more of the following reasons:

(1) They cannot or prefer not to make the minimum down payment required by private mortgage insurers.
(2) Their credit scores are weak.
(3) Their employment histories are short or spotty, or they are self-employed.
(4) Their total debt-to-income ratios are higher than a private mortgage insurer would accept.

Thus, the FHA effectively extends credit to borrowers who other lenders reject, at least on the terms desired by the borrowers. The existence of PMI is explained in large part because of the FHA's cross-subsidization model by which low-risk borrowers pay the same premium as high-risk borrowers. A PMI company can offer a better deal to the low-risk borrower and often has additional competitive advantages, such as easier paperwork and faster approval times.

The FHA does most of its work through the operation of five insurance funds. The Mutual Mortgage Insurance (MMI) Fund is its largest by far. It is used for most of the FHA single-family programs. The MMI Fund covers more than $1 trillion of insured mortgages. Indeed, even before the financial crisis, the massive MMI Fund amounted to 43 percent of all types of loans and guaranties made by the federal government. The MMI's programs are "unique among federal direct loan and guarantee programs as they are required to be self-supporting."[24] In contrast, the VA mortgage guaranty program is subsidized by the federal government.

At the outset, the MMI Fund was operated conservatively. But the FHA changed in many ways over its 80-year history. It faced competitive pressures from a resurgent private mortgage insurance industry. It responded to great social and economic upheavals and shed some of those responses as times changed. And most importantly for this article, it loosened its underwriting to achieve various social goals to good and ill effect.

Congress added and discontinued various missions of the FHA since its creation during the Great Depression. Depending on the political winds, it targeted different types of buyers and different types of residential units at different times. Some programs were successful and some were abject failures.

The FHA has come under attack for its poor execution of some of its attempts to expand homeownership opportunities, and leading commentators have called for the federal government to stop assigning such mandates to the FHA. They argue that the FHA should focus on providing liquidity for the portion of the mortgage market that serves low- and moderate-income households. These critics rely on a couple of examples of failed programs, such as the Section 235 program enacted as part of the Housing and Urban Development Act of 1968 and the American Dream Downpayment Assistance Act of 2003.

These programs required tiny or even nominal down payments. The Section 235 program was enacted in response to the riots that burned through U.S. cities in the 1960s. It was intended to expand homeownership opportunities for low-income households, particularly African-American ones. The American Dream program was also geared to increasing homeownership among lower-income and minority households. The crux of the critique of these programs is that they failed to ensure that borrowers had the capacity to repay their mortgages, leading to bad results for the FHA and borrowers alike.

Notwithstanding these bad initiatives, the FHA has a parallel history of successfully undertaking new homeownership programs. These successes include programs for veterans returning home from World War II, a mission that was later handed off to the VA. Unfortunately, the FHA has not really grappled with its past failures as it moves beyond the financial crisis. In order to address operational failures, the FHA must first identify what its goals should be.

Underwriting Sustainable Homeownership

What is needed — what all of the commentators agree upon — is for appropriate underwriting to drive the FHA. This is not to say that promoting homeownership for various groups is not a legitimate goal. It is just to say that if it is not done in a way that avoids frequent default and foreclosure, it can do more harm than good to the FHA itself and the homeowners it serves.

A key element of appropriate underwriting is the down payment requirement, as expressed in the loan-to-value (LTV) ratio. Indeed, as seen previously, there is a strong correlation between low LTV and low default rates over the FHA's 80-year history. From an underwriting perspective, a 20 percent down payment is great. It keeps defaults very low. But it is hard for low- and moderate-income families to save enough money in a reasonable amount of time to put together a 20 percent down payment. The median household income in 2014 was a bit more than $50,000. The median house price in 2014 was around $200,000 at the end of 2014. It would take quite some time for that median household to save the $40,000 necessary to have a 20 percent down payment on that median house. Also, high down payment requirements would have a disproportionate effect on communities of color, which tend to have lower income and less wealth than white households. As seen previously, there have been periodic pushes to decrease down payment requirements in order to increase homeownership rates, but those pushes have not been accompanied by an evaluation of the sustainability of that increase.

Advocates for low-income communities, lenders, and advocates of an "ownership society" have all pushed for much lower down payment requirements, particularly for first-time homeowners. This occurred, most notably, in the late 1960s and late 1990s, but also as veterans returned from World War II. Some of these pushes are accompanied by little thought as to the impact that low down payments have on the likelihood that a household will keep its home over the long term. Others are more thoughtful, and are based on empirical research. Let us dismiss the first set out of hand, for there have been a number of low- or no-down-payment initiatives that have been unmitigated failures.

Let us begin by addressing the criticisms of low-down-payment initiatives. The flaws with the FHA that commentators such as Van Order and Yezer and Pinto have identified are almost completely flaws of ultra-low- or no-down payment initiatives. Throwing the baby out with the bathwater, their prescription is to end innovative homeownership programs. Instead, the focus should be on the predictors of default, and in particular, the scholarly literature regarding the relationship between low down payments and default. It is clear that the FHA (and the VA) has had success with relatively small down payments at times as have other entities such as the Self-Help Credit Union.

Much of the down payment literature is focused on the way lowering down payment requirements increases homeownership rates. But there is also a substantial body of literature that indicates that no-down-payment and low-down-payment mortgages are much more likely to default than mortgages with larger down payments. One article by Austin Kelly stands out for studying mortgage default rates when the borrower has made no down payment. It confirms what seems intuitive: "Borrowers who provide even modest down payments from their own resources have substantially lower default propensities than do borrowers whose down payments come from relatives, government agencies, or nonprofits."[25] This finding — that "skin in the game" reduces defaults — implies that the borrowers will assess the risk of purchasing a home more carefully if their own capital is at risk and will fight harder to keep their house in order to protect that capital. Otherwise a home purchase looks more like a long-term lease with an option to purchase should prices rise.

The question, of course, is what is the socially optimal level for down payments? No one has answered this question in the context of the FHA, but a body of research about down payments has recently sprung up as various parties have attempted to influence the rulemakings that define "Qualified Mortgages" (QM) and "Qualified Residential Mortgages" (QRM) pursuant to Dodd-Frank.

The Center for Responsible Lending, an advocate for low- and moderate-income borrowers that also engages in serious research on lending issues, has looked at the question of whether very low down payments are unacceptably risky. ACR report starts out by noting that "it would take the typical family 22 years to save for a 10 percent down payment and 14 years for a 5 percent down payment."[26] In a study of Self-Help Credit Union's (the Center's affiliated lender) borrower defaults, researchers found that "72 percent of borrowers made a down payment of less than 5 percent" but they were delinquent less than a quarter the rate of subprime adjustable rate mortgage borrowers.[27]

There is some evidence that there is a down payment sweet spot of around 5 percent at which default rates are within an acceptable range. The Coalition for a Sensible Housing Policy, a coalition of lenders and consumer advocates, argues that:[28]

> [O]nce you apply the strong underwriting standards in the sample QRM definition, moving from a 5 percent to a 10 percent down payment requirement reduces the overall default experience by an average of only two- to three-tenths of one percent for each cohort year. However, the increase in the minimum down payment from 5 percent to 10 percent would eliminate from 4 to 7 percent of borrowers from qualifying for a lower rate QRM loan.

The higher requirements would also have a strongly disproportionate effect on communities of color.

Quercia, *et al.*, have looked at the trade-offs between safe underwriting and access to credit in the context of the QRM rules. They have also developed a useful metric, which they refer to as a "benefit ratio." The benefit ratio compares "the percent reduction in the number of defaults to the percent reduction in the number of borrowers who would have access to QRM mortgages."[29] A metric of this sort would go a long way to ensuring that there is transparency for both homeowners and policymakers as to the likelihood that homeowners can pay their mortgages and keep their homes.

Quercia, *et al.*, would push the optimal down payment size even lower, arguing that "LTVs of 97 percent result in a better benefit ratio, suggesting that a small down payment requirement may have an important protective effect against default risk while still providing broad access to mortgage credit."[30] They conclude that "restricting the origination of risky loan features and underwriting a loan with a consideration of a borrower's ability to repay has the largest benefit in terms of reducing default risk without limiting access to credit."[31]

In deciding the right benefit ratio, we must ask: What are we trying to achieve with FHA underwriting?

There are three generally agreed upon goals for FHA underwriting:

(1) FHA insurance should not require support from the public fisc.

(2) The FHA should use lower-risk eligible borrowers to cross-subsidize higher-risk eligible borrowers.
(3) The class of eligible borrowers should be limited to those with a reasonable likelihood of not defaulting on their loan.

These three goals, taken together, reflect a view that the FHA's long-term health depends on it navigating longstanding political debates over the "ownership society," wealth redistribution, and consumer protection regulation. The debate over the appropriate role of the FHA is often driven by broader ideological agendas, so it would be helpful for those commenting on it to make clear whether they agree or disagree with these three goals. To be clear: I think all three goals are appropriate and politically feasible for the FHA.

The first goal, that FHA insurance should not require support from the public fisc, has been part of the FHA's mission since it was created. The FHA's recent financial difficulties have not been sympathetically received in the Capitol. Moreover, the current political environment is one in which there are frequent calls to end Fannie and Freddie resounding in the Capitol after the two companies needed extraordinary support from taxpayers during the Subprime Crisis. It is difficult, in this environment, to imagine a politically feasible alternative to a self-supporting FHA.

The second goal, that the FHA should use lower-risk eligible borrowers to cross-subsidize higher-risk eligible borrowers, has also been integral to the FHA since its founding. Indeed, the Mutual Mortgage Insurance Fund was designed, per its name, to be a form of mutual insurance through which policyholders spread the risk of default among themselves. This second goal has also been a relatively non-controversial one, although one could imagine alternatives to it.

Surprisingly, the third goal — ensuring that borrowers do not default in high numbers — is less of a constant than one might suppose. The policy of the FHA was surely to err on the side of low defaults from the 1930s through the 1950s. But starting in the 1960s, this approach was loosened up and at times it was implicitly rejected or ignored. This was seen with the Section 235 fiasco of the 1970s as well as the American Dream Downpayment Act debacle the 2000s. Households and communities of color are most harmed by such thoughtlessly loose underwriting criteria because they were disproportionately represented among homeowners impacted by the defaults and foreclosures from those failed programs.

History teaches us that the goal of sustainable homeownership should not have been ignored. It should be closely hewed to for the sake of the FHA's viability. It should also be closely hewed to for the sake of FHA-insured borrowers who should be able to rely on FHA underwriting as a signal that they will likely be able to afford their housing payments and keep their homes.

There will always be some percentage of FHA mortgagors who will default on their loans. The key policy question is what the acceptable range of default is over the long term. If the rate is too low, it would imply that some were not given the opportunity to benefit from homeownership. If the rate is too high, it would likely imply that an FHA mortgage was reducing household net worth and having too many negative social impacts on households as families deal with the effects of default, foreclosure and eviction.

There is no objective way to identify the most ideal default rate for FHA mortgages. One might, however, look at the alternatives available to households. Because FHA-eligible households have the option of renting, the benefits and drawbacks of an FHA mortgage to a household should be compared to renting as well as to other mortgage products that might be available to them. Researchers at the UNC Center for Community Capital argue that homeownership beats renting in a number of ways, although their study is drawn from a very limited number of homeowners with mortgages from a particular loan program, Community Advantage Program (CAP).

The UNC researchers find that ownership provides a greater financial cushion than renting for low-income families. Most important for my purposes, they find that the loans in their study "are notable for their high loan-to-value ratios: 97 percent is the typical maximum loan-to-value ratio, though some programs issue loans all the way up to 103 percent of house value."[32]

They conclude that "having received assistance toward one's down payment and closing costs has no significant effect whatsoever on CAP homeowners' mortgage performance."[33] The authors of the study note some "important caveats" in their findings that severely limit their generalizability.

I am cautious of assuming that the FHA's results with low down payments would be the same as CAP's, given the significant differences between the two programs. But CAP's results do, at least, suggest that we do not yet know how low down payments can go and still have a socially acceptable level of mortgage defaults.

Combining the UNC study with Quercia *et al*.'s (also affiliated to UNC) benefit ratio discussed previously, we can reasonably identify a range of 3 to 5 percent down payments as a starting point for FHA underwriting, and assume that future performance data could push that range lower over time. We can also imagine that a more sophisticated underwriting process could allow for trade-offs among LTV, credit score and debt-to-income (DTI) that could push that range even lower for select borrowers.

Conclusion

The FHA has been a versatile tool of government since it was created during the Great Depression. It was created in large part to inject liquidity into a moribund mortgage market. It has since been repositioned to achieve a variety of additional social goals, some of which have not been realized. The FHA's failed programs, coupled with the recent financial woes of the FHA that resulted in a government bailout, have fueled criticism of the institution and demands that the federal government stop employing the FHA for any goal other than providing liquidity to the low end of the mortgage market. The FHA has, however, been more successful in achieving its broader goals than is generally recognized, but its mission needs to be refined.

Notes

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