THE FHA SINGLE-FAMILY INSURANCE PROGRAM: PERFORMING A NEEDED ROLE IN THE HOUSING FINANCE MARKET

U.S. Department of Housing and Urban Development | Office of Policy Development and Research

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Executive Summary

Introduction

In laying out the Federal Housing Administration's (FHA's) mission in the single-family mortgage market and in presenting its historical role in meeting immediate and emerging challenges over its history, this paper serves as a useful foundation for considering FHA's future role in housing finance as both institutional and regulatory reforms are debated. The paper focuses on the historical and ongoing role of FHA mortgage insurance in sustaining access to mortgage credit, stabilizing housing markets, and expanding sustainable homeownership opportunities. In so doing, it provides useful facts, descriptions of policies undertaken, and information that can inform debates about FHA's appropriate role going forward. In performing its historical role, FHA has insured more than 41 million mortgages since its inception in 1934.

The paper is organized into four sections and an appendix. The first section provides a historical overview of FHA's role in stabilizing housing markets, setting market standards, providing information, and addressing market failures such as credit rationing. The second section shows how this role provides improved opportunities for low-wealth (often newly formed) households to access affordable, sustainable homeownership. The third section describes some significant challenges that FHA has faced over the years and the steps it has taken to meet these challenges. Throughout the current crisis, FHA has borrowed from lessons it learned in the past. The fourth section examines FHA's response to the current housing crisis: FHA has stabilized declining markets by maintaining access to federally guaranteed mortgage credit in the face of a severe curtailment of private capital in the market, and it has assisted distressed homeowners to keep their homes. Finally, the appendix reviews key questions and policies that will inform the future role of FHA, including questions related to the costs and benefits of FHA's countercyclical role, pending regulatory and institutional reforms that could affect underwriting standards in the conventional mortgage market.

Historical Overview of FHA's Role

Before the government's involvement in the 1930s, the recorded homeownership rate was never higher than 48 percent. Financial markets were highly volatile with financial panics every 10 to 20 years and frequent depressions. Mortgage loans were difficult to obtain. Substantial downpayments for first-lien mortgages were in the neighborhood of 50 percent, and second- and third-lien financing at high interest rates were commonplace. In 1934, with new mortgage credit frozen, residential construction stalled, and a serious nationwide decline in construction employment, Congress authorized FHA mortgage insurance with the aim of getting the building trades and private credit back to work.

Initially, FHA was intended to revitalize the housing industry and make home financing attainable for a much larger share of American families in the face of national recession. It has since extended this role to help soften the effects of local or regional downturns and increase homeownership opportunities for lower wealth, minority, and first-time buyers. Studies show that profit-maximizing conventional lenders do not raise prices just when lending becomes riskier in areas experiencing economic downturns; instead, they tighten underwriting to ration the number of mortgages made in such an area. FHA, on the other hand, maintains its presence in all markets, providing stability and liquidity in markets experiencing recession. By addressing the

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tendency of the private marketplace to ration credit, FHA has always brought a great deal more stability to mortgage markets and extended the opportunity for homeownership to a much broader segment of the population.

It should be noted that mortgage loan limits rather than borrower income limits have been the principal method of targeting FHA's insurance activities over its history. This has the effect of focusing FHA insurance activity on specific segments of the housing market, and it helps maintain stability in credit flow to these market segments. Temporary expansion of FHA's loan limits in the current housing crisis has extended FHA access to a broader segment of the housing market, thereby leveraging FHA's ability to provide stability to the distressed housing market.

In its early days, FHA also took on the task of developing and building the national infrastructure to operate an economically sound insurance program across the United States. FHA redefined mortgage underwriting standards to allow a much broader segment the population to qualify for mortgage finance, and it created new uniform construction and appraisal standards in the building and finance industries so that the FHA mortgage contract was readily tradable across the country. Another important role of FHA was to make information available to the market on the performance of relatively high loan-to-value ratio (LTV) mortgage lending (compared with the low LTV loans before the Great Depression). By the mid-1950s FHA had demonstrated the feasibility of such lending, given the sound underwriting and appraisal standards it pioneered. The upshot of this was a rebirth in the 1950s of the private mortgage insurance (PMI) industry, which originally operated for a time before the Great Depression wiped it out. By 1970, the system of thrifts, commercial banks, FHA-insured lending, PMI-insured conventional lending, and access to private capital via secondary market support from Ginnie Mae (a government agency) and Fannie Mae (a government-sponsored enterprise [GSE]) had helped to raise the national homeownership rate from its 1930 measure of 46 percent to 63 percent.

FHA Offers Opportunities for Low-Wealth Families

To a large extent, FHA does not compete with conventional lenders. FHA focuses on homebuyers who, in comparison with those typically served in the conventional market, have lower wealth and pose moderately higher risks, yet are deemed creditworthy. FHA addresses the credit market imperfections that prevent households from accessing the type and level of housing consumption best suiting their needs and budget. As a result, and as an ancillary benefit to addressing these market imperfections, FHA provides opportunities for newly formed lower wealth households that wish to buy a home that meets their family's needs at a time when their children are young and can still experience the full range of benefits from homeownership.

To illustrate the above, the Office of Policy Development and Research at the U.S. Department of Housing and Urban Development (HUD) has compared characteristics of FHA and GSE (Fannie Mae and Freddie Mac combined) first-time homebuyer loans (the latter restricted to those falling below FHA loan limits) for selected origination years to gain understanding of how FHA has been used by first-time homebuyers in relation to the (prime) conventional market. The vast majority of FHA home purchase loans over the past 15 years have been made to first-time homebuyers. Except for the peak housing boom years, first-time homebuyers tended to rely more heavily on FHA financing—by two to three times as much—than on GSE conventional financing, and that reliance has grown dramatically in the past 2 years. For younger homebuyers using FHA—those under age 35—FHA's first-time buyer percentage has been consistently 80 to 90 percent; for those over age 35, 60 to 80 percent; and, overall, nearly 80 percent. Among FHA's first-time buyers, nearly 70 percent have been below age 35—consistent with the notion that FHA provides greater opportunities than the conventional market to families starting out.

FHA has also long been known to serve a disproportionately larger number and share of minority homebuyers, particularly African-American and Hispanic buyers. For example, in 2001, FHA served more than twice as many minority first-time buyers (about 220,000) than Fannie Mae and Freddie Mac combined (about 100,000). During the peak boom years, when many minority homebuyers chose subprime or other nontraditional conventional loans, the FHA minority first-time buyer counts dipped below those of the GSEs; however, since the crisis began, FHA has returned to serving a disproportionate number of minority first-time buyers.

FHA Has Overcome Challenges in Its History

Over its history, FHA has faced challenges regarding its financial condition or its relegation to small niche status in the marketplace. Three such challenges and FHA's responses are discussed: (1) in 1989, FHA faced a severe financial crisis and a large portfolio of unsound legacy business insured over many prior years; (2) large market shifts between 2001 and 2006 during the runup of the housing bubble called into question the continuing relevance of FHA in the market; and (3) poor performance during the 2000s from home purchase mortgages with downpayment gifts provided by nonprofit organizations in which the gift funds were contributed by the homesellers involved in the specific transactions, and possibly financed by inflated house values.

1. It may not be widely known, but FHA faced a severe financial crisis once before in its history during the administration of George H.W. Bush. The accounting firm of Price Waterhouse was commissioned in 1989 to conduct an independent actuarial review (the first of many such annual reports) of FHA's Mutual Mortgage Insurance (MMI) Fund, the principal accounting fund used by FHA to insure its home mortgages. The Price Waterhouse analysis found that FHA was underpricing its mortgage insurance and had been doing so for a decade. Price Waterhouse attributed a sharp decline in the MMI Fund's net worth during the 1980s, primarily to the lower rates of inflation and house price appreciation in the 1980s compared with the 1970s. The 1980-to-1982 recession years and the economic problems in the energy-producing states generated particularly large losses; losses due to lax management also were a contributing factor, but the underlying trend in house price appreciation was cited as the fundamental problem.

   During 1990, Congress and the Bush administration considered various policy proposals to shore up the MMI Fund. The policy debate in 1990 centered on how best to balance the public purposes of FHA with policies designed to improve its financial soundness. The Cranston-Gonzales National Affordable Housing Act (NAHA) of 1990 was ultimately enacted to restore the MMI Fund to actuarial soundness (along with other legislation enacted in 1989 to improve management effectiveness). The NAHA established a new actuarial soundness standard for FHA—a target level of capital of at least 2.0 percent of insurance-in-force (aggregate balance on insured loans in FHA's portfolio). But it was understood at the time that this target was designed only to enable FHA to withstand a moderate recession—not a severe downturn as has occurred since 2007. The law requires FHA to operate in an actuarially sound manner, but it does not require FHA to hold reserves that would make it able to withstand a severe economic event.

   Two years after the initial Price Waterhouse study and after the implementation of NAHA and other reforms, the fiscal year (FY) 1991 actuarial review of the MMI Fund found that the capital ratio of the fund had continued to fall. Price Waterhouse estimated the FY 1991 capital ratio to have declined to negative 0.2 percent (-0.2 percent) of insurance-in-force. NAHA and other reform measures adopted to reduce MMI Fund risks and to raise premiums were too new to offset the factors causing losses from the legacy business. That finding, however, did not mean that FHA needed a bailout. Rather, the 1991 actuarial review itself predicted future capital ratios would rebound, because the reforms would improve the performance of newly insured loans and the economy would recover. Price Waterhouse predicted the MMI Fund would meet its long-run capital ratio target of 2.0 percent by year 2000, and history shows that the fund actually achieved the 2.0 percent goal in FY 1995.

2. Large market share fluctuations during the decade of the 2000s also posed a challenge for FHA. Unlike a profit-motivated private insurer or lender, FHA does not actively seek to maximize market share. The extreme fluctuations observed in FHA's market share since 2000, however, have given rise to questions regarding FHA's appropriate role in the market. In particular, FHA had gone for more than a decade from capturing about 10 to 15 percent of the home purchase market—the approximate share it had for many years leading up to the new millennium—to less than 5 percent of the market during the boom years immediately preceding 2007 and rebounding to around 30 percent from mid-2008 forward. Although many believe the current 30 percent home purchase share represents too large a footprint for the FHA in the long term, there is less clarity about whether the very low (below 5 percent) precrisis share is the appropriate level for FHA going forward. The low FHA shares during the boom years occurred at a time when predatory and subprime lenders offering high-risk or high-cost alternative mortgage products attracted large numbers of homebuyers who might otherwise have chosen more sustainable FHA financing.

   Subprime underwriting criteria were "liberal to nonexistent" back then, and the high cost of these loans was often masked by short-run mortgage payments (before teaser rates adjusted) that were lower, giving borrowers the perception that the loan was affordable. A disproportionate share taking these products were minority homebuyers; thus, the declines in FHA market share were greatest for African American and Hispanic homebuyers. After the crisis hit, minority homebuyers were disproportionately affected by the dramatic tightening of conventional mortgage credit, and FHA's share of minority homebuyers has increased above the levels observed at the start of the decade.

FHA did not follow the market's lead into teaser rate adjustable-rate mortgages (ARMs), low-documentation loans, or "piggy-back" second liens. If FHA were to have extended itself into these products, it would likely have incurred large losses once home prices began to fall that could have undermined FHA's ability use its institutional capacity to assume a countercyclical role during the crisis. Although FHA is likely to sustain large losses on the loans it did insure during the precrisis boom years of 2005 to 2007—in part, because it may have been adversely selected during those years when the GSEs, in response to HUD affordable housing goals, were also extending credit to borrowers not typically served by the prime conventional market—FHA did avert even greater losses by staying principally with its traditional line of business.

3. Although FHA did not follow the market's lead into the non-traditional loan products, it did insure a group of loans that proved to be high risk: loans with downpayment gifts from nonprofit or charitable organizations in which the gift funds were ultimately replenished from a donation to the organization by the seller of the home. Often the borrowers who received the seller-funded downpayment gifts had weak credit histories as well. The combination of low or zero equity in a property often sold at an inflated sale price (sellers would recoup their donations through raising asking prices) to a buyer with weak credit history resulted in a group of loans that, on average, had a frequency of mortgage insurance claims that was two to three times the average for other comparable FHA loans.

   In 1996, FHA published guidance for mortgagees on the acceptable sources of the homebuyer's required investment (downpayment) beyond the homebuyer's own cash savings. Nowhere did FHA extend permission to obtain downpayment funds from the seller of the property—a practice expressly prohibited by conventional lenders. In the 1990s, however, some charitable organizations, which are permissible sources of downpayment gifts, began to circumvent the FHA restriction on gifts from sellers in various ways, including the establishment of a fund that provides the "gift" to the homebuyer that is replenished by the homeseller through a "charitable donation" to the organization after the sale is completed.

   As early as 1999, FHA took steps to prohibit the funding of downpayment gifts in which the source of the funds directly or indirectly comes from the seller of the property. Ultimately, the elimination of the seller-funded downpayment gifts would be accomplished through statutory prohibition of the practice. The passage of the Housing and Economic Recovery Act (HERA) on July 30, 2008, finally terminated seller-funded downpayment assistance effective for loans underwritten on or after October 1, 2008. The practice, however, did result in large losses for FHA, as documented in FHA's MMI Fund actuarial reviews.

FHA Response to the Crisis

Beginning in 2007, FHA began to focus on its countercyclical role as conventional credit dramatically tightened in response to the rise in delinquencies and foreclosures among subprime mortgages and the drop in home prices. Home prices continued falling for 33 consecutive months through early 2009, and the FHA played a major part in the government's efforts to slow this trend and stabilize prices. Mark Zandi, chief economist at Moody's Analytics, offered this assessment of FHA's role during the crisis:

> The FHA had been virtually dormant during the housing bubble, but it made about one-third of all U.S. mortgage loans in the period after the bust. Without such credit, the housing market would have completely shut down, taking the economy with it. The effort took a toll on the agency's finances, but so far the FHA has avoided turning to taxpayers for help, making it one of the few housing-related enterprises—public or private—that have not.

As home prices peaked and began to decline, and as delinquencies and foreclosures increased, lenders withdrew credit from the conventional mortgage market. The sheer volume of delinquent mortgages and foreclosure filings, along with numerous failures of mortgage lenders beginning in 2007, created a situation in which markets were in a self-perpetuating spiral with declining home prices and rising mortgage defaults; that is, defaults and foreclosures in the subprime sector led to falling home prices and tighter underwriting by conventional lenders, which, in turn, affected the prime sector and caused further home price declines. Arguably, FHA's response to the crisis was one of many actions taken by the federal government to help break the home price downward spiral. FHA's response consisted of (1) enabling home purchases, (2) enabling mortgage refinances, and (3) helping homeowners keep their homes.

The increase in FHA's home purchase market share starting in 2008 is due to three principal factors: (1) the tightening of private credit, (2) FHA keeping its underwriting standards fairly constant, and (3) the temporary increases in FHA's loan limits enacted by Congress. In 2006, FHA was authorized to insure loans of up to $200,160 in all markets and up to $363,790 in high-cost markets. In 2008, the Emergency Economic Stabilization Act (EESA) and, later, HERA granted FHA temporary authorization to insure mortgage loans of up to $271,050 in all markets and up to $729,750 in high-cost areas. The result was that, during FY 2006, as the crisis was about to begin, FHA insured 314,000 home purchase loans, but, by FY 2009, it had increased it volume of home purchase loans to 996,000 during a year in which the overall home purchase market was considerably smaller.

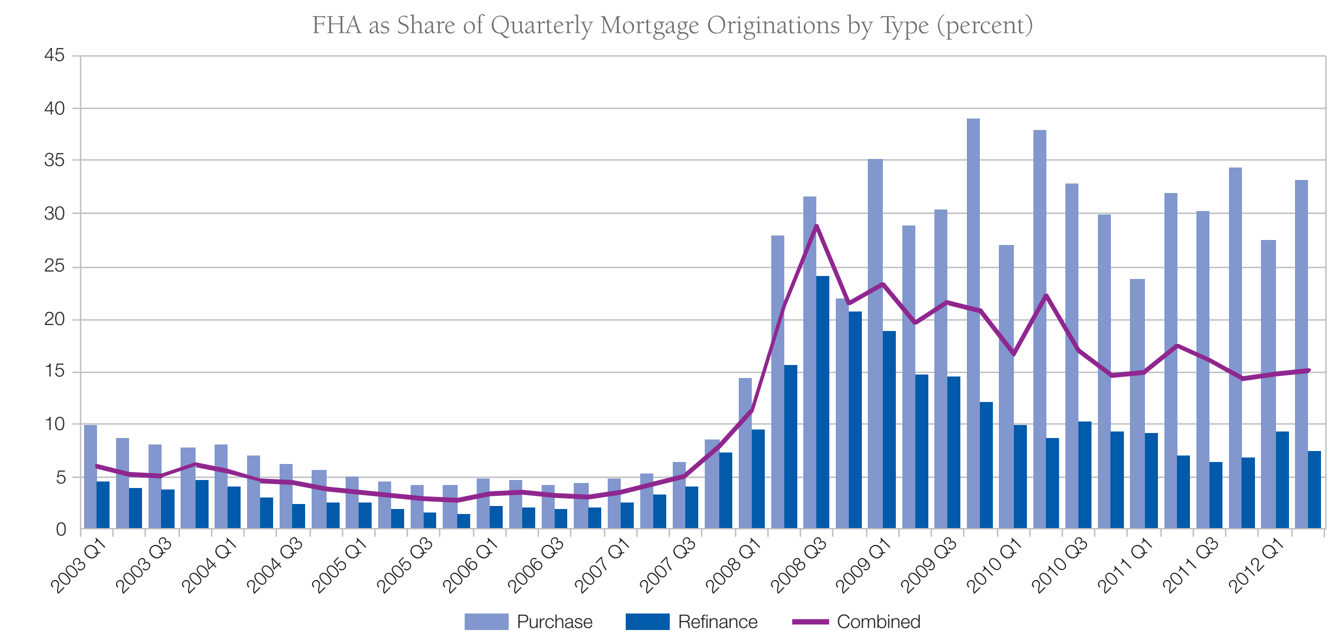
Not widely known is the fact that FHA also provided support for the refinance segment of the housing market during the crisis. Beginning in 2007, FHA stepped in to enable growing numbers of homeowners facing interest rate resets from expiring teaser rates on conventional ARMs to avoid large payment shocks. These conventional-to-FHA "product refinances" helped hundreds of thousands of borrowers who met FHA's standard underwriting criteria to convert conventional mortgages facing (or that already had received) monthly payment increases into far more sustainable FHA loans. In addition to providing help to homeowners with unsustainable conventional loans, FHA also enabled borrowers with existing FHA loans to refinance through its streamlined FHA-to-FHA refinance programs. Because FHA already holds the default risk on the loan, it is not taking on new risk with a streamlined rate or term refinance of the loan (with no cash out other than to cover closing costs), even if the loan were to be under water, or if the borrower's credit history had deteriorated.

The exhibit from the paper shown below illustrates FHA's response to the crisis in terms of market shares by loan type (purchase or refinance).

Although FHA's expansion of mortgage credit has been and continues to be critical to housing markets, the FHA's support for the market during the crisis also includes help for distressed homeowners. Although not as widely recognized as the U.S. Department of the Treasury's Home Affordable Modification Program for conventional loans, FHA has actually extended loss mitigation aid to more than 1.4 million distressed homeowners with existing FHA loans since the second quarter of 2009.

Finally, any discussion of FHA's countercyclical role during the current crisis should consider the costs incurred by FHA in performing this role. Loans FHA insured during the 2005-to-2009 period are likely to suffer the most (in terms of lifetime performance) from the recent national housing recession. These loan vintages contained high shares of seller-funded downpayment gifts, which historically have performed much worse than other FHA loans. These vintages also were underwritten when home prices were near or at their peak in mid-2006, which was followed by 33 consecutive months of decline in national price levels, creating the greatest potential for significant negative equity. FHA's relatively low market shares during these boom years with high-loss potential, helped mitigate the impact of

FHA Is Known To Have Ramped Up Its Support for Home Purchases; Less Well Known Is Its Support for Refinances During Crisis



Sources: Mortgage Bankers Association and the U.S. Department of Housing and Urban Development these loan vintages on FHA itself, however. Also, in certain states such as California, for which falling home prices were especially severe, FHA had even more limited exposure due to precrisis loan limits that restricted origination volumes. As a result of FHA's countercyclical activity, however, the high origination volumes insured between 2009 and 2012 now constitute about 78 percent of FHA's insured loan portfolio, and although the bulk of these loans have better risk characteristics than is typical for FHA, they will nevertheless be entering their peak default periods during 2013 through 2017.

Appendix

The authors hope that this paper serves as a useful foundation for considering FHA's future role in housing finance as both institutional and regulatory reforms are debated. FHA's history has shown that the public policy debate after FHA's financial crisis of the 1980s was driven by balancing the dual objectives of carrying out FHA's purpose and mission with maintaining and improving its financial soundness. In the current environment, FHA is still helping to mend the ailing housing market. Looking forward to a time when that objective will have been substantially accomplished, there are numerous policy questions to be addressed. Some questions involve balancing the costs and benefits of FHA assuming a countercyclical role when future market distress may occur at the same time that it is meeting the other aspects of its mission. This and other questions about FHA's institutional role are integral to the policy debate framed by the White Paper on Reforming America's Housing Finance Market that was jointly released by the Department of the Treasury and HUD in February 2011.

In addition, there are questions related to regulatory reforms now under consideration that are likely to impact FHA's role going forward. These are the Qualified Mortgage rule, the Qualified Residential Mortgage rule, and Basel III capital rules for financial institutions. If, in the context of these reforms, FHA continues its tradition of serving creditworthy, lower wealth households not well served by the conventional market, its relative size and role could depend significantly on how the rules are interpreted and implemented.

Other considerations may also affect the future size of the FHA market. Specifically, demographic trends, which recently have shown a decline in the rate at which individuals form households and a sharp drop in immigration, may suppress the number of FHA's major historical client group, first-time homebuyers.

The appendix provides background information on these issues to help frame the discussion of the relevant policy questions to be addressed regarding the future role of FHA.