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Ensuring That Homeownership Is Sustainable

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The Federal Housing Administration has suffered as a result of many of the same unrealistic underwriting assumptions that led to problems for many lenders during the 2000s. It, too, was harmed by a housing market as bad as any since the Great Depression.

As a result, the federal government announced in 2013 that the FHA would require the first bailout in the agency's history. While facing financial challenges, the FHA has also come under attack for the poor execution of policies designed to expand homeownership opportunities.

Leading commentators have called for the federal government to stop having the FHA do anything but provide liquidity to the low end of the mortgage market.

These critics rely on a few examples of agency programs that were clearly failures, but they do not address the FHA's long history of undertaking comparable initiatives.

In fact, the FHA has a history of successfully undertaking new homeownership programs. However, it also has operational flaws that should be addressed before it undertakes similar future homeownership initiatives.

INTRODUCTION TO THE FHA

Mortgage insurance is a product that is paid for by the *homeowner* but protects the *lender* if the homeowner defaults on the mortgage. The insurer pays the lender for losses it suffers from the homeowner's default. Mortgage insurance is typically required for borrowers who have limited funds for down payments.

The FHA provides mortgage insurance for loans on single family and multifamily homes, and it is the world's largest government mortgage insurer. Other significant providers are the Department of Veterans Affairs and private companies known as private mortgage insurers.

Mortgage insurance makes homeownership possible for many households that would otherwise not be able to meet lenders' underwriting requirements.

Just like 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. Companies in the industry began to fail as almost half of all mortgages went into default. The government created the FHA to replace the PMI industry, which remained dormant for decades.

In the Great Depression, the housing markets faced problems that were similar to those faced by the same markets in the late 2000s. These problems included rapidly falling housing prices, widespread unemployment and underemployment, the rapid tightening of credit and — as a result of all of those trends — much higher default and foreclosure rates.

The FHA noted in its second annual report, issued in 1936, 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 homeownership available to a broad swath of American households. Indeed, the FHA mortgage has been essential to America's transformation from a nation of renters to one of homeowners.

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The early FHA created the modern American housing finance system, as well as the look and feel of post-war suburban communities through the construction standards the agency set for the new houses 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. This changed mission had a major impact on everything the FHA did, including how it underwrote mortgage insurance and for whom it did so.

In recent years, the FHA has come under attack for poorly executing some of its attempts to expand homeownership opportunities, and leading commentators have called for the federal government to stop assigning such mandates to the agency. They argue that the FHA should focus only 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.

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Those programs required borrowers to make only tiny and sometimes even nominal down payments. The government enacted the Section 235 program 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 black 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 failed 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, historically the FHA has clearly suffered from operational failures that should be addressed in the design of any future initiatives.

Unfortunately, the agency has not really grappled with its past failures as it moves beyond the financial crisis. To properly address operational failures, the FHA must first identify its goals.

UNDERWRITING SUSTAINABLE HOMEOWNERSHIP

The modern FHA says 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."[2]

More specifically, 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 does not seem that the FHA learned much from the financial crisis. By having homeownership goals drive its underwriting, the agency is bound to repeat the fiscal calamities of the past.

What is needed — and all of the commentators agree — 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 unless promotion is done in a way that avoids frequent default and foreclosure, it can do more harm than good.

A key element of appropriate underwriting is the down payment requirement, as expressed in the loan-to-value ratio. Indeed, there is a strong correlation between low LTV and low default rates over the FHA's 80-plus-year history.

From an underwriting perspective, a 20 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 20 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-income household (let alone a low-income household) to save the $40,000 necessary to have a 20 percent down payment on that median-priced house.

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High down payment requirements would have a disproportionate effect on communities of color, which tend to have lower income and less wealth than communities with 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 such an increase.

To rationalize the FHA's mission, we must ensure that its underwriting practices make sense. There are three generally agreed-upon goals of FHA underwriting:

- FHA insurance should not require support from the public fisc.
- The FHA should use lower-risk eligible borrowers to cross-subsidize higher-risk eligible borrowers
- The class of eligible borrowers should be limited to those with a reasonable likelihood of not defaulting.

These three goals, taken together, reflect a view that the FHA's long-term health depends on its successful navigation of 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 from the start. The agency'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 of the 2000s.

It appears that households and communities of color suffer the most harm from thoughtlessly loose underwriting criteria because they were disproportionately represented among the homeowners impacted by the defaults and foreclosures from those failed programs.

History teaches us that the goal of sustainable homeownership should not be 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 agency underwriting as a signal that they will likely be able to afford their payments and keep their homes.

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The FHA must work to identify a down payment requirement that balances access (no 20 percent down payments) with sustainability (no 0 percent down payments). Academic research is beginning to tease out how low the FHA's down payment requirement can responsibly go, and it seems that programs can work in the 3-5 percent range.

But we should know from history that sustainable homeownership cannot be willed into existence. Underwriting matters, and people must be able 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 factors into account, too many homeowners will suffer from the stresses of default, foreclosure and eviction.

The FHA has been a versatile government tool since its creation during the Great Depression. It was formed 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 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.

Nonetheless, 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 so they can get a mortgage but also so they can sustain it over the long term. WJ

NOTES

[1] Memorandum from Stewart McDonald, Adm'r, Fed. Hous. Admin., to Hon. Marriner S. Eccles (June 25, 1936), http://bit.ly/1NNvBkX.

[2] Fed. Hous. Admin., Fiscal Year 2015 Annual Management Report (2015), at 4.