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Insuring Sustainable Homeownership

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INSURING SUSTAINABLE HOMEOWNERSHIP

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The Federal Housing Administration (FHA) has suffered from many of the same unrealistic underwriting assumptions that had done in so many lenders during the 2000s. It too had been harmed 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 has faced these financial challenges, the FHA has also come under attack for the poor execution of some of its policies to expand homeownership opportunities.

Leading commentators have called for the federal government to stop employing the FHA to do anything other than providing liquidity to the low end of the mortgage market. These critics' 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. In fact, the FHA has a history of successfully undertaking new homeownership programs. The FHA does have operational flaws, however, that should be addressed in order to prevent them from reoccurring if the FHA were to undertake similar homeownership initiatives in the future.

Introduction to the FHA

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 by the homeowner. Mortgage insurance is typically required for borrowers with limited funds for down payments. The FHA provides mortgage insurance for mortgage loans on single family and multifamily homes, and is the world's largest government mortgage insurer. Other significant providers are the Department of Veterans Affairs (VA) and private companies, known as private mortgage insurers

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(PMIs). Mortgage insurance makes homeownership possible for many households that would otherwise not be able to meet the underwriting requirements of lenders.

As with much of the federal housing infrastructure, the FHA has its roots in the Great Depression. The private mortgage insurance 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 FHA was created to replace the PMI industry, which remained dormant for decades.

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 . . .."[1] Needless to say, the same could be said of our most recent housing bust.

Over its lifetime, the FHA has insured more than 40 million mortgages, helping to make home ownership available to a broad swath of American households. And indeed, the FHA mortgage had been essential to America's transformation from a nation of renters to homeowners. The early FHA really created the modern American housing finance system, as well as the look and feel of post-War suburban communities because of the construction standards it set for the new houses that it insured.

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.

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.

In recent years, the FHA has come under attack for its poor execution of some of its attempts to expand homeownership opportunities and the leading commentators have called for the federal government to just stop assigning such mandates to the FHA. They argue that the FHA should just focus on providing liquidity for the portion of the mortgage market that serves low- and moderate-income households. These critics heavily 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 American 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. At the same time, the FHA has clearly suffered from operational failures over the course of its existence that should be addressed in the design of any future initiatives. Unfortunately, the FHA has not really grappled with its past failures as it moves beyond the financial crisis.

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 looser underwriting standards is that the “FHA, as currently organized, should not be used as an experimental program to encourage homeownership.”[2] They argue that this is nonetheless unavoidable because “[T]here are powerful political forces willing to push FHA to allow very unsound lending practices.”[3] 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.”[4] Housing economist Joseph Gyourko is more succinct, but equally pessimistic: The FHA “has failed by any reasonable metric.”[5]

There is much to support these characterizations of the FHA, but 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-plus years of operation, these commentators fail to make a convincing case that the FHA’s history is a one of failed government action.

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.”[6] 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.

Underwriting Sustainable Homeownership

The modern FHA states that its mission is to serve borrowers that the conventional mortgage market does not serve effectively: first-time homebuyers as well as "minorities, low-income families and residents of underserved communities."[7] More concretely, right after the financial crisis, it set concrete performance goals such as increasing homeownership by insuring over 1.4 million single-family mortgages.

Sadly, it did not seem that the FHA learned much from the financial crisis. By having homeownership goals drive its underwriting, it is bound to repeat the fiscal calamities of the past. 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 claims to serve.

A key element of appropriate underwriting is the down payment requirement, as expressed in the loan-to-value (LTV) ratio. Indeed, there is a strong correlation between low LTV and low default rates over the FHA's eighty-plus year history. From an underwriting perspective, a twenty percent down payment is great. It keeps defaults very low. But it is very hard for low- and moderate-income families to save enough money in a reasonable amount of time to put together a twenty percent down payment. The median household income in 2014 was a bit more than $50,000. The median existing home sales price in 2014 was around $200,000. It would take quite some time for that median household (let alone a low-income household) to save the $40,000 necessary to have a twenty percent down payment on that median house. And 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. 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.

In order to rationalize the FHA's mission, we must ensure that its underwriting practices make sense. 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; and (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 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. It is hard, 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 FHA's main program, the Mutual Mortgage Insurance Fund, was designed to be a form of mutual insurance where policyholders spread the risk of default among themselves. This second goal has also been a relatively non-controversial one.

Surprisingly, the third goal – ensuring that borrowers do not default in high numbers – has been given just lip service at various times in the FHA's history. 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. It appears that 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.

The FHA must work to identify a down payment requirement that balances access (therefore no 20% down payments) with sustainability (thus no 0% down payments). Academic research is beginning to tease out how low the FHA's down payment requirement can responsibly go: it seems that programs can work in the 3-5% range. But we should learn enough from history to know that sustainable homeownership cannot be willed into existence – underwriting matters and people must have the capacity to maintain their mortgages as they deal with the slings and arrows of fate, including unemployment, divorce, and poor health. If the FHA does not take these into account, too many homeowners will suffer from the stresses of default, foreclosure and eviction.

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. The FHA has, however, been more successful in achieving its broader goals than is generally recognized. But still, its mission needs to be clarified and its operations need to be rationalized if it is to assist the low- and moderate-income borrowers it claims to serve, not just to get a mortgage but also to sustain it over the long term.

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1. U.S. FED. HOUS. ADMIN, SECOND ANN. REP. FED. HOUSING ADMIN. 28 (1936).
2. Robert Van Order and Anthony Yezer, George Washington University Center For Real Estate And Urban Analysis, *FHA Assessment Report: The Role of The Federal Housing Administration in a Recovering U.S. Housing Market* 9 (June 2011).
3. *Id*.
4. Edward J. Pinto, *Truth in Government Lending Is Long Overdue*, American Enterprise Inst., Mar. 20, 2012.
5. Joseph Gyourko, *Rethinking the FHA*, American Enterprise Inst., at iii (June 2013).
6. VAN ORDER AND YEZER, *supra* n.2, at 2.
7. U.S. FED. HOUS. ADMIN., ANN. MGMT. REP. FISCAL YEAR 2015 4.