FHA AT 80: PREPARING FOR THE FUTURE

FHA AT 80: PREPARING FOR THE FUTURE

Edward L. Golding

Edward J. Szymanoski

Pamela P. Lee

August 2014

This issue brief lays out FHA's mission in the single-family mortgage market and presents its historical role in meeting immediate and emerging challenges over its history. The paper draws from "The FHA Single-Family Insurance Program: Performing a Needed Role in the Housing Finance Market," a 2012 research paper by Edward Szymanoski, William Reeder, Padmasini Raman, and John Comeau.

FHA at 80: Preparing for the Future

Executive Summary

The mission of the Federal Housing Administration (FHA), which turned 80 in June 2014, is as important today as it was when the agency was founded in 1934. This article looks briefly at FHA's past to highlight the integral role it has played in American homeownership and rental housing. In looking at the data, three themes emerge: (1) FHA has been instrumental in helping American families purchase their first homes; (2) FHA loans have been available in periods of market disruption when other sources were not; and (3) FHA mortgages have been the product of choice—and in some cases, necessity—for many low- and moderate-income and minority families. Similar themes extend to FHA's multifamily business and related programs: FHA's Office of Multifamily Housing Programs (OMHP), for example, focuses on properties with affordable rents; at times when other lenders have reduced credit access, OMPH has increased its volume of lending. As the amount of time since the most recent crisis grows longer, FHA is moving into the future, focusing on rebuilding and strategic planning so it can continue delivering on its mission while protecting taxpayers. During the Great Recession (from December 2007 through June 2009), FHA's financial health was tested, but recent data show significant improvement on this front. Work to prevent and reduce the ultimate costs of foreclosures continues, and FHA origination volumes are returning to long-term, precrisis levels. The future is certainly brighter, albeit still somewhat uncertain as Congress weighs housing finance reform and the Federal Housing Finance Agency's new director, Melvin Watt, considers the short-term direction for the conventional market. Despite this uncertainty, FHA's core mission remains the same, although it will need to be refined to accommodate demographic trends that indicate growing numbers of first-time homebuyers with limited means and a deficit of affordable multifamily properties. In anticipation of future economic volatility, FHA is strengthening its financial vitality to ensure that it can continue playing a vital role in American homeownership and rental housing.

A Brief History of FHA

FHA has played an integral role in the American housing system and homeownership during the past eight decades. Created in the midst of the Great Depression to address a housing crisis that affected millions, FHA transformed the American mortgage system and enabled millions of Americans to purchase their first homes.

In 1934, when FHA was established, the standard mortgage product was a balloon instrument, with a repayment schedule spread across 3 to 5 years and ending with a balloon payment, which typically forced borrowers to take out another mortgage. Growing unemployment rates and a shortage of lenders for even creditworthy borrowers threatened millions of homeowners with foreclosure. With a goal of reducing the impact of the crisis and preventing, or at least dampening, future crises, FHA responded by creating a new housing finance system to incentivize lending and ensure the vitality of the housing market. FHA created national lending standards and revolutionized the mortgage market by providing insurance against default to lenders who (1) offered fixed-rate, long-term, fully amortizing mortgages, and (2) ensured that mortgages and borrowers met national underwriting and construction standards. Standardization and minimum standards helped identify creditworthy borrowers, provided borrowers with a measure of certainty about their long-term financial picture, and ensured that properties were habitable and marketable. Along the way, the Government National Mortgage Association (now known as Ginnie Mae) was created to provide liquidity for FHA mortgages.

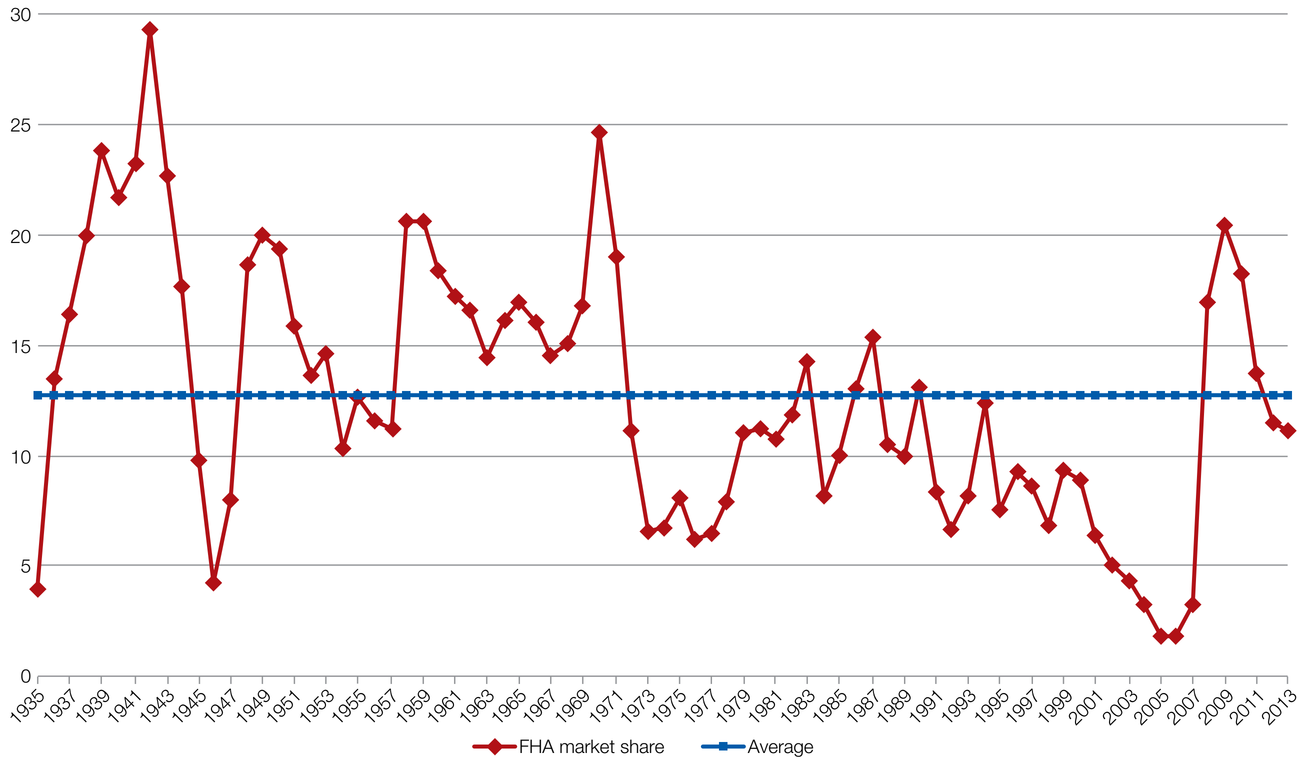
Although FHA has been an important stabilizing force in the housing market and has been instrumental in extending credit to underserved markets, it also has a history of limiting lending in minority communities. It is important to not only remember this history, but also to recognize that, today, FHA has evolved past these discriminatory practices and is now providing the most assistance to groups to which it would not have lent in the past.

Countercyclical Role

From its origins countering the impact of the Great Depression on the housing market, FHA has grown to become a major stabilizing force in the American economy. The agency's countercyclical role is evidenced by trends in the agency's share of mortgage originations (see exhibit 1). On average, during the past 80 years, the share of total mortgages originated by FHA has been about 13 percent, but its market share varies with fluctuations in the economy. During times of market disruption, for instance, the share of FHA-originated mortgages increases. Since World War II, FHA's market share increased by more than 5 percentage points in a year's time during four instances (1948, 1958, 1970, and 2008). According to the National

Exhibit 1. FHA's Market Share Varies With Fluctuations in the Economy

FHA Share of Mortgage Originations (percent)



FHA = Federal Housing Administration.
Sources: U.S. Department of Housing and Urban Development; Freddie Mac; Inside Mortgage Finance

Bureau of Economic Research, these four periods have been times of economic recession, when non-FHA mortgages were difficult to obtain.

FHA more recently demonstrated its vital countercyclical role during the Great Recession. Although other sources of liquidity retreated from the market, FHA continued to originate loans; in addition, Ginnie Mae, created in 1968, continued to ensure adequate liquidity for FHA mortgages. Research indicates that, in the absence of FHA-insured mortgages, home sales prices would have declined another 25 percent, which would have contributed to an additional $4 trillion loss of household wealth and exacerbated the already severe impacts of the economic meltdown (Griffith, 2014).

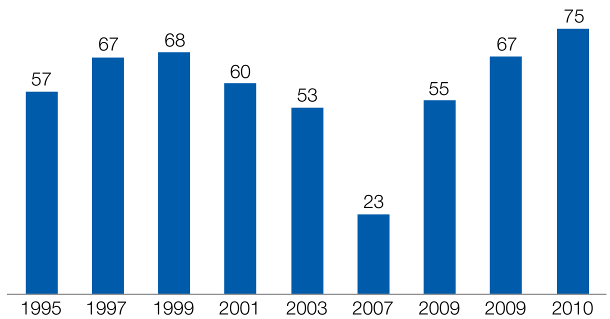
First-Time Homebuyers

FHA has insured about 13 percent of all mortgage originations during the past 80 years, but it has funded more than 50 percent of all first-time homebuyer mortgages during this same time (see exhibit 2). Because first-time homebuyers tend to have smaller savings from which to draw, FHA helps them secure first-time homeownership through the agency's relatively smaller down-payment requirement, which is 3.5 percent.

A 2012 study by the Center for Responsible Lending (CRL) underscores the importance of low-downpayment mortgages in promoting homeownership (Bocian, 2012). Using 2010 American Community Survey data, CRL estimated that the average household would require 20 years to save enough money for a 10-percent downpayment. The barriers to homeownership are greatest for minority households: African-American households would require 31 years and Hispanic households would require 26 years to save enough money for a 10-percent downpayment. In contrast, a low-downpayment FHA mortgage reduces by two-thirds the time required to secure a mortgage, enabling more households to own their first home earlier. Earlier homeownership has been shown to be particularly beneficial for school-aged children (Green, Painter, and White, 2012). In promoting homeownership, FHA provides tangible benefits to families and communities.

Exhibit 2. First-Time Homebuyers Rely More on FHA Loans Than on Conventional Loans

FHA Share of First-Time Buyer Loans for Selected Years (percent)



Note: Conventional market data limited to loans purchased or guaranteed by GSEs (government-sponsored enterprises such as Fannie Mae and Freddie Mac).
Sources: U.S. Department of Housing and Urban Development; Federal Housing Finance Agency (GSE public-use database)

Underserved Communities

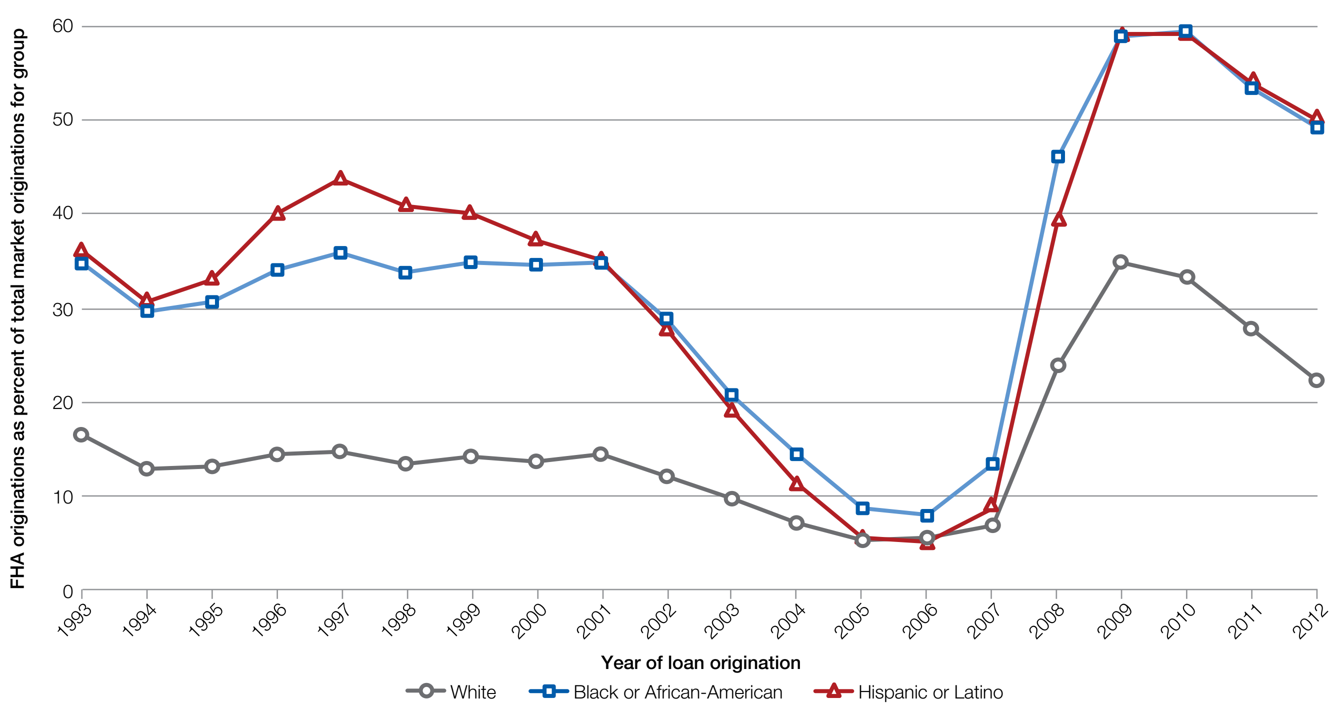
Since 2008 through 2009, more than one-half of mortgage-seeking African-American and Hispanic households have obtained an FHA mortgage. Over the past two decades, the ratio of African-American and Hispanic households obtaining an FHA mortgage has averaged more than one-third. Exhibit 3 shows that FHA has provided a stable source of financing for communities that have not been served well by the conventional market.

Multifamily and Rental Programs

Slightly more than one-third of American families (35 percent) rent their homes. As the cost burden of rental housing has grown, FHA has increased its efforts to finance market-rate multifamily rental units. For instance, the volume of FHA multifamily mortgages increased from approximately $3 billion per year before the Great Recession to more than $13 billion as conventional financing grew scarce. Providing low-cost financing for apartments supports affordable rents. Furthermore, properties with FHA-insured mortgages tend to be more affordable, especially for low- and moderate-income households. In addition to insuring traditional multifamily rental properties, FHA insures residential care mortgages that support assisted-living facilities,

Exhibit 3. FHA Has Provided a Stable Source of Financing for Communities That Have Not Been Well Served by the Conventional Market

FHA as Share of HMDA-Reported Home Purchase Mortgage Originations by Race/Ethnicity of Borrower (percent)

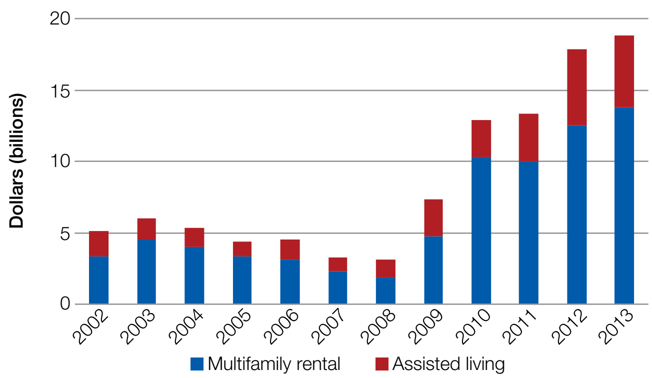


FHA = Federal Housing Administration. HMDA = Home Mortgage Disclosure Act.
Note: One- to four-unit (single-family) home purchase loan originations—first-lien, owner- and nonowner-occupant borrowers, including manufactured housing.
Source: HMDA

nursing homes, intermediate-care facilities, and board-and-care homes. Like the multifamily rental segment, this segment also increased after the Great Recession (see exhibit 4). With the increased share of Americans renting, FHA's support for rental housing is as important as its support for homeownership.

Exhibit 4. FHA Endorsements of Multifamily and Residential Care Mortgages Have Exhibited a Countercyclical Rise Since 2008

FHA Multifamily and Residential Care Mortgage Insurance Endorsements



FHA = Federal Housing Administration.
Note: FHA multifamily rental and residential care mortgage dollar volumes by year of initial endorsement.
Source: U.S. Department of Housing and Urban Development

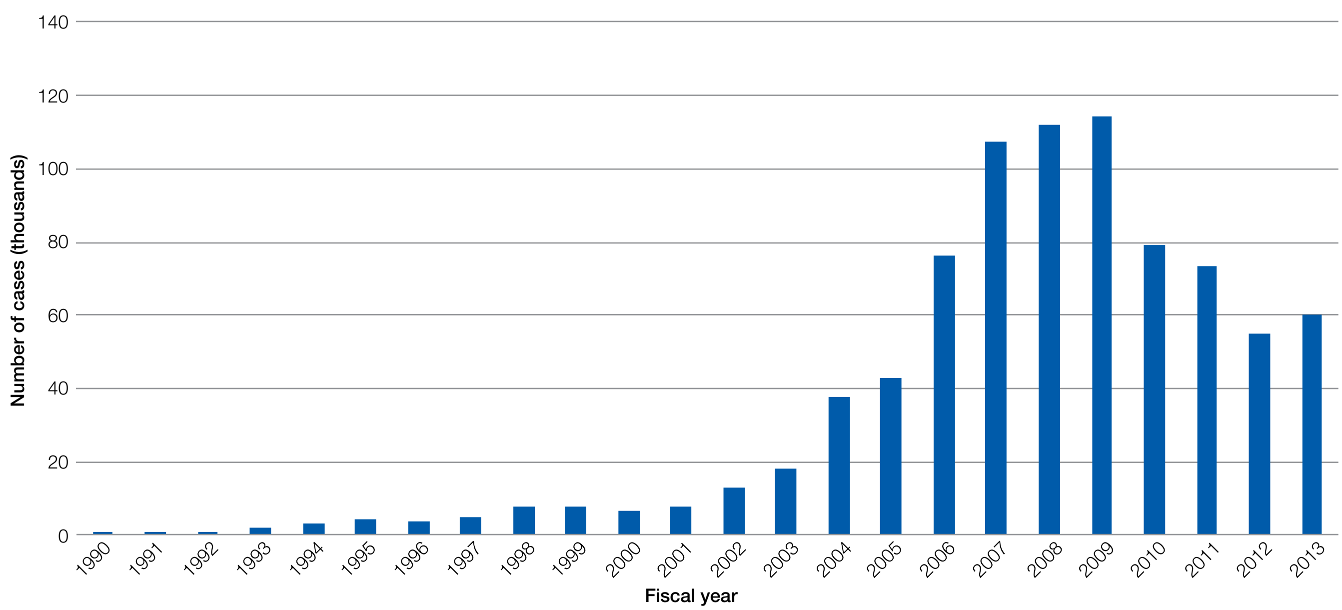
Other FHA Programs

FHA also plays an important role in markets that are traditionally not served well by the conventional mortgage market. For example, the Home Equity Conversion Mortgage (HECM, or FHA reverse mortgage) program enables senior citizens to tap into the home equity they have accumulated while enabling them to stay in their homes. FHA facilitates these mortgages by providing government-backed insurance that protects lenders and investors from losses, if any, when loans become due. In the recent past, the volume of HECM origination has climbed for a variety of reasons. In the run-up to the crisis, between 2004 and 2009, rising home sales prices and falling interest rates contributed to a surge in HECM popularity (see exhibit 5); during this same period, baby boomers also began to reach retirement age. Following the crisis, even as the senior population has continued to grow, retirement assets have been adversely impacted by the Great Recession. With recent changes to the HECM program and the improving economy, volumes are returning to prerecession trend levels.

FHA also finances hospitals, manufactured housing, and home improvements. Although these programs serve a smaller role in the housing market than FHA's single-family business line, overall, FHA has ensured continuity of mortgage credit for

Exhibit 5. FHA Plays an Important Role in the Reverse Mortgage Market

FHA HECM Cases Endorsed for Insurance



FHA = Federal Housing Administration. HECM = Home Equity Conversion Mortgage.
Note: Fiscal years (FYs) begin October 1 and end September 30; for example, FY 2013 is October 1, 2012, to September 30, 2013.
Source: U.S. Department of Housing and Urban Development

families, communities, and segments of the market that otherwise would have had difficulty obtaining financing. FHA plays a stabilizing role and steps in when other conventional lenders exit the market during periods of market stress.

Present and Future

Having served its mission once again, following the Great Recession, FHA's resources were strained by its rapid growth in market share (as it stepped in to fill the gap left by other retreating lenders) and by the drop in home sales prices. In 2012, the Mutual Mortgage Insurance Fund (MMIF), which funds insurance on FHA's core single-family business line, declined to negative $16 billion, as measured by its economic net worth (capital reserves plus present value of future cash flows on existing loans). Due to the recession, FHA's cash reserves were down but never depleted; however, projected cash flows for the next 30 years were sufficiently negative to produce a negative net worth. As of the latest assessment, in 2013, the MMIF was at a negative $1.3 billion and remained below its required 2-percent capital reserve ratio. But the tide is shifting, and in the right direction: the MMIF gained $15 billion in economic value between 2012 and 2013, and it is projected to return to the required 2-percent capital reserve ratio next year, 2 years ahead of schedule.

Even as the economy has improved, FHA has made significant changes in risk management to mitigate existing and reduce future losses, including increases to its mortgage insurance premiums, which will position FHA to continue fulfilling its mission into the future. Emerging trends, however, will present challenges, and regulators will need to consider how the agency can fulfill its mission and protect taxpayers while evolving to meet changing demographic needs. Recent research from Harvard University indicates that economic conditions have been conspiring to reduce household formation rates among young adults, who are likely to have low incomes, live with their parents out of necessity, and rent (driving up demand and the prices of rental homes) (Joint Center for Housing Studies, 2014). In the future, new household formation will largely be driven by African-Americans, Hispanics, and other traditionally lower income and lower wealth minorities, who will account for three-fourths of household growth during the coming decade.

FHA is well positioned to serve the next generation of younger, relatively lower income and lower wealth households to either obtain affordable market-rate rental housing or earlier access to homeownership. These new homeowners will lean heavily on FHA, because high levels of indebtedness and relatively low incomes will impede their ability to save large downpayments. As it has been in the past, FHA will remain a major source of mortgage credit for underserved markets, first-time homebuyers, and minority families, and it will provide financing in future economic downturns.

References

Bocian, Debbie Gruenstein. 2012. "The Negative Impact of a Government-Mandated 10 Percent Down Payment for Qualified Residential Mortgages (QRMs)." Durham, NC: Center for Responsible Lending. http://www.responsiblelending.org/mortgage-lending/policy-legislation/regulators/QRM-10percent-issue-brief-Aug16-1-2.pdf (accessed July 15, 2014).

Green, Richard K., Gary Painter, and Michelle J. White. 2012. "Measuring the Benefits of Homeowning: Effects on Children Redux." Research Institute for Housing America Research Paper No. 12-01. http://www.ssrn.com/abstract=2171327 (accessed July 15, 2014).

Griffith, John. 2014. "The Federal Housing Administration Saved the Housing Market." Washington DC: Center for American Progress. http://www.americanprogress.org/issues/housing/report/2012/10/11/40824/the-federal-housing-administration-saved-the-housing-market/ (accessed July 15, 2014).

Joint Center for Housing Studies. 2014. "The State of the Nation's Housing 2014. Cambridge, MA: Harvard University. http://www.jchs.harvard.edu/research/state_nations_housing (accessed July 15, 2014).