FUTURE ROLE OF FHA

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PRESIDENTIAL SUMMARY

Introduction

The Federal Housing Administration (FHA) was created in 1934 to address the serious problems affecting homeowners and the residential construction industry as a result of the Depression. FHA's original goals were to stimulate housing construction, broaden opportunities for homeownership, and ensure an adequate and balanced flow of mortgage credit. FHA has been successful. By reducing the relative risk of the mortgage instrument as an investment alternative, FHA mortgage insurance has increased the availability of mortgage credit and assisted in the establishment of a national secondary mortgage market. FHA also played a significant role in popularizing the fully amortized, fixed interest, level-payment mortgage, low down-payments and long-term mortgage contracts, innovations which have made homeownership possible for millions of American families.

FHA had its greatest impact in the years immediately following its creation. The proportion of mortgages insured by FHA has been decreasing in recent years. In the single family market, FHA-insured starts represented 30-45 percent of all new home construction between 1935 and 1945 and 15-20 percent between 1945 and 1969. FHA's relative share of new starts rose somewhat in the early 1970's, primarily because of activity under the subsidized Section 235 homeownership assistance program. By 1975, however, FHA's market share had again receded, constituting less than 8 percent of total home construction. FHA's role in the multifamily market followed a similar pattern, dropping from 80 percent of all multifamily starts in 1946-50 to less than 25 percent in 1976.

The decline in FHA activity is largely attributable to changes in mortgage and default insurance markets. Of these changes, the most important have been the growth of a viable private mortgage insurance industry, liberalization of conventional mortgage lending terms by Federal and State regulatory agencies, and the recent creation of a secondary market for conventional mortgages. Other factors which have contributed to the decline in FHA activity include the establishment of competing mortgage insurance and guarantee

programs within other Federal agencies (VA and Farmers Home Administration), secondary market innovations such as mortgage-backed securities collateralized by conventional mortgages, and the introduction of stringent FHA processing requirements related to consumer protection, environmental quality and equal opportunity.

Today, FHA primarily serves households at the margin of the mortgage credit and housing markets. In the single family market, for example, private mortgage insurers have captured much of FHA's lower risk business. Private insurance activity now exceeds FHA production, a trend which is likely to continue. As a consequence, FHA activity has recently been oriented more towards serving low and moderate income households and urban neighborhoods. These tr nds are leading to higher claims rates and insurance losses . many of FHA's programs. As a result, several FHA programs now are operating on a non-actuarially sound basis and have required Congressional appropriations to remain solvent.

FHA's declining underwriting volume and increasing default losses, juxtaposed against the growing independence of the private market from FHA insurance, have called into question the traditional role of FHA in the housing and mortgage markets. The Future Role of FHA Presidential paper defines an appropriate role for FHA in this changed environment and presents policy and program recommendations for redirecting HUD mortgage insurance efforts. These recommendations are summarized below.

- o FHA's role should be to expand the availability of mortgage credit at reasonable interest rates by providing insurance in areas and to groups inadequately served by private mortgage insurers, and to exert a latent competitive influence on private-market pricing.

- Insurance premiums should be established for each program at a level intended to achieve actuarial soundness. An initial premium should be charged at the time of loan closing and a level annual percentage premium thereafter, in a manner which is intended to more closely parallel anticipated losses. In addition, the mutuality feature (e.g., premium rebates) should be eliminated from FHA insurance programs.

- Underwriting should be based on the "economic life" of a property, rather than its physical life, in order to reduce average per-case losses.

- Downpayments should be lowered to bring homeownership within the reach of more families.

- Artificial statutory limitations on FHA, which restrict the availability of mortgage insurance, should be lifted. Specifically, legislation is recommended to eliminate the ceilings on FHA interest rates and to allow the Secretary of HUD to determine maximum mortgage amounts.

- Mortgage insurance should no longer be provided under Sections 221(d)(2) and 223(e), but credit-worthy families who previously purchased homes under these two programs should be eligible for mortgage insurance under the Section 203 basic homeownership program or the Section 235 subsidized homeownership program, with their decreased downpayment requirements. In addition, an alternative older urban area mortgage insurance program should be developed to focus specifically on neighborhood preservation areas.

- FHA must continue to take an active role in providing default insurance for mortgages on subsidized multifamily rental properties.

- FHA should place more emphasis on its historic role of demonstrating innovative mortgage instruments. Increased use of the graduated payment mortgage should be actively supported by FHA. Legislative authority should be sought for broader experimentation with other innovative debt instruments, such as variable rate mortgages.

- Means should be developed, such as a GNMA conventional mortgage backed securities program, to expand the secondary mortgage market without reliance on FHA's primary market insurance volume.

Many of its critics point to FHA's decreased volume as evidence of its decreasing effectiveness. On the contrary, the decline in FHA's activity suggests that it has been successful in meeting its initial goal of increasing homeownership opportunities. Seventy-five percent of American families today own their own homes, largely as a result of FHA's innovative role in mortgage finance. Homeownership has been made possible for millions of American families because the fully amortized, long-term, low-downpayment mortgage which FHA pioneered has gained universal acceptance. FHA's role in creating and expanding the secondary mortgage market also has contributed to our high levels of housing production and homeownership, by increasing the flow of mortgage credit. Thus, the fact that the private market has emulated FHA's innovations and is now successfully competing with FHA indicates that FHA has succeeded, not failed, in meeting its goal of increasing homeownership opportunities.

The decreasing uniqueness of its service does not mean that FHA should recede into a passive role. Rather, FHA should take an aggressive stance in expanding the availability of mortgage credit to those areas of the country and to those families who are still not being adequately served by the private market, in continuing to support programs for subsidized housing, and in demonstrating innovative approaches to mortgage finance. By aggressively seeking to expand the availability of mortgage credit, rather than by competing to serve families already adequately served by conventional lenders and private mortgage insurers, FHA can continue to play a significant role in the production of housing and the continuing growth in the proportion of American families who own their own homes.

FUTURE ROLE OF FHA

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I. INTRODUCTION

A. Purpose of the Report

The Federal Housing Administration (FHA) is now over forty years old. It was established during the Depression as a means of broadening opportunities for homeownership. In a period of unprecedented social and economic dislocation, the creation of FHA was a tangible expression of our continuing vision of ourselves as a nation of homeowners. It was part of a commitment to make the opportunity to own a home available to as many American families as possible, and to make safe and decent housing available to all of them. That commitment remains as strong today as it was in 1934. What is less clear is FHA's role in meeting it.

Some consider FHA's original mission to have been accomplished; the private mortgage and housing industries currently operate at high levels of production independent of the use of Federal mortgage insurance. With the emergence of a private mortgage insurance industry, supported by (1) the periodic liberalization of mortgage lending terms by Federal and State regulatory agencies and (2) institutional changes in the secondary market which have increased the utilization of conventional loans, the private sector has developed financing and insurance mechanisms similar to those previously available only through FHA insurance programs. As a result, the volume of mortgages insured by FHA and the proportional share

of FHA insured mortgage sales in the secondary market have declined substantially in recent years.

At the same time that market changes were diminishing FHA's importance in the unsubsidized market, the nature of the Federal effort in housing was changing. Early Federal housing programs emphasized indirect supports to housing and mortgage markets. Over the past decade, new programs have been initiated to provide direct federal production subsidies. In most instances, FHA mortgage insurance was linked to these housing subsidies.

These market and program changes have altered FHA's role. An increasing share of FHA business is now written in connection with relatively high-risk borrowers and marginal properties. As a result, claims and loss rates have risen substantially. Many FHA programs are no longer actuarially sound and require Treasury borrowings to meet deficits.

Because of these changes in FHA's role, there have been frequent proposals for the elimination of FHA, for the revitalization of FHA in its traditional role, or for the restructuring of FHA to better serve the needs of the housing and mortgage markets. It is the purpose of this report to analyze the historical role of FHA and to articulate its future role in meeting our commitment to provide a safe and decent home for all American families and the opportunity for homeownership for as many of them as possible. The report focuses on the concept of mortgage default insurance, its evolution in both

the public and private sectors, and its potential role in future housing and mortgage markets. In addition, the report discusses ways in which FHA can continue its historic role of demonstrating and supporting innovative ways of increasing opportunities for homeownership.

The report does not deal with other issues which also bear directly on our capacity to meet this commitment and the means by which we do so. In particular, it does not discuss the role and programs of the Veterans Administration (VA) and Farmers Home Administration (FmHA) (even though their guarantee/ insurance programs approximate those of FHA); the impact of the federal income tax laws on the housing and mortgage markets; the effect of federal regulation of financial institutions on the availability and terms of residential mortgage credit; major reform of our welfare and income maintenance programs as a means of meeting the housing needs of our poorest citizens; or the organization of HUD-FHA.

B. Outline of the Report

The report is organized as follows:

Section II reviews the goals FHA originally was intended to serve, presents an analysis of the causes for the recent decline in the volume of FHA activity; and examines long term trends in FHA activity.

Sections III to V describe the key conceptual elements of the future role of FHA. In subsequent sections, recommendations

are provided with respect to the future role of FHA in assisting moderate income homebuyers (VI), in older urban areas (VII), in supporting low income multifamily rental housing (VIII), in supporting experimentation with innovative mortgage instruments (IX), in the secondary market (X), and in pursuing various social goals (XI). The Appendix provides the reader with a summary of major FHA insurance programs, including their statutory authorization, purpose, program requirements, activity levels and insurance in force.

C. A Definition of Mortgage Insurance

Before proceeding, it is appropriate to describe briefly the nature of mortgage credit insurance. The objective of any insurance operation is to spread the risk of loss. In issuing a mortgage, a lender provides financing in return for interest income. The loan involves risk of loss because the borrower may default on the mortgage and the lender may not recover enough cash from the sale of the mortgaged property to repay the initial loan and compensate for lost interest income and the costs of foreclosing. The lender will establish an interest rate or terms (such as a larger downpayment) related to the risk of the loan. If mortgage insurance reduces this risk, the lender is able to offer more favorable terms to the borrower.

The mortgage insurance concept is made operational through the development of a system of estimating expected losses and

needed reserves to meet those losses. The necessary reserves are accumulated through premium charges and through earnings on investments and fees, net of the expenses of administering the operation and of losses arising from disposition of properties on which insured loans have been foreclosed.

The level of premiums charged must take into account the likelihood of experiencing losses and losses reflect the degree of underwriting risk that is taken. Risks, in turn, depend upon the creditworthiness of the home buyer or owner, the terms and conditions of the mortgage, and the future value of the underlying property which serves as security for the mortgage. A significant element of mortgage insurance risks is the degree of appreciation or depreciation in the value of the underlying property, since, if depreciation occurs, the borrower, having lost some or all of his equity in the property, often has little incentive to continue making mortgage payments.

II. BACKGROUND

FHA's Original Goals

The Federal Housing Administration's various programs were originally conceived during the Depression as a direct response to the depressed condition of the economy in general and the building and construction trades in particular. The state of the economy was such that the flow of funds through the mortgage market had been reduced to a trickle. Mortgage loans were all but unavailable, and where available only on terms beyond the reach of most families. The standard mortgage

instrument had a term of only five years and required downpayments of up to 50%. The private mortgage insurance industry that had developed out of the title insurance business around the turn of the century had ceased to operate. All the firms in that industry were bankrupt and home mortgage default insurance was completely unavailable. The Nation was rapidly losing its capacity to provide the opportunity for homeownership to a significant proportion of its population.

Residential construction activity had virtually ceased. The production of new homes fell to 93,000 units in 1933 (less than ten percent of the number built in 1925) and on-site construction employed only 150,000 people throughout the country. Approximately one-half of all home mortgages were in default, and foreclosures were occurring at the phenomenal rate of over one thousand per day.

The Federal Government's response to these conditions consisted of an array of housing-oriented programs created over a six year span from 1932 to 1938. Among these were the FHA mortgage insurance programs. At the time, the primary objective of FHA was to increase the flow of funds through the mortgage market, thereby increasing the overall demand for housing services and, in turn, reducing the extremely high rate of unemployment in the building trades and construction industry. FHA contributed to this objective in three ways.

First, FHA mortgage insurance increased homeownership opportunities and the demand for residential mortgage credit generally, by bringing about important reforms in mortgage finance, including (1) the popular acceptance and standardization of the fully amortized, fixed interest, level payment mortgage that has since become almost universal; (2) the gradual but significant lengthening of the contract life on mortgage obligations; and (3) a substantial increase in the accepted loan-to-value ratio on residential mortgages. The effect of these changes was to decrease both the necessary downpayment and the monthly installments required to amortize a mortgage, thereby bringing homeownership within the reach of many middle and moderate income families.

Second, the provision of insurance against default loss reduced the relative risk of the mortgage instrument as an investment, thereby increasing its attractiveness vis-a-vis other investment opportunities.

Third, FHA insurance, combined with the application of FHA's Minimum Property Standards, its standardized appraisals, the standardization of the mortgage contract, and the creation of the Federal National Mortgage Association (in 1938), led to the establishment of a national secondary mortgage market, increasing the willingness of investors to hold mortgages. The secondary mortgage market also helped reduce regional disparities in the availability of mortgage funds.

The combined effect of these factors was to increase both the supply of and demand for mortgage funds and, thus, to increase the quantity of funds flowing through the mortgage market.

B. Reasons for the Decline in FHA Activity

The long term trends for FHA insurance in the residential mortgage market are traced in Tables 1-6. Tables 1 and 2 display single family and multifamily FHA-insured and conventional starts from 1921 to 1976; Tables 3 and 4 display single family and multifamily FHA insured and conventional loan originations from 1970 to 1975; and Tables 5 and 6 provide, in greater detail, data on FHA insurance written since 1966 including data for new and existing, as well as unsubsidized and subsidized housing units.

In terms of its share of total new home construction, FHA had its greatest impact in the years immediately following its creation. FHA starts were 31 percent of the total homes started during 1936-1940, and 43 percent of the total during World War II. The FHA share of total starts dropped to 19.5 percent in the latter half of the 1950's and remained fairly constant at that level through the 1960's. FHA's relative share of new starts rose dramatically in 1970 and 1971, mainly because of a sharp increase in activity under the subsidized Section 235 homeownership assistance program.

In the multifamily sector, FHA's importance followed a similar path, with FHA involved in 80 percent of the financing

Table 1

Starts of 1-4 Family Non-Farm Homes By Type of Loan 1921-1976

(Units in Thousands)

	Number of Units Started				Percent Distribution		
	Total	FHA	VA	Conventional	FHA	VA	Conventional
1921-1925	3163			3163			100.0%
1926-1930	2383			2383			100.0
1931-1935	728	14		714	1.9%		98.1
1936-1940	1811	566		1245	31.3		68.8
1941-1945	1557	667	9	881	42.8	.6%	56.6
1946-1950	6527	1042	605	4880	16.0	9.3	74.8
1951-1955	7066	1153	1147	4766	16.3	16.2	67.5
1956-1960	5833	1136	685	4012	19.5	11.7	68.8
1961-1965	5273	876	340	4057	16.6	6.5	76.9
1966-1970	4424	806	257	3351	18.2	5.8	75.7
1971-1975	5772	700	434	4638	12.1	7.5	80.4
1966	817	129	37	651	15.8	4.5	79.7
1967	892	142	52	698	15.9	5.8	78.3
1968	956	148	56	752	15.5	5.9	78.7
1969	878	154	51	673	17.5	5.8	76.7
1970	881	233	61	648	26.4	6.9	73.6
1971	1247	301	94	852	24.1	7.5	68.4
1972	1423	198	104	1121	13.9	7.3	78.8
1973	1226	74	86	1066	6.0	7.0	87.0
1974	938	57	73	808	6.1	7.8	86.1
1975	938	70	77	791	7.5	8.2	84.3
1976*	1170	74	92	1004	6.3	7.9	85.8

Source: U. S. Department of Housing and Urban Development; Veterans Administration; Census Bureau.

*First eleven months

Starts under Farmers Home Administration programs are included in the figures for conventional lending.

Table 2

Starts of Multifamily Units
By Type of Loan
1921-1976

(Units in thousands)

	Number of Units Started			Percent Distribution	
	Total	FHA	Conventional	FHA	Conventional
1921-1925	704		704		100.0%
1926-1930	868		868		100.0
1931-1935	95	1	94	1.0%	99.0
1936-1940	285	32	253	11.2	88.8
1941-1945	160	41	119	25.6	74.4
1946-1950	500	400	100	80.0	20.0
1951-1955	361	196	165	54.3	45.7
1956-1960	706	110	596	15.6	84.4
1961-1965	1985	249	1736	12.5	87.5
1966-1970	2335	406	1929	17.4	82.6
1971-1975	3069	552	2517	18.0	82.0
1966	325	29	296	8.9	91.1
1967	376	38	338	10.1	89.9
1968	527	72	455	13.7	86.3
1969	571	80	491	14.0	86.0
1970	536	187	349	34.9	65.1
1971	781	225	556	28.8	71.2
1972	906	172	734	19.0	81.0
1973	795	89	706	11.2	88.8
1974	382	38	344	9.9	90.1
1975	205	28	177	13.7	86.3
1976*	260	63	197	24.2	75.8

Source: U. S. Department of Housing and Urban Development; Census Bureau.
*First eleven months.

TABLE 3

SINGLE FAMILY LOAN ORIGINATIONS
(dollars in millions)

Year	FHA New	FHA Existing	Conventional New	Conventional Existing	V.A.	PMI Insured (included in conventional)
1970	7769	6104	8480	14493	3845	1267
1971	4441	6553	13371	26592	6830	3740
1972	3416	5040	19380	40280	7748	9158
1973	2046	3139	22972	43392	7578	12627
1974	1390	3144	20231	34858	7891	9219
1975	2104	4306	19564	42786	9182	10015

Source: Table QGF S.1 to 20
Table 2-7
Supply of Mortgage Credit

Note: Figures include both subsidized and unsubsidized.

TABLE 4

MULTIFAMILY LOAN ORIGINATION
(dollars in millions)

Year	FHA New	FHA Existing	Conventional New	Conventional Existing
1970	1794	123	5183	1683
1971	2635	202	5587	4031
1972	2845	344	6369	5809
1973	2918	141	5765	5196
1974	3104	237	5302	3623
1975	1910	244	3883	4640

Source: Tables QGF M-1 to 1020 - Supply of Mortgage Credit

Note: Figures include subsidized and unsubsidized.

Table 5

FHA-Insured Units on 1-4 Family Non-Farm Homes
1966-1976
(units in thousands)

	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976
Total (All programs)	436.2	411.8	452.6	491.3	518.3	608.2	452.7	251.6	205.2	267.0	263.0
New - Total	104.8	79.0	86.4	82.5	140.4	198.2	170.0	80.2	31.0	39.1	34.6
Unsubsidized	104.8	79.0	86.4	72.1	61.8	68.3	69.7	35.5	26.1	38.3	33.8
Subsidized	--	--	1/	10.5	78.6	130.0	100.2	44.8	4.9	.8	.8
Existing - Total	331.4	332.8	366.2	408.7	377.9	409.9	282.9	171.4	174.1	227.9	228.4
Unsubsidized	331.4	332.8	336.2	394.8	349.2	394.1	262.7	157.7	164.7	222.7	228.1
Subsidized	--	--	1/	13.9	28.7	15.8	20.2	13.7	9.4	5.2	.3
Percent Distribution											
Total (All programs)	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
New - Total	24.0	19.2	19.1	16.8	27.1	32.6	37.5	31.9	15.1	14.6	13.2
Unsubsidized	24.0	19.2	19.1	14.7	11.9	11.2	15.4	14.1	12.7	14.3	12.8
Subsidized	--	--	2/	2.1	15.2	21.4	22.1	17.8	2.4	.3	.3
Existing - Total	76.0	80.8	80.9	83.2	72.9	67.4	62.5	68.1	84.9	85.4	86.8
Unsubsidized	76.0	80.8	80.9	80.4	67.4	64.8	58.0	62.7	80.3	83.4	86.7
Subsidized	--	--	2/	2.8	5.5	2.6	4.5	5.4	4.6	2.0	.1

1/ Less than 100 units.
2/ Less than 0.1 percent.
Source: U. S. Department of Housing and Urban Development.

TABLE 6

FHA-INSURED UNITS ON MULTI-FAMILY PROJECTS
(1966-1975)
(units in thousands)

	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975
Total (All programs)	33.7	41.2	76.2	82.1	200.9	205.4	188.2	120.4	54.6	38.0
New - Total	30.1	36.8	68.3	76.1	176.8	194.7	170.0	110.1	47.2	32.0
Unsubsidized	17.2	10.3	9.5	14.7	32.0	84.2	70.8	46.2	20.7	14.8
Subsidized	12.9	26.5	58.8	61.4	144.8	110.5	99.2	63.9	26.5	17.1
Existing - Total	3.6	4.4	7.9	5.9	24.2	10.6	18.3	10.4	7.4	6.1
Unsubsidized	2.0	1.6	1.0	.6	11.0	.9	1.2	1.1	.9	1.9
Subsidized	1.6	2.8	6.9	5.3	13.2	9.7	17.1	9.3	6.5	4.2
	Percent distribution									
Total (All programs)	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
New - Total	89.3	89.3	89.6	92.8	88.0	94.8	90.3	91.4	86.4	84.(
Unsubsidized	51.0	25.0	12.5	18.0	15.9	41.0	37.6	38.4	37.9	39.(
Subsidized	38.3	64.3	77.1	74.8	72.1	53.8	52.7	53.0	48.5	45.(
Existing - Total	10.7	10.7	10.4	7.2	12.0	5.2	9.7	8.6	13.6	16.(
Unsubsidized	5.9	3.9	1.3	.7	5.5	.4	.6	.9	1.7	5.(
Subsidized	4.8	6.8	9.1	6.5	6.5	4.8	9.1	7.7	11.9	11.(

Source: U. S. Department of Housing and Urban Development.

for all new rental housing during the 1946-1950 period, but only 14 percent by 1969. FHA's share of the market rose again in the early 1970's primarily because of the increase in federally subsidized multifamily housing.

In both the single family and multifamily sectors, FHA's current share of the unsubsidized mortgage market is relatively small. FHA currently insures eight percent of all newly constructed, unsubsidized single family homes, approximately one half of its traditional post-war share of the market. Even when transactions involving existing single family homes are included, FHA's share of the market remains small. FHA currently represents less than 8 percent of home mortgage financing. There are several reasons for this dramatic decline.

1. Reasons for the Decline in FHA Activity in the Single Family Sector

HUD has conducted an exhaustive analysis of the reasons for the decline in FHA single family unsubsidized activity, which attributes the decline in FHA activity to a combination of forces, including the emergence of alternative financing arrangements and new institutional constraints.

The single most significant contributor to the erosion of FHA's importance seems to have been the development of a national private mortgage insurance (PMI) industry. Beginning in 1957, with the creation of the Mortgage Guarantee

Insurance Corporation (MGIC), private firms began to insure conventional mortgage loans for the first time since the Depression. The PMIs offer a different product but perform essentially the same service as FHA. PMI single family insurance differs from FHA insurance in three ways:

(1) The PMIs insure the lender against only a portion of the loss while FHA provides 100% coverage. The PMIs reimburse the lender for all losses up to a predetermined limit expressed as a percentage (usually 20 or 25%) of the mortgage amount.

(2) As shown on Chart 7, PMI premiums are lower, apply only during the early years of a mortgage, and are collected in advance of each year of insurance. FHA's premiums are generally 0.5 percent of the outstanding mortgage amount, collected over the life of the mortgage on a current basis.

(3) The PMIs delegate underwriting and property disposition to the lender. FHA performs both of these functions.

By the beginning of the 1970's there were over a dozen firms active in the PMI industry and, as shown on Tables 8 and 9, they are substantially displacing federally underwritten mortgages in the single family residential market. One major reason for the growth of the PMI industry was the liberalization of mortgage lending terms by Federal and State regulatory agencies. For example, a surge of PMI activity occurred in 1972-1973 after regulations were promulgated permitting thrift institutions to originate mortgages at 95% of value when the individual loans are insured.

CHART 7

PMI Premiums

PMI premiums vary according to three factors: the loan-to-value ratio of the mortgage, the percentage of the mortgage amount insured, and the choice of a prepayment option with fixed length of coverage. The MGIC premium schedule is presented below as an example.

LTV ratio	% of sale price insured	1st year premium	Subsequent year premium
Less than 80%	10%	.15%	.15%
Less than 80%	20%	.25%	.25%
80-90%	20%	.50% + $20	.25%
80-90%	25%	.75% + $20	.25%
90-95%	20%	.75% + $20	.25%
90-95%	25%	1.00% + $20	.25%

		Single prepayment, 10 year coverage*
80-90%	20%	2%
80-90%	25%	2.25%
90-95%	20%	2.25%
90-95%	25%	2.5%

*MGIC also offers 5 year and 7 year coverage options.

Table 8

Insurance Status of Long-Term Home Mortgage Loan Originations 1970-1975
(Dollar Amounts in Billions)

	1970	1971	1972	1973	1974	1975
FHA insured	$ 8.8	$11.0	$ 8.5	$ 5.2	$ 4.4	$ 6.4
VA guaranteed	3.8	6.8	7.7	7.6	7.9	9.2
FHDA insured	.9	1.3	1.4	1.3	1.7	2.2
Total federally underwritten	13.5	19.1	17.6	14.1	14.1	17.8
Conventional insured	1.3	3.7	9.2	12.6	9.2	10.0
Conventional uninsured	20.8	35.0	49.1	52.4	44.2	50.2
Total conventional	22.1	38.7	58.3	65.0	53.4	60.2
Total home mortgage loans	35.6	57.8	75.9	79.1	67.5	78.0
	Percent distribution					
FHA insured	24.7%	19.0%	11.2%	6.6%	6.7%	8.2%
VA guaranteed	10.7	11.8	10.2	9.6	11.7	11.8
FHDA insured	2.5	2.2	1.8	1.6	2.5	2.8
Total federally underwritten	37.9	33.0	23.2	17.8	20.9	22.8
Conventional insured	3.7	6.4	12.1	15.9	13.6	12.8
Conventional uninsured	58.4	60.6	64.7	66.3	65.5	64.4
Total conventional	62.1	67.0	76.8	82.2	79.1	77.2
Total home mortgage loans	100.0	100.0	100.0	100.0	100.0	100.0

Source: U. S. Department of Housing and Urban Development

Table 9

Insurance Status of Federally-Insured and Privately Insured Long-Term Home Mortgage Loans 1970-1975

(units in thousands)

	1970	1971	1972	1973	1974	1975
Total Insured	830.4	1,209.9	1,330.9	1,183.8	940.0	991.4
Federally Insured	754.4	999.2	934.9	683.8	609.4	669.5
FHA-Insured [Section 203(b)]	518.3 [303.8]	603.2 [332.5]	452.7 [230.5]	251.6 [135.3]	205.2 [151.2]	267.0 [226.2]
VA-Guaranteed	167.5	282.3	370.0	315.5	309.8	300.0
FHDA-Insured	68.6	108.7	112.2	116.7	94.4	102.5
Privately Insured	76.0 E	212.0 E	396.0	500.0	330.6	321.9
	Percent Distribution					
Total Insured	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Federally Insured	90.8	82.6	70.2	57.8	64.8	67.5
FHA-Insured [Section 203(b)]	62.4 [36.6]	50.3 [27.5]	30.1 [17.3]	21.3 [11.4]	21.8 [16.1]	26.9 [22.8]
VA-Guaranteed	20.2	23.3	27.8	26.6	33.0	30.3
FHDA-Insured	8.3	9.0	8.4	9.9	10.0	10.3
Privately Insured	9.2	17.5	29.8	42.2	35.2	32.5

E - Estimate

Source: U.S. Department of Housing and Urban Development
Veterans Administration
Farmers Home Administration, Department of Agriculture

For conventional lenders, the availability of private insurance made it possible to offer loan-to-value ratios, loan maturities, and interest rates which were comparable or superior to the terms available on FHA-insured loans. Moreover, the private insurers made their insurance available at a lower cost (the reduced premiums resulting in part from the PMI's less than 100% coverage) and processed applications more quickly than FHA. As a result, the uniqueness of FHA's product declined significantly.

FHA policies with respect to pricing -- its premium charges -- also contributed to the growth of the PMI's. FHA pools readily distinguishable risk classes under a single premium rate, resulting in a cross-subsidization of insurance premiums. Preferred risk customers, in effect, subsidize the premiums of higher risk customers. By not charging premiums which reflect the identifiable risks of individual mortgages, FHA made it possible for private firms profitably to enter the market by bidding away FHA's lower risk business and leaving FHA to insure higher risk cases. Thus, the FHA approach to pricing has contributed both to the long run decline in its insurance volume and to the decreasing quality of the average FHA insurance application.

Another factor in the decline of FHA's single family activity has been the subsidized mortgage insurance available from other Federal agencies. The coverage provided under the VA Home Loan Guarantee program, for instance, has significantly

reduced the demand for FHA coverage. The VA charges no premium and requires no downpayment.

FHA mortgage limits and interest rate ceilings also have contributed to the decline in FHA's market share. In addition, increases in the "red tape" associated with obtaining FHA insurance, including the costs, paperwork and delays associated with environmental reviews, Davis-Bacon wages and other requirements not related to the insurability of a loan, have contributed to FHA's particularly dramatic decline in new construction activity.

Two institutional forces appear to have retarded, to some degree, the rate of decline of FHA single family activity in recent years. First, the recent policy of keeping the FHA interest rate ceiling more closely aligned with private market rates appears to have somewhat mitigated the decline in FHA activity. The other factor is the positive effect of secondary market purchases of FHA-insured mortgages by FNMA, GNMA, and the Federal Home Loan Mortgage Corporation (FHLMC), and of GNMA's FHA-Insured Mortgage Backed Securities program. To the extent that the secondary market increasingly adapts to private insurance coverage, however, this source of support may diminish.

C. Current FHA Single Family Activity

In the mid-1940's, when federally underwritten mortgage credit represented over 40 percent of all new single family mortgages,

Federal insurance and guarantees were important to the assurance of an adequate availability of credit. Federally insured mortgages now constitute only about 23 percent of all home mortgage credit and FHA represents only 8 percent of the total.

Nonetheless, FHA continues to insure home mortgages for a large number of families -- 263,000 in 1976* In order to articulate FHA's future role in meeting our national commitment to homeownership, it is necessary to reach some conclusion as to whether the availability of FHA insurance was necessary for these families to purchase a home. The following section looks at the characteristics of FHA mortgagors -- their incomes, race, and locational characteristics -- and considers whether lenders are making adequate credit available to such borrowers.

1. Income and Property Values

The average income of FHA borrowers and the average price of the property they buy is lower than that of borrowers with PMI insurance and conventional financing. FHA-insured loans, on the average, are made to somewhat younger families buying somewhat smaller homes than is the case with conventional and PMI mortgages. Conventional and PMI borrowers include a much larger number of high income mortgagors than are included among FHA borrowers because they are preferred risks and because FHA's statutory mortgage limits tend to exclude higher priced homes and higher income mortgagors.

2. Race

Few statistics are available on the racial characteristics of homebuyers. Data from the 1970 Census indicate that the

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* Preliminary; based on estimate for December 1976

majority of minority group homebuyers financed their purchases with conventional loans, without any Federal insurance or guarantees. Nevertheless, the proportion of minority group homebuyers using FHA insurance was higher than for homebuyers as a whole. It is estimated that roughly one out of every three minority homebuyers use FHA insurance. About 22 percent of FHA Section 203(b) and 39 percent of Section 221(d)(2) home mortgage credit currently is written for minority purchasers.

3. Location

Available data indicate that neither FHA nor PMI loans play a significant role in rural housing markets. The Farmers Home Administration has active programs for rural housing finance and, through the Department of Agriculture's system of county offices, FmHA is better equipped than FHA to handle the special requirements of this dispersed market.

Within metropolitan areas, FHA appears to play a role complementary to the PMI industry. Charts 11 and 12 provide a comparison of FHA and PMI insured lending during 1973 in suburban and central city areas. Privately insured lending far outstrips FHA insured lending in the suburban areas and overlaps FHA in terms of the incomes of the families receiving financing and the value of properties insured.

In central city areas, however, FHA predominates, at least in serving relatively lower income mortgagors. Currently,

TABLE 10

FHA Home Mortgages by
Geographic Area (1976)*
(Percentage)

	Urban	Suburban	Rural
203b New	38.7	60.0	1.3
203b Existing	59.6	38.9	1.5
221(d)(2) New	30.9	69.1	--
221(d)(2) Existing	66.4	33.2	.4
223e New**	87.5	12.5	--
223e Existing	91.5	8.5	--

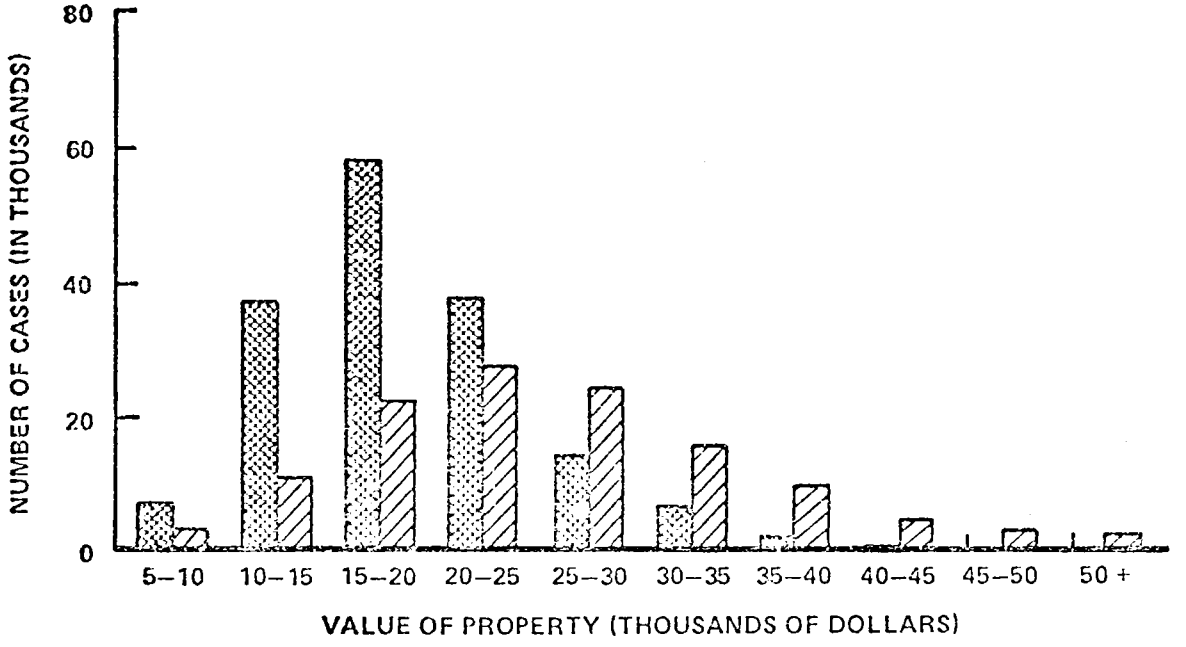
Source: Housing, Single Family Insured Branch

* Based on last three quarters of FY '76.
** Total number of mortgages used for calculation is very small.

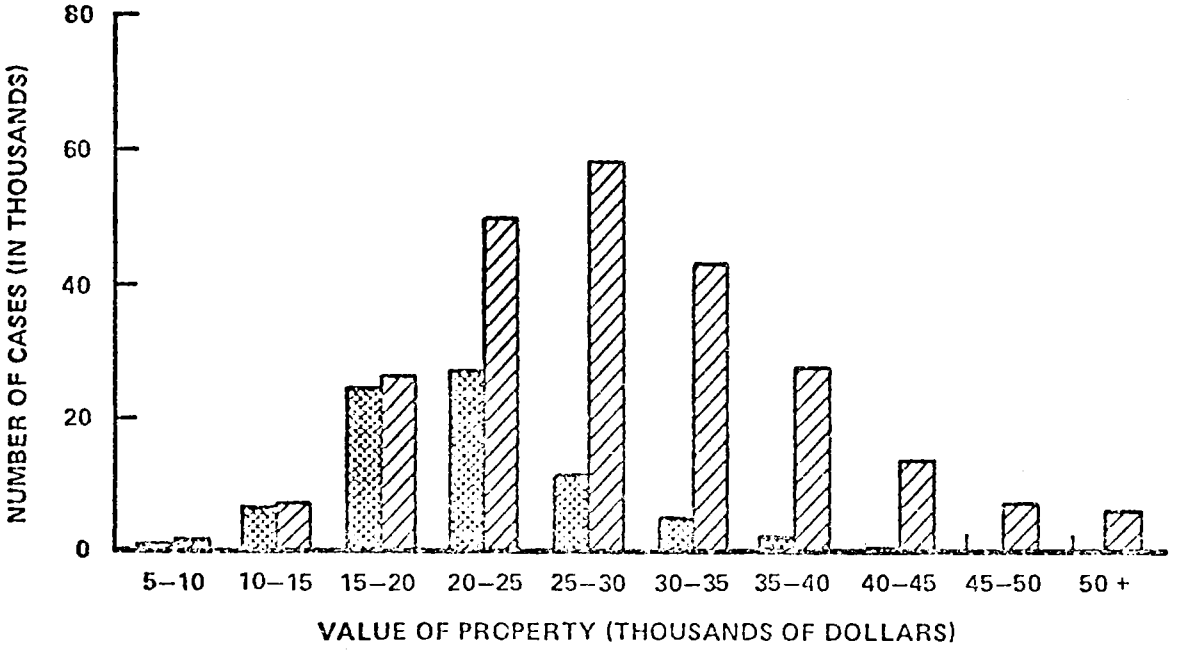
CHART 11

COMPARISON OF FHA AND PMI ACTIVITY IN 1973

CENTRAL CITY



SUBURBAN



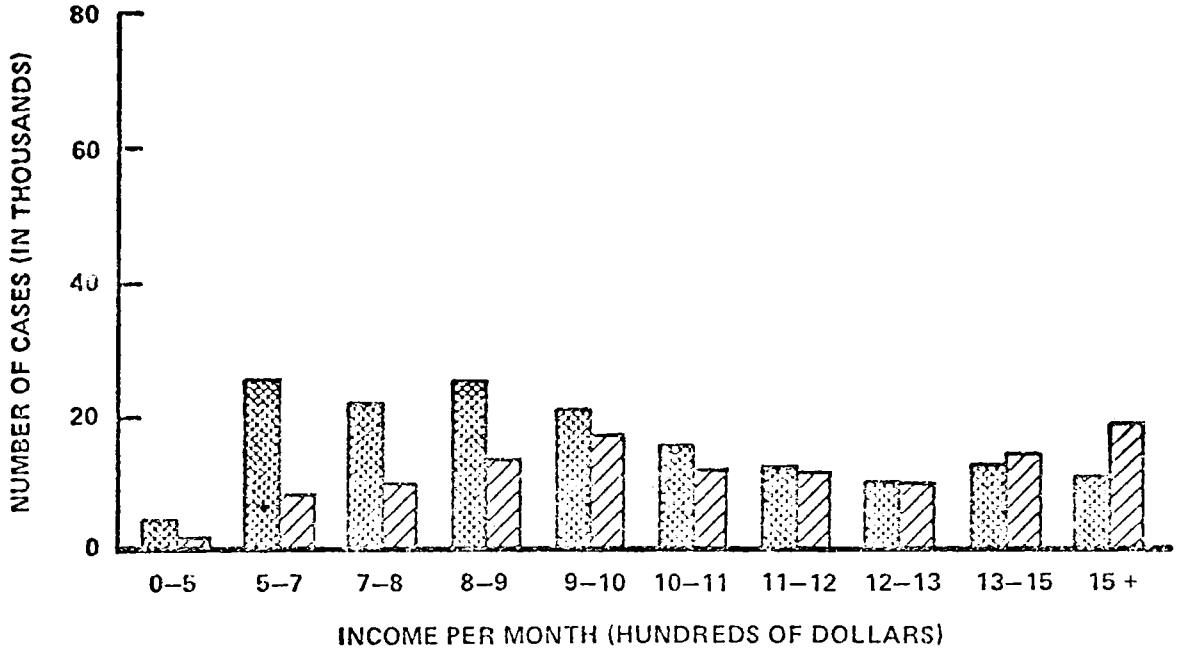
FHA

PMI

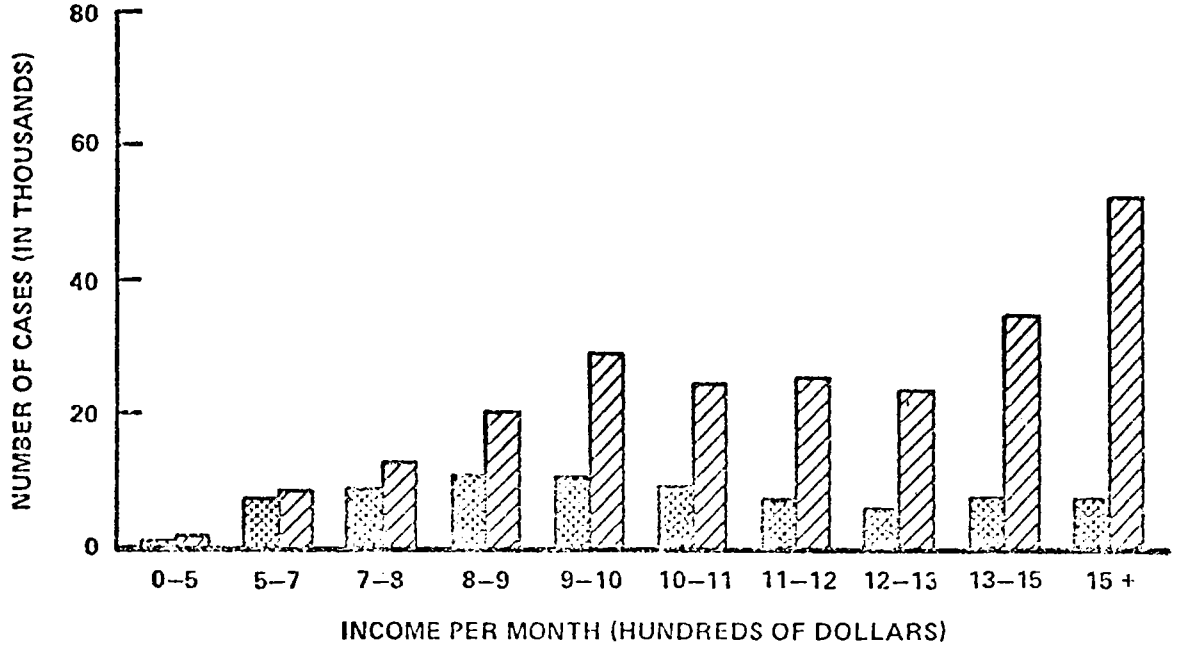
CHART 12

COMPARISON OF FHA AND PMI ACTIVITY IN 1973

CENTRAL CITY



SUBURBAN



FHA

PMI

about 60 percent of all FHA insurance is written in central city areas with the remaining 40 percent written in suburban or rural locations.*

FHA loans tend to be used more frequently in financing existing home purchases (see Table 3) whereas PMI insurance in recent years has been used more in connection with the purchase of new homes. Thus, the availability of FHA credit appears to benefit the marketability of existing homes, especially in central city areas, more than new homes.

FHA insurance also appears to be used more frequently in the South, West and parts of the Midwest while privately-insured conventional loans are used relatively more often in the East and Northeast. This may reflect the use of FHA insured mortgages to facilitate the transfer of capital from areas with capital surpluses to areas with lower savings relative to housing demands.

4. Summary

In view of the growth and competitiveness of the PMI s, the rapid service they can offer, and their lower premium charges as compared to FHA, it seems reasonable to expect that most of the borrowers now using FHA insurance are those who do not have access to conventional or PMI financing. Such borrowers include,

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*/ It should be noted that "central city" refers to the central city of a SMSA, so it includes, but is not limited to, so-called "inner city" areas.

for example, families in areas where PMI s have not yet become active and families, both white and non-white, seeking to buy older homes in urban areas where private lenders perceive risks to be higher than they are willing to underwrite themselves. The continued availability of FHA insurance is necessary if these families are to achieve homeownership.

D. Reasons for a Decline in FHA Activity in the Multifamily Sector

FHA's relative share of the multifamily market decreased from 80% in 1946-50 and 54% in 1951-55 to 14% at the end of the 1960's. As in the single family sector, terms offered by conventional lenders have been liberalized in recent years, so that average loan-to-value ratios and the typical pay-out period for conventional mortgages are now more comparable to the terms available through FHA than they were in the past. Interest rates available on conventional multifamily loans are essentially the same as the effective interest rates required on FHA financing, but the payment of discount points on FHA loans may impose unnecessarily harsh equity requirements on developers.

Although the private mortgage insurance industry is not nearly as active in the multifamily market as it is in the single family market, it has made inroads. Currently, four companies write mortgage insurance for apartment properties,

and have in excess of $600 million of such insurance in force.

Finally, FHA "red tape" has had a more severe impact on multifamily new construction than on single family activity. It is in the multifamily sector, where processing times of 9 to 12 months, Davis-Bacon wages, and environmental reviews seem to have taken their greatest toll.

Since 1972, the decline in the total volume of FHA multifamily activity has also reflected a decline in overall apartment construction. Rents in most major housing markets have not increased commensurately with the increased costs of constructing, financing, and operating rental housing. Consequently, potential investors do not find new apartment undertakings financially attractive. Recent trends toward local rent controls and land use restrictions also have contributed to reduced interest in apartment construction.

E. Current FHA Multifamily Activity

Because most apartment projects are located in either cities or close-in suburban areas, it is difficult to assess the potential market overlap between FHA and conventional loans on a purely geographic basis. On an income basis, the distinction is clearer. Tenants in FHA-insured projects belong to a somewhat lower income group than those in conventionally financed projects. Furthermore, unsubsidized FHA-insured projects are generally more modest in scale than are conventional projects.

This seems to indicate that the same group of moderate income urban families who would be most affected by the termination of the FHA home loan insurance programs also would be most affected by a termination of FHA project insurance.

Since FHA insurance is used in fewer than 25 percent of all unsubsidized multifamily project units started, an end to the FHA project insurance programs might not have a major impact on the overall availability of credit for unsubsidized multifamily housing. It is possible that a decline in or elimination of FHA multifamily insurance would be largely offset by increases in conventionally financed construction. Since the aggregate demand for unsubsidized rental housing should not diminish as a result of less FHA activity, market demand alone should induce increased activity in the conventionally financed sector. Private mortgage insurance companies, as noted earlier, have entered the multifamily sector only to a modest degree, but this may be partially because of a lack of demand.

An end to FHA project insurance programs might result in a distributional shift in the families benefiting from multifamily production, however. Conventionally financed new construction would tend to benefit somewhat higher income families than does FHA insured rental housing. Thus,

a reduction in FHA insured project financing could reduce the availability of newly constructed housing to families who, by reason of income, race, or geography have the least access to such housing.

Greater study should be given to FHA's role in ensuring that there is an adequate supply of safe and decent multifamily housing, particularly for those who cannot afford homeownership, before any further changes in FHA's role in multifamily sector is undertaken.

III. The Relationship of FHA to PMIs

A. The Single Family Home Market

The continued importance of FHA insurance, particularly for single family residential mortgages, depends upon the extent to which private insurers cannot or will not provide mortgage insurance to families capable of homeownership at premium rates which are acceptable in terms of our national commitment to increasing homeownership opportunities.

Three potential shortcomings in the PMI industry have been examined:

1. The financial integrity (actuarial soundness) of the private firms in the industry;
2. The degree of monopoly power in the private market; and
3. The ability (or willingness) of the private firms to meet the insurance needs of the various sectors of the housing market.

It appears that, at least in the first two instances, the PMIs do not suffer problems sufficiently serious to warrant concern.*

On the other hand, the evidence clearly does not warrant elimination of Federal mortgage insurance. In

*An extensive analysis of the strength and structure of the PMI industry by the A.D. Little Co. documents this and the subsequent conclusions. (A.D. Little Co., The Private Mortgage Insurance Industry, April 1975)

several States, the default insurance market is dominated by a single firm which, in the absence of an FHA alternative, could exhibit monopolistic behavior. In these areas the availability of FHA mortgage insurance provides a latent restraint on the pricing policies of those private insurers.

In other areas PMIs are not yet active and for some groups of homeowners, such as young first-time purchasers, the private sector may not be providing mortgage credit at reasonable terms.

An abrupt exit by FHA from the home mortgage market also would have a disruptive effect on the secondary mortgage market, because of many investors' continuing preference for the 100%, full faith and credit insurance coverage available from FHA. FHA increasingly is serving mortgage bankers, who originate loans for sale in the secondary market rather than their own portfolios.

Thus, FHA should not exit the unsubsidized single family default insurance market, but it should focus its efforts on offering coverage where the PMIs are unable or unwilling to do so, while at the same time exerting a latent restraint on the pricing policies of private firms.

In such a "complementary" role, FHA would be providing coverage on individual loans primarily when: (a) private mortgage insurance is unavailable due to either an absence of active private mortgage insurance firms in particular market areas or to unacceptably

restrictive underwriting policies on the part of those firms that are present; or (b) private mortgage insurance is available only at unreasonably high prices.

To achieve this market role, FHA's strategy should incorporate three basic features. First, the insurance coverage provided by FHA should be priced at a cost which avoids subsidization of the insurance premium, thereby ensuring that consumers will not be bid away from the private market at public expense. This strategy is dependent, therefore, upon HUD's success in achieving actuarial soundness in most of its programs.

Second, FHA should guard against unnecessarily stifling th future growth of the private mortgage insurance industry. As new firms enter the industry and as the private firms expand their underwriting policies to incorporate more risky business, FHA should not be protective of its share of the single family market.

Third, FHA should place a greater emphasis on its historic role in demonstrating and supporting innovative mortgage instruments as well as on serving discrete segments of the home purchasing market, which private mortgage insurers either have not or cannot assist because of the potential risks involved.

The volume of FHA insurance activity may continue to decline as the private mortgage insurance industry

expands. It is likely, too, that FHA insurance activity will be concentrated increasingly in certain regional markets and higher risk markets, such as inner city areas. And, the nature of FHA's activity is likely to change over time as the PMIs enter some markets and leave others.

A decline in FHA activity is not inevitable, however. If FHA procedures can be made more efficient, through the elimination of unnecessary "red tape," and there is an increasing willingness to meet needs which PMIs cannot or will not serve, it may be possible to benefit even larger numbers of families than presently have access to FHA insured financing.

Recommendation:

The appropriate future role of FHA should be to expand the availability of mortgage credit at reasonable interest rates by providing insurance in areas and to groups inadequately served by the private mortgage insurance industry, and to exert a latent competitive influence on the pricing policies of private insurers.

B. The Multifamily Sector

In the multifamily sector, FHA's impact should be the same as in the single family sector -- complementing private insurance by meeting demands the private

sector is unwilling to meet and exercising a latent restraint on its pricing policies. This goal can be achieved more easily in the multifamily sector than in the single family sector because the PMIs have become only minimally involved in multifamily financing, hence there is relatively little risk of overlap between FHA and the PMIs. Also, a significant portion of FHA multifamily activity involves the financing of subsidized housing, with FNMA and GNMA purchases of FHA loans providing access to sources of long-term investment funds. This is an area in which private conventional lenders have displayed little interest.

Moreover, FHA enjoys a better risk spreading capacity in the insurance of project mortgages than does the private sector. In the single family sector, individual lenders are capable of accumulating fairly large portfolios, and the individual PMIs can amass a large enough number of loans, so that there are adequate opportunities to spread the risk of loss. In the multifamily sector, however, this opportunity to spread the risk of loss is reduced because a typical loan may involve millions of dollars. This difficulty of concentrated risks may have prevented all but the largest PMIs from becoming involved in the multifamily sector. The Federal Government, on the other hand, is

in a position to insure larger numbers of project mortgages than any private single entity and, therefore, can achieve a better distribution of risks.

The slower growth of PMI activity in the multifamily market is also due, in part, to the greater difficulty in measuring risks for multifamily than for single family mortgages. In the single family sector, the insurer deals with individual families as homeowners but, in the multifamily sector, the insurer must deal with complex corporate structures, partnership agreements, and other approaches to minimizing the financial exposure of the owners. In addition, the valuation of properties is much more difficult, requiring projections of future income streams from rents and projections of operating costs and other expenses. The valuation of properties based on comparable market prices is also more difficult because the relatively low volume of turnover of multifamily properties makes it difficult to find true comparables.

Studies of large numbers of FHA insured projects, some of which have gone into default, display remarkably little consistency from project to project in the reasons for success or failure, but they do show that many FHA insured projects are in a financially tenuous position. Those which are not in default remain viable

only because of the particular characteristics of individual managers; the willingness of sponsors to put up more funds, even after the project is completed; the vagaries of individual markets; the actions of local public officials, such as property tax assessments and tax abatements; or the aggressiveness of tenant organizations. Because most of these factors cannot be predicted in advance using traditional underwriting practices, FHA's greater capacity to assume risks is of particular importance.

Recommendation:

In the multifamily sector, FHA also should play a complementary role, but the need to focus on the relationship with private mortgage insurers is less critical than in the single family sector, because of the low level of PMI involvement in the financing of housing for those groups which FHA serves in the rental sector.

IV. Premium Structure and Actuarial Soundness

A. Actuarial Soundness

It is appropriate to ask whether FHA insurance programs should be actuarially sound, that is, whether premium income should be expected to cover administrative expenses and the benefits provided to lenders in the case of foreclosure. Until recently, FHA insurance activities have been actuarially sound. The basic homeownership program, Section 203(b), has actually produced a surplus. This experience suggests that the

mortgage insurance instrument does not have to be subsidized to be effective. The more stringent terms which lenders would require in the absence of insurance are likely to be more costly or burdensome to the borrower than the insurance premium.

On the other hand, subsidized rates would increase the benefits to the borrower. The question of subsidization vs. actuarial soundness depends on public policy objectives. Although subsidized FHA insurance premiums could make homeownership easier to achieve for some lower income families, the quantitative effect is likely to be small, and the cost large. For example, if the FHA interest rate is 8%, complete subsidization of the insurance premium on a $33,000 house with a 30 year mortgage would reduce the $253.77 monthly mortgage payments by only $11.60 in the first year and by a decreasing amount in each subsequent year. This is a small sum, compared with the $76.59 reduction possible through the Section 235 interest subsidy program, for example. But, relying on actuarially unsound premiums to encourage homeownership would require providing this implicit (premium) subsidy to the hundreds of thousands of families who would have purchased homes even without the subsidy.

In addition, the income redistribution achievable through subsidizing FHA insurance premiums would be generally from lower and higher income families to

moderate income families. Lower income families cannot afford to purchase their own homes and therefore could not benefit from the subsidy. Higher income families generally purchase more expensive homes than are anticipated by the current FHA mortgage ceiling and therefore do not participate in the program. Both groups, however, contribute to costs of subsidization through their taxes. The resulting pattern of redistribution is undesirable.

Since subsidization is not necessary to achieve the benefits of mortgage insurance and would have little incremental effect on homeownership, an actuarially sound premium structure is generally desirable for FHA insurance programs.

Recommendation:

FHA insurance programs generally should be provided on an actuarially sound basis and the current premium structure should be adjusted to achieve this goal.

B. Premium Structure

Currently all FHA insurance programs charge the same premium, one-half percent per annum of the remaining mortgage balance. Thus, the current premium structure results in all borrowers, regardless of the riskiness of the mortgage, paying the same premium.

This feature has resulted in a cross-subsidization of insurance premiums both within and between programs

and has enabled and encouraged "cream-skimming" on the part of the private mortgage insurance industry. Cross subsidization of insurance premiums refers to the fact that, in an actuarially sound insurance program which pools different risk classes in an insurance fund that is financed by levying the same premium on all customers, low-risk customers will be forced to pay premiums that exceed the expected costs of providing coverage to them and high-risk customers will pay premiums that are below the expected costs of providing their insurance coverage. In effect, the elevated prices charged the preferred risk customers are used to maintain the depressed prices (relative to costs) charged the high risk customers.

"Cream-skimming" refers to the process whereby PMIs offer FHA's preferred risk customers premium rates that more closely approximate the expected costs of providing insurance coverage to them and are, consequently, below the rates offered by FHA. Obviously, it is to the advantage of these low risk customers to opt for the lower-priced coverage. In the long run, FHA is left with only the higher risk customers for which the stipulated premium rate may no longer be sufficient, jeopardizing the actuarial soundness of the program. Because of this process, the pricing policy adopted by FHA has contributed to a long-run decline in both the

volume of activity carried out under its programs and the average underwriting quality of the mortgages submitted for participation. While it is impossible to predict the long run effect on FHA volume that would be achieved by an alteration of this pricing policy, it appears that a continuation of the single price scheme will serve to hasten the declining volume of FHA activity.

C. Alternative Premium Policies

There are three approaches FHA could take in structuring its premiums. The first is to continue the single rate approach, traditional to FHA, in which the same premium applies to all insurance programs. The second approach is to establish different premiums for different classes of loans so that premium rates vary directly with expected losses. Under this "risk rating" approach, individual risk categories within individual programs would be established, with differential premiums set accordingly. A third approach, which involves an indirect form of risk rating, is to set different premium rates for each FHA program, with the individual premiums based on average risks experienced within the respective programs.

1. The Single Rate Structure

As noted earlier, almost all FHA mortgagors now pay an annual premium of .5% of the

average outstanding balance over the life of the loan. Continuation of this single rate structure encourages private mortgage insurers to continue expanding their market by bidding away lower risk business, leaving FHA with the higher risk customers. As FHA loses the lower risk segment of its market, upward revisions in the FHA premiums rate will be necessary to preserve actuarial soundness, allowing the PMIs to bid away additional FHA business. As private insurers broaden their services, both geographically and in terms of the risks that they are willing to accept, FHA's presence would provide a ceiling on their ability to practice monopolistic pricing or underwriting. Thus, the actuarial soundness of FHA program would be preserved and direct competition with the private market avoided.

The basic strengths of this premium structure are its operational simplicity and the encouragement it provides for market expansion by the PMIs. It does, however, have weaknesses. First, by charging a single premium to all customers, this option severely penalizes borrowers with low risk loans originated in geographic areas in which

private mortgage insurance is not available. Second, although the FHA premium rate serves as an upper ceiling which may curtail possible monopolistic pricing behavior on the part of the private firms in the market, this ceiling may become quite high as upward revisions occur, thereby increasing the opportunity for monopolistic pricing exploitation below the ceiling.

The attractiveness of this option depends, in large measure, upon the future rate of growth in the size and competitiveness of the private mortgage insurance industry. If rapid growth occurs, the costs of maintaining the single-rate premium structure might be short-term in nature and may be justified by the benefits of PMI expansion. On the other hand, if these market adjustments are slow, then the costs are more difficult to justify.

2. Risk Rating

The second premium structure option -- the creation of multiple premium rates -- would reduce or eliminate the cross-subsidization of insurance premiums within programs by charging prices that approximate the expected costs of providing coverage on individual loans. The

actual number of risk classes that should be delineated depends on the trade-off involved between the costs of increasing FHA's ability to distinguish separate classes of risk and the benefits of a greater reduction of cross-subsidization between classes. Administrative considerations suggest that a fairly small number of risk classes would be appropriate.

The use of multiple rates requires an ability to predict the expected default loss on individual loans from a set of characteristics which are readily observable at the time of the insurance application. Studies are presently being conducted which, if successful, would provide a basis for consideration of a multiple-rate structure within programs. It appears that location and loan-to-value ratios have the greatest influence on risk. The development of neighborhood indicators has proven impractical, however. Nonetheless, a multiple premium structure based only on loan-to-value ratios might be implemented upon completion of the current studies.

The basic advantage of the multiple rate structure is that lower risk homebuyers pay reduced premiums under this approach. As a result, the risk-rating option imposes a tighter restraint on

PMI pricing policies. Also, this approach does not penalize lower risk mortgagors who may be located in areas in which private coverage is not available by forcing them to pay premiums which exceed the cost of providing coverage to them.

However, because the National Housing Act limits premium rates that can be charged to the range of .25% to 1% annually and does not allow for intra-program premium differentials, a statutory amendment would be required if premiums in excess of 1% or intra-program differentials were to be adopted. Moreover, the burdens of this option would fall most heavily on those high risk mortgagors, not adequately served by the private market, for whom the provision of FHA mortgage insurance at affordable prices is most important. It should be remembered that the objective of FHA is not to assure that insurance is available to low risk mortgagors at the best possible competitive price, but to assure that mortgage insurance is available at an acceptable price to those not adequately served by the PMIs.

Finally, even if a risk rating system were implemented, it would be necessary to establish a minimum premium, perhaps at the current premium

rate of .5%, to avoid actively bidding away business from PMIs who are adequately serving the relevant market. Such a minimum premium would eliminate many of the potential benefits of a risk-rating system.

3. Inter-Program Premium Differentials

The third premium structure option -- that of implementing multiple rates through inter-program differentials (such as by charging higher rates on Section 235 coverage than on Section 203(b) coverage) involves some of the same strengths and weaknesses as the direct risk-rating approach, although a pure risk-rating approach would provide a more accurate pricing policy.

The primary stengths of the inter-program approach are: First, it recognizes clear distinctions among programs as to purpose, prospective clientele, and possible need for explicit subsidization in the case of "special needs" users. Second, it is relatively simple to implement and administer. Third, it permits FHA and the Congress to define individual programs to meet specific needs and to determine appropriate premium requirements (including subsidization if necessary) for each such program.

Ample analysis has been completed to determine the premiums required to make the respective programs actuarially sound, assuming future program performance reflects historical experience. Making these changes now would be a positive step toward mitigating cross-subsidization, at least among programs, and toward achieving actuarial soundness. The proposed premiums for the home mortgage insurance programs are suggested in Chart 13.

Chart 13

Premiums - Expressed as a Percent of Declining Outstanding Balance

Home Program-Section		Premium at Closing	Annual Premium	Number of Years
203(b)	Standard	1.0%	.5%	7 years
221(d)(2)	Relocation or Low Cost	1.0	.8	full term
223(e)	Older Declining Urban Areas 1/	1.0	1.0	full term
235	Assistance for Lower-Income Families	1.0	.7	12 years
203(h)	Disaster victims	1.0	.5	7 years
203(i)	Outlying areas	1.0	.5	7 years
203(k)	Home Improvements	1.0	.5	7 years
213	Sales-type cooperative	1.0	.5	7 years
220	Urban renewal	1.0	.5	7 years
220(h)	Improvement loans-urban renewal	1.0	.5	7 years
222	Servicemen	1.0	.5	7 years
234(c)	Condominium units	1.0	.5	7 years
240	Fee - Simple title from Lessors	1.0	.5	7 years
809	Armed Services-civilian employees	1.0	.5	7 years
810	Armed Services-individual sales	1.0	.5	7 years
221(h)	Low-income rehabilitation	1.0	1.0	12 years
221(i)	Low & Moderate income condominium	1.0	1.0	12 years

1 - For Section 223(e), the recommended premium of 1 percent for the life of the mortgage is not sufficient for actuarial soundness, assuming a continuation of the average loss experience of the recent past. It is considered likely that a level 1 percent premium will be adequate only if the policies this report recommends with respect to mortgages on inner-city properties are adopted. If no substantive modifications were made to present inner city users of FHA insurance, a level annual premium of 2.75 percent of the mortgage balance would be required in the Section 223(e) program. Accordingly, a statutory amendment would have to be sounght to permit a rate which exceeds the 1 percent statutory limit, if actuarial soundness were to be achieved.

The specific program-by-program premiums recommended for the project mortgage programs are described in Chart 14. In each case, the recommendation is for a premium of 1 percent of the average first year's outstanding balance payable at the beginning of the first year, with subsequent level percentage annual premiums to be paid for the balance of the life of the loan. In the Section 223(f) program, a 1 percent premium is charged at origination and 1/2 percent thereafter. In effect, for the 223(f) program, FHA already has opted for the inter-program premium differential approach to achieve actuarial soundness.

Recommendation:

FHA should adopt a policy of differential premiums on a program-by-program basis; however, the actuarial studies currently underway on risk rating should be continued so that a decision on a specific plan for premium differentials on the basis of loan-to-value ratios can be considered at an early date.

D. Mutuality of FHA Premiums

The Section 203(b) insurance program was created at a time when there was no other mortgage insurance, little actuarial experience that could be used in setting insurance rates, and a great deal of uncertainty regarding the impact of default insurance and liberalized mortgage

Chart 14

	Program	Premiums - Expressed as a Percent of Declining Outstanding Balance: Premium at Closing	Annual Premium
207	Multifamily Housing	1.0 %	.5 %
207M	Mobile Home Parks	1.0	1.0
213	Cooperatives	1.0	.25
220	Urban Renewal-Projects	1.0	.5
231	Housing for the Elderly	1.0	1.0
221	Low and Moderate Income and Displacees*	1.0	1.0
232	Nursing Homes	1.0	.5
233	Experimental-Projects	1.0	1.0
234	Condominium-Projects	1.0	.5
241	Supplemental Project Loans	1.0	.5
242	Hospitals	1.0	.5
803	Military	1.0	.5
803	Armed Services	1.0	.5
810	Armed Services-Impacted Areas-Projects	1.0	1.0
908	National Defense-Rental Projects	1.0	.7
1101	Group Practice Facilities	1.0	.5
236	Lower Income Rental Projects*	1.0	1.0

*For these programs, a premium in excess of 1 percent may be required, at least with respect to cases involving insurance of advances. Further analysis is required, however.

terms on home mortgage financing practices. As a result, the program has been constrained by a premium policy that, in today's market, is no longer required.

One of the features incorporated in the 1934 program design of FHA single family mortgage insurance was a mutuality of insurance premiums. (Mutuality has also been employed in the Section 213 -- cooperatives -- program.) Mortgagors are grouped into classes and may receive partial reimbursement of insurance premiums at the time their loan is retired. The amount received depends upon the default performance of the class of loans of which the mortgagor is a part, with a larger amount returned to those whose group experiences relatively low losses. The mutuality feature is an attempt to approximate actuarially fair pricing in the absence of an ability to predict the risks on individual loans.

Two arguments support the elimination of this program feature. First, the administrative difficulties involved in reimbursing individual mortgagors on a post-insurance basis have led to pronounced inequities. Often the family receiving the insurance premium refund is a recent purchaser of the property (who has assumed the FHA-insured mortgage) and is not the one that paid most of the premiums. Second, FHA's

current ability to predict expected default loss and the proposed shift toward actuarially fair pricing of the insurance service should obviate the need for mutuality. Finally, the objective of actuarial fairness is approached more directly and efficiently through the use of actuarially sound premium rates.

Recommendation:

> The mutuality feature should be eliminated prospectively from FHA insurance programs.

E. Timing of Premium Collections

As noted earlier, almost all FHA mortgagors now pay annual insurance premiums of 5 percent of the average outstanding balance over the life of the loan. This compounds the cross-subsidization problem by permitting defaulting borrowers also to "default" on the payment of insurance premiums. The unpaid premiums of these borrowers must be compensated for by charging those mortgagors who do not default a sufficiently high rate to cover both the expected loss on their loans and the unpaid premiums on defaulted loans, if the program is to maintain actuarial soundness.

Payment of a large share of the insurance premium prior to the coverage period would eliminate this source of cross-subsidization and inequity.

The collection of insurance premiums after the coverage period also complicates FHA's effort to attain actuarial soundness. The attempt to maintain a positive reserve accumulation is threatened when mortgagors are allowed to default on insurance premiums. If, as a result, FHA is forced to borrow from the Treasury to pay claims, significant borrowing costs are incurred. Adequate reserves, accumulated through the payment of larger front-end premiums, would eliminate this cost.

On the other hand, a policy of collecting some or all of the premium "up-front," at the time of closing, could have some effect on the demand for FHA insurance. One might expect that such a change would reduce the demand for FHA insurance because it would, in effect, increase the dollar amount required to close a loan. By the same token,

prepayment or "up-front" collection reduces the monthly installments by the amount of the up-front premium payment. Consequently, whether demand would increase or decrease with prepayment is uncertain on purely intuitive grounds.

In the multifamily programs, the arguments for an "up-front" premium are particularly strong. The insurance coverage most directly benefits the investor or owner of the project, rather than the tenants. Thus, the cross-subsidization premiums is among project owners rather than among the occupants whose housing needs FHA insurance is intended to help meet. It is unlikely that the full benefits of this cross-subsidization are passed along to the occupants, consequently, there is even less reason for allowing it to continue.

A variety of means exist to implement a policy of advanced premium collection. Payment for coverage over the entire life of the loan could be required at closing, or partial payment could be made at closing and the remainder collected over some fixed number of years. The latter approach appears to be the best compromise between the programmatic benefits of an up-front premium and its potential effects on the demand for FHA insurance.

Recommendation:

HUD should adopt a general policy of charging a

significant portion of insurance costs at the time of loan closing, in anticipation of losses that typically occur in the early years of coverage, and of charging a level annual percentage premium thereafter, in a manner which is intended more closely to parallel anticipated losses. The determination of "up-front" and annual premium requirements for individual programs, in addition to considering actuarial expectations, should consider the potential demand effects of increasing initial borrower cash outlays.

V. ADMINISTRATIVE REFORMS

In order to make the benefits of FHA mortgage insurance more generally available, certain artificial statutory restrictions on FHA activities should be removed.

A. FHA Interest Rate Ceilings

At present, the Secretary of HUD is required by statute to set a maximum contract interest rate for FHA insured mortgages. In December 1976, the maximum rate applicable to home mortgage loans was 8 percent and the rate applicable to project mortgage loans was 9 percent. The rate is changed from time to time as rates in the private market change. Setting the FHA interest rate ceiling involves a choice between limiting the cost of mortgage funds and limiting their availability.

The arguments for interest rate ceilings for federally-assisted mortgages are that: (1) The government has an obligation to establish ceilings because it assumes most of the risk on the mortgages; (2) In an imperfectly competitive market, proper regulation of prices (or, in this case, interest rates) can benefit the general public; and (3) A carefully administered rate ceiling serves as a kind of "anchor" that

keeps mortgage interest rates from rising as much as they might during tight money periods and brings mortgage rates down more quickly when monetary policy eases.

The dependence of the last two arguments on "proper" administration of the ceilings cannot be over-emphasized. Once account is taken of the administrative problems inherent in setting the ceilings, the case for ceilings loses its force. One difficulty is that the "right" national ceiling simply cannot be found, much less maintained over any period. And the wrong ceiling either curtails mortgage availability or provides a basis for lenders to charge higher rates than necessary. Historically, administration of the ceilings has focused more on attempting to hold down mortgage rates to levels below those demanded by the market than on assuring "reasonable" rates. Available evidence indicates that, even if such an approach can hold rates down to some very modest degree, it does so at the cost of decreasing significantly the level of FHA activity.

A further difficulty is that the inevitable by-product of interest rate ceilings is the appearance of discounts or points on the mortgages originated under FHA programs. Through this system of charging an up-front discount, the lender compensates for the fact that the interest rate ceiling may be below the prevailing rate required by the market. Current statutory requirements stipulate that such discounts not be paid by the home buyer and, consequently, they are

paid by the seller who, in turn, recoups them by adding the points to the price of the house.

Discounts can become excessive. Moreover, substantial discounts, which occur when market interest rates rise well above the FHA/VA ceilings, have a constraining effect on the real estate and mortgage markets, since lenders are reluctant to make loans with high discount requirements. Also, the burdensome cost of these points cuts some buyers and sellers out of the market as effectively as high interest rates. As discounts persist, they also tend to get built into the selling prices of homes, whether sold with FHA or conventional financing, and have a general inflationary impact on home prices. They tend to take on a life of their own and no longer serve simply as a flexible mechanism for adjusting mortgage yields.

Moreover, discounts can adversely affect FHA's risk since, having collected part of the finance charge up-front, the lender receives a higher effective return the earlier the loan is terminated, creating a moral hazard of early foreclosure.

There have been a number of analyses of the effects of interest rate ceilings on FHA programs. The general conclusion has been that such ceilings seriously weaken the programs which they are intended to assist and for that reason should be eliminated. By ending FHA/VA interest rate ceilings, interest rates can achieve the flexibility needed to respond freely to market forces in the same way that rates on conventional mortgages fluctuate.

To the extent that loan originators still require discounts to be paid at the time of loan closing, points should be permitted if the home buyer and seller agree. In recent years, the practice of charging one or two points (unlike the 4-6 points which are now typical of FHA loans) has become widespread among lenders making conventional loans. Such up-front payments help to defer costs of appraisals, credit reviews, and the other costs of administering the making of a new mortgage loan. There should not be restrictions as to who pays such discounts or points; this should be settled by open negotiation among the parties to the transaction rather than hidden from the borrower, as is now the case with FHA loans.

A further reason why some level of discounts should be permitted relates to the manner in which the market for GNMA mortgage-backed securities functions. Mortgage lenders will typically close loans over a period of some weeks or months and package those loans into a pool to secure an issue of mortgage-backed securities. All the mortgages in such a pool must bear the same contract interest rate. But since market rates may vary over the period during which the loans are being closed and since the mortgage lender needs some way to compensate for the interest rate risk encountered between the closing of the loan and the issuance of a security,

the lender needs to be able to adjust yields through the charging of points. Since GNMA mortgage-backed securities provide a major proportion of all funds that go into FHA-insured loans, a prohibition on points could undermine that major component of the FHA insurance operation.

Recommendation:

> It is recommended that establishment of financing costs be left entirely to the market. The statutory requirement for the Secretary to establish interest rate ceilings for FHA loans should be eliminated and there should be no prohibition on the charing of points or discounts.

B. Downpayments

Currently, the minimum downpayment under the Section 203 basic homeownership program is 3 percent of the first $25,000; 10 percent of the next $10,000; and 20 percent of any excess of the purchase price. Although many young families have the incomes to support a mortgage, they do not have the necessary downpayment to purchase a home. A few private mortgage insurers have experimented with 95 percent loans to their best-qualified borrowers, but such loans are relatively rare and 10 to 20 percent downpayments are most common. Accordingly, legislation should be submitted to reduce the downpayment requirements for FHA-insured loans so that a typical family can purchase a home with no more than a 5 percent downpayment. Minimum downpayment on FHA loans should be reduced to 3 percent of the first $25,000 and 5 percent of the excess in acquisition costs. This would allow for reductions of 50 to 75 percent in the amount of

equity most FHA purchasers would require. FHA can play an important role in demonstrating that such 95 percent loans are a viable investment for the mortgage lending community. And, these high loan-to-value ratio mortgages could be provided without an increase in the current FHA mortgage insurance premium.

Recommendation:

> FHA downpayment requirements should be lowered to bring homeownership within the reach of more young families.

C. FHA Mortgage Limits

Congress traditionally has set the maximum per unit mortgage amount that can be insured under FHA programs. At present, under the basic 203(b) single family mortgage insurance program, the limit is $45,000. Under the basic 207 project mortgage program, the limit ranges from $19,500 for a unit without a bedroom, up to $36,000 for a three bedroom unit. Limited upward adjustments are permitted to take into account high construction costs in individual areas. Somewhat lower per unit limits are applicable with respect to subsidized housing.

The mortgage limits are intended to help assure that FHA programs serve primarily low- and moderate-income families and individuals. It is sometimes argued that the limits also help to avoid inflationary pressures on housing costs which might occur if there were no mandated limits.

These mortgage limits have caused several problems. First, Congress is often slow to act in adjusting limits upward to take account of inflation. For example, until the Housing

and Community Development Act of 1974 was passed, the single family mortgage limit was only $33,000 -- a level significantly below the price of most new homes being sold. As a result, in many market areas, such as Washington, D. C. and much of New York and New England, there were no new homes available which could be financed using FHA insurance. Even moderate income families in those areas could not gain access to federally-insured mortgage credit.

A second detrimental effect of the ceiling is that, when Congress lags in making upward adjustments to take account of inflation, the result is a noticeable reduction in the volume of FHA applications, leaving valuable staff resources under-utilized. When the mortgage limits ultimately are raised, it is difficult to re-create the same trained, qualified staff, resulting in inefficiencies and diminished productivity.

Recommendation:

> The Secretary of HUD should be given statutory authority to establish mortgage limits administratively. If a statutory limitation were still considered necessary, the administered ceiling could be limited to the local median per unit mortgage amount in the conventional market (or some percentage thereof).

D. The Potential Role of Coinsurance

HUD should consider new types of mortgage default insurance to improve processing efficiencies, limit FHA staff involvement in underwriting, reduce claims and loss rates, and make

FHA more responsive to the needs of families who are not being adequately served by private insurers. Recently, considerable attention has been given to the potential of coinsurance. Under coinsurance, basic underwriting decisions and processing responsibilities are delegated to the mortgagee, who also shares in the risk of loss. This risk sharing provision, by which the mortgagee bears a percentage of any default loss, provides some assurance to HUD that the mortgagee will carry out underwriting and loan management in a sound manner.

Section 307 of the Housing and Community Development Act of 1974 (adding a new Section 224 to the National Housing Act) authorized FHA to provide coinsurance on a limited, experimental basis. In response, FHA has implemented an experimental single family coinsurance program, in which the lender is responsible for basic underwriting and shares with FHA in any resulting loss. Because the program is designed to meet the needs of the thinly capitalized mortgage banking industry, the mortgagee is responsible for 10 percent of any individual mortgage loss, but the total lender exposure with respect to all mortgages coinsured in any calendar year is limited to 1 percent of the total of the original principal amount of those mortgages. HUD also has a State Housing Finance Agency portfolio coinsurance program, in which a State Agency is responsible for all losses up to 3 percent of the outstanding balance of the mortgages in its coinsured

portfolio with a proportionate 80 percent-HUD and 20 percent-agency sharing of additional losses. Both programs are designed to test alternatives to 100 percent federal mortgage insurance.

For FHA, the potential advantages of coinsurance are several. First, the standard fully insured mortgage includes an inherent moral hazard -- since the loan originator bears none of the risk, it has little incentive to conduct sound underwriting. The moral hazard is exacerbated by the discount point system used by lenders with FHA-insured loans. Points are paid in order to compensate lenders for originating loans that carry a regulated interest rate which is below the market level. Points, in effect, represent a payment at closing for foregone interest earnings and the lender retains the unearned future interest earnings represented by the points, even if the loan quickly goes into default. Thus, the full burden of risk assessment now falls upon FHA staff. By requiring the loan originator or loan holder to share in the default risk, the moral hazard is significantly reduced.

A second potential benefit is greater underwriting efficiency because loan origination is carried out by knowledgeable local lenders. Proximity to and familiarity with developers, home buyers, and individual properties often places the originating mortgagee in a better position to judge the risk in individual cases. Finally, by permitting underwriting decisions to be delegated to the originating lenders, coinsurance minimizes FHA staff involvement in

those decisions, thereby reducing delays and administrative costs.

Coinsurance may have particular potential for serving those primary market lenders which originate loans for their own portfolios but require federal insurance support in order to market or improve the saleability of their mortgage-backed bonds. Coinsurance also may be an appropriate devise to support subsidized housing programs, if the combination of federal income transfer subsidies and partial insurance coverage is found sufficient to attract private investment.

The current FHA single family coinsurance experiment and the service provided by the PMIs in this market are quite similar, with three major exceptions. First, FHA shares all losses on a straight percentage basis (with the mortgagee absorbing 10 percent of any net loss experienced), while the PMIs usually pay losses up to 20 percent or 25 percent of the sale price. Second the FHA program provides mortgagees with a share of insurance premiums. Third, the FHA program provides catastrophic loss coverage to participating mortgagees in the form of the one percent stop loss provision. Conceivably, the second and third features could make the FHA program more attractive than private mortgage insurance. However, several features of

the FHA experimental program are deterring lender participation. First, the complex method employed to share the premiums collected has created technical accounting problems that make the program difficult to learn and to administer. Second, it has proven to be difficult to market mortgages insured under this program in the secondary market, upon which the mortgage banking industry relies heavily. Third, the retention of the standard FHA premium schedule as compared to lower PMI premiums has reduced the attractivness of the FHA program.

Although FHA has had relatively little experience with coinsurance, it appears that the coinsurance concept could become a useful element in future FHA programs. New coinsurance programs should be carefully designed, however, to preserve FHA's complementary role.

Recommendation:

> It is recommended that HUD's single family and State Agency multifamily coinsurance programs be carefully monitored and evaluated to determine the contribution they make to the availability of mortgage credit for homeownership and residential construction. New experimental coinsurance programs should be considered to meet the needs of specific market segments, not being adequately served by private insurers.

VI. FHA INSURANCE TO PROMOTE HOMEOWNERSHIP FOR MODERATE INCOME HOUSEHOLDS

Over time, FHA's Section 203 basic homeownership program has made possible increased loan-to-value ratios and extended loan maturities which lowered downpayments and monthly payments for more and more moderate-income home buyers. More recently,

FHA programs have sought to extend ownership opportunities to lower-income families by permitting very low downpayments and longer loan maturities as well as in the case of Section 235, providing interest reduction subsidies. The rationale for these programs was the belief that increasing the rate of home-ownership among low-income households not only improved the beneficiaries' housing situation, but also led to community improvements, specifically, improved property maintenance, neighbor-hood appearance, and increased social and economic stability.

High FHA insurance losses in these programs have called into question FHA's role in assisting lower-income home buyers. Homeownership does not appear to be a sound investment for many poor families. Discretionary income and income security are low, exposing these families to the potential hazard of mortgage default due to an inability to make costly and unexpected home repairs or because of even temprary income disruptions. The real costs of FHA's experiment with subsidized low-income home-ownership include high levels of default and resulting vacant boarded-up houses in neighborhoods and subdivisions all around the country. Nonetheless, many moderate income families have become successful homeowners because of the Section 235 program.

A. Section 235

Because of HUD's experience with the original Section 235 program in providing homeownership for the very low income families, emphasis on housing the very poor has

shifted to assisted rental accommodations. However, the federal government still has an important role in providing assistance to the increasing number of American families who are being priced out of homeownership by high interest rates and recent increases in other housing costs. A new Section 235 program was implemented in January 1976, to provide a shallower mortgage interest subsidy to those moderate-income families who traditionally would have been homeowners but for recent rapid escalations in the cost of homeownership.

Like its predecessor, the new Section 235 program involves a combination of FHA default insurance and subsidy payments. The FHA mortgage interest rate is subsidized down to 5 percent, instead of 1 percent (as under the old program), so as to limit participation to the lower-income families who were most successful under the prior program. A family is still required to contribute at least 20 percent of its income to mortgage payments. Downpayment requirements have also been significantly increased from $200 under the old program to nearly $1,000 under the new Section 235. Finally, some geographical dispersal of assisted units is mandated. It is expected that these changes should make Section 235 a useful vehicle for providing assistance to lower-income home buyers who are capable of homeownership, but priced out of the market.

B. Section 221(d)(2)

Section 221(d)(2) provides no explicit subsidy, but affords insurance on terms more liberal than Section 203(b) for low- and moderate-income families and to families displaced by government action or as a result of a disaster. There is, however, an indirect subsidy in the Section 221(d)(2) program, since it is currently operating on an actuarially unsound basis. Current program experience indicates that an annual premium of more than 1 percent, as opposed to the present .5 percent, would be required to make the program actuarially sound.

Section 221(d)(2) makes FHA insurance available to families who cannot afford the downpayment required under Section 203. The minimum downpayment under Section 221(d)(2) is 3 percent of total acquisition cost, including prepaid expenses. For displacees, the minimum downpayment is only $200. Another benefit of Section 221(d)(2) is a provision that the maximum mortgage term can be up to 40 years, if monthly payments under a shorter amortization period are not within the mortgagor's ability to pay. The maximum mortgage term under Section 203 is only 35 years. Despite these liberal terms and an implicit subsidy only 28,000 mortgages were insured under Section 221(d)(2) in 1975.

There are obvious overlaps between Section 221(d)(2) and other FHA programs, such as Section 235 and Section 203(b), both of which are expected to be actuarially sound*. These overlaps will be exacerbated by the previously described proposal to lower FHA downpayment requirements to 3 percent of the first $25,000 and 5 percent of the excess in acquisition costs, which would practically eliminate the difference between Section 203(b) or Section 235 and Section 221(d)(2) minimum downpayments.

The only other salient feature of Section 221(d)(2), its extended term, does not have a significant impact on promoting homeownership among low- and moderate-income families. For example, on a $25,000 mortgage at 8 percent, an extension in the mortgage term from 30 to 40 years would reduce the monthly mortgage payments of $192.23 by only $8.95 and monthly housing costs by 3 percent or less. On the other hand, extending the mortgage term beyond 30 years adds significantly to the homeowner's total debt service and has been shown to be a substantial cause of default. Raising the premium for Section 221(d)(2) to an actuarially sound level would increase monthly payments by more than the reduction resulting from an extended term.

There is also an element of program overlap between the Section 221(d)(2) benefits and those provided in other HUD programs. For example, the Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970, which provides benefits to displacees in a lump sum dollar amount, is a far more equitable means of benefitting displacees than Section 221(d)(2).

Section 221(d)(2) is an inefficient and inequitable way of increasing homeownership opportunities. If homeownership subsidies are to be provided to lower-income families, it should be through an explicit subsidy, coupled with counseling, such as are provided in the revised Section 235 program.

Recommendation:

> For the immediate future, it is recommended that HUD provide mortgage insurance for low- and moderate-income families through Section 203(b) and subsidized mortgage insurance only through Section 235. Business under Section 221(d)(2) should be suspended.

VII. FHA INSURANCE IN OLDER URBAN AREAS

The role proposed for FHA should not be a passive one. On the contrary, FHA should actively use its insurance programs to support housing and mortgage markets which are not adequately being served by private mortgage insurers. Housing transactions in older urban areas present a context in which an active and well-designed FHA presence might be most useful.

Investment in housing in urban neighborhoods is subject to greater risks than investment in other areas, because of the uncertainties surrounding property appreciation. Because of this risk, a mortgage insurance service is particularly valuable, but the same risk also makes underwriting and premium setting difficult. PMIs, so far, have concentrated primarily on lower risk markets, leaving insurance in older urban areas to FHA. In time, as underwriting and premium setting techniques improve and there is less room for expansion in the lower risk market, the PMIs may provide more services in older urban areas. At present, however, there is a need for FHA to continue providing mortgage default insurance in such areas.

This section makes recommendations on how FHA should serve older urban areas.

A. FHA's Older Urban Area Activity

For many years, FHA followed the practice of conventional lenders by treating loans in older urban areas cautiously -- resulting in charges of redlining. This pattern began to change in 1965 when FHA advised its field offices to reassess their treatment of older urban areas to ensure that insurance was available in areas where "stable long-term neighborhood values exist or where changes are taking place which give promise of arresting neighborhood decline so that stable values for the future may be reasonably predicted by the appraiser." In 1966, Congress established Section 203(l) to provide insurance in riot affected or threatened urban areas. This authority was expanded in 1968 by the passage of Section 223(e) to provide insurance in "an older, declining urban area" where "one or more of the eligibility requirements (for mortgage insurance)....could not be met" if "(1) the area is reasonably viable" and "(2) the property is an acceptable risk." A substantial number of mortgages were insured pursuant to Section 223(e) in the late 1960's and early 1970's.

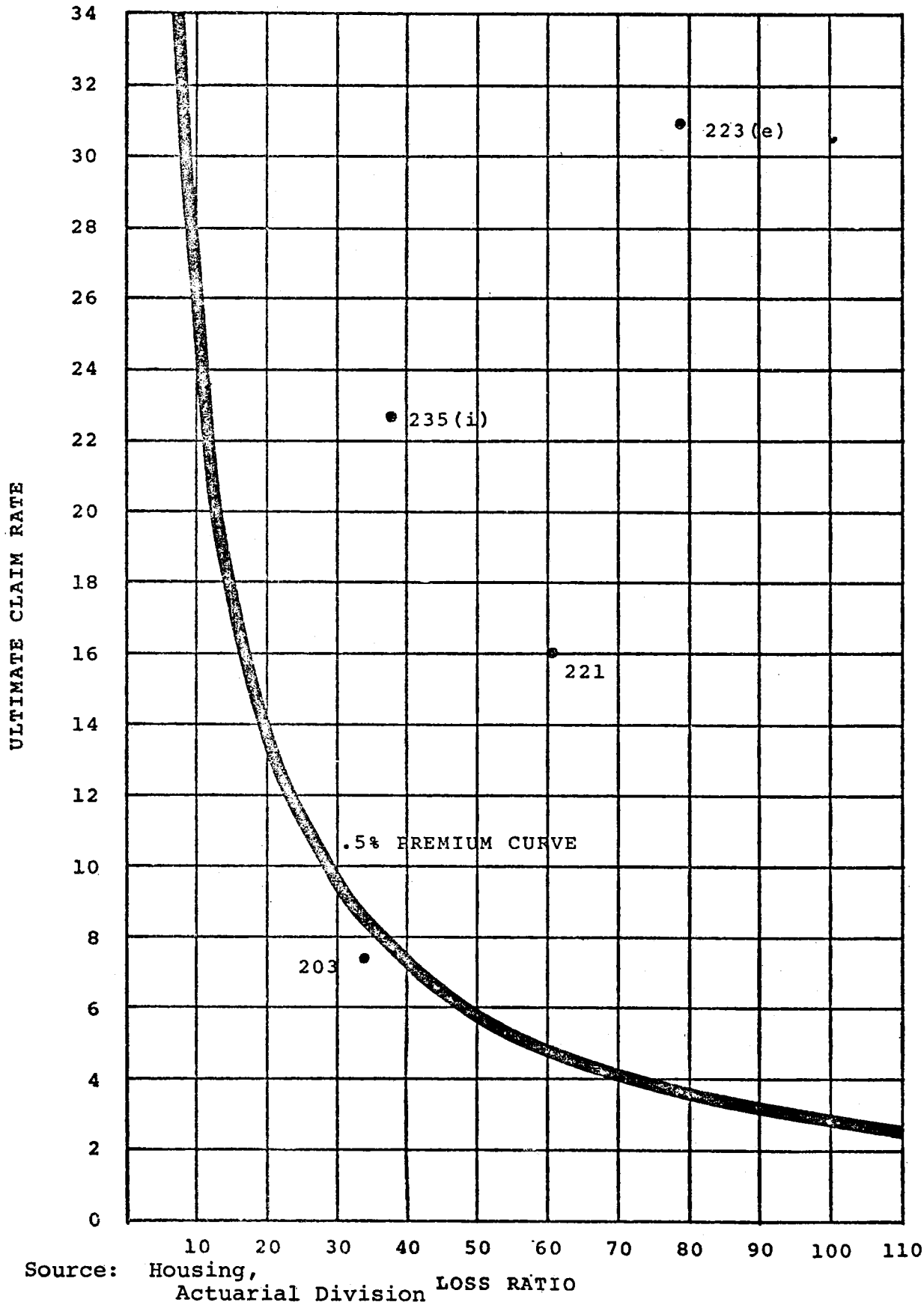
FHA involvement in older urban areas is not limited to Section 223(e). A large percentage of loans insured under both Section 221(d)(2) and Section 203(b) also are located in older urban neighborhoods. In the first three-quarters of 1976, 60 percent of all Section 203(b) and 66 percent of all Section 221(d)(2) insurance on existing structures was written in central cities.

Insurance losses under Section 223(e) have substantially exceeded premium income, hence the program provides a substantial implicit premium subsidy. An annual premium of at least 2.75 percent would be necessary to achieve actuarial soundness, as compared to the present .5 percent premium. The currently estimated ultimate foreclosure rate is significantly higher under Section 223(e) (31 percent) than under Section 221(d)(2) (16 percent) or Section 203(b) (7 percent) as Chart 15 shows. Section 223(e)'s implicit subsidy is also the result of a large average loss per claim. In the average foreclosure under Section 223(e), the final loss is 93 percent of the insurance claim. Comparable figures for Section 221(d)(2) and Section 203(b) are 71 percent and 54 percent, respectively, as Chart 16 shows. Furthermore, it appears that the Section 203(b) averages conceal a wide variance between higher risk business written in older urban areas and other, more traditional Section 203(b) business.

FHA's increased volume of business and high losses in older urban areas are the result, at least in part, of past pressure on HUD to assume an aggressive role in inner city neighborhoods and to enable families with limited and relatively unstable incomes to purchase homes with little equity investment. These pressures resulted in FHA staff relaxing the application of traditional FHA underwriting and mortgage credit standards in some instances. When large losses resulted, HUD attempted to improve the performance of Section 223(e) by tightening up

CHART 15

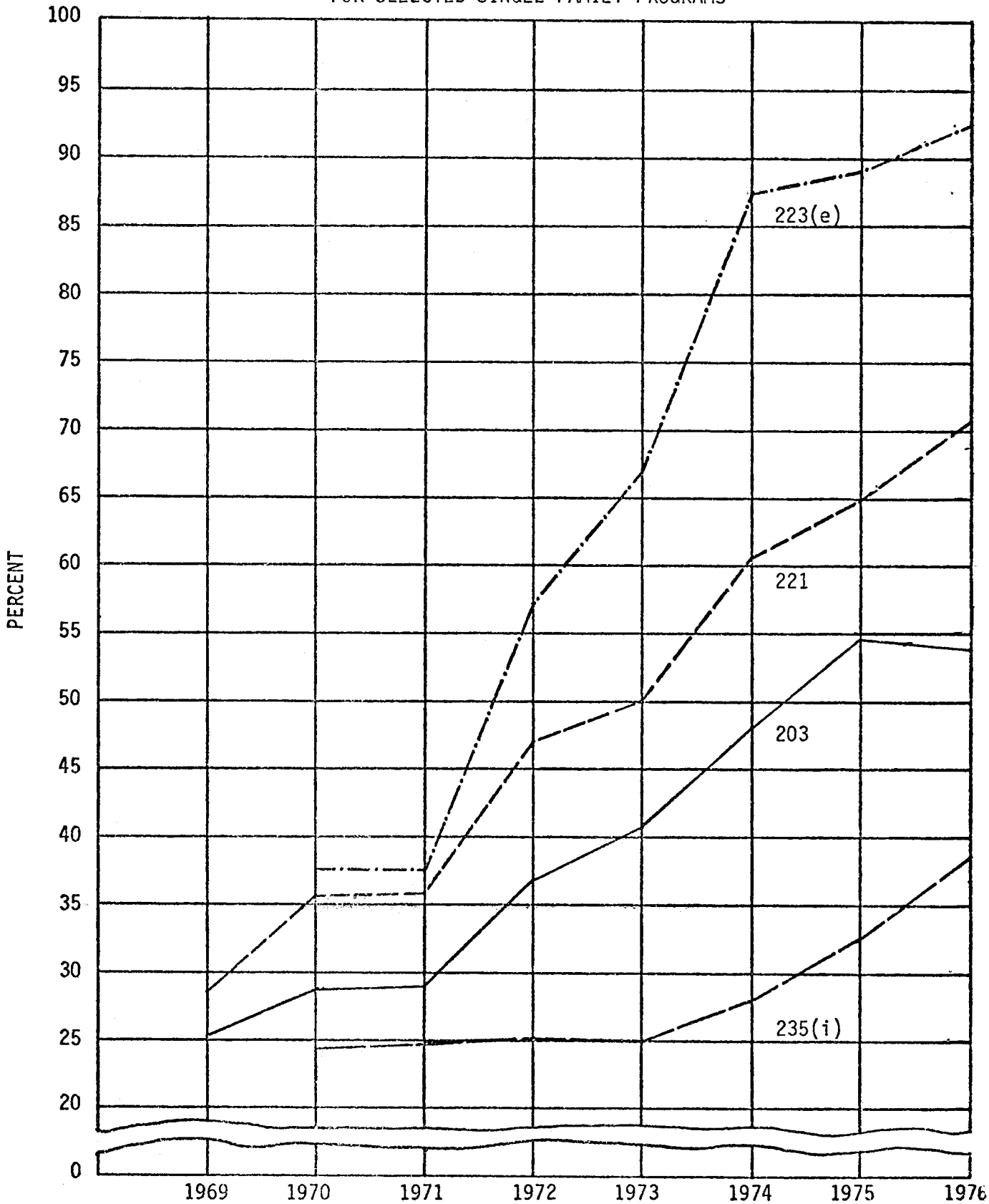
SINGLE FAMILY CLAIM RATES AND LOSS RATIOS



Source: Housing, Actuarial Division

CHART 16

PERCENT LOSS PER CLAIM
(based on acquisition cost)
FOR SELECTED SINGLE FAMILY PROGRAMS



Source: Housing,
Actuarial Division

its administration of the program. The resulting administrative changes decreased not only default losses, but also the level of activity. In 1976 fewer than 7,500 mortgages were insured pursuant to Section 223(e), only 14 percent of the program's peak volume in 1969.

In recent years, actuarial problems have tended to obscure the possible benefits of FHA activity in older declining urban areas. The direct costs of the FHA insurance programs for urban areas are the losses in excess of premium income. The direct benefits are the reduction in the cost of financing brought about by the reduction in lender risk through insurance. At present, there is little evidence on the difference in financing costs (including differences in interest rates, downpayments, associated secondary financing and term to maturity) between FHA financing and conventional financing in older urban areas. These benefits are divided between buyers and sellers, however, because easier access to credit increases demand and, therefore, the price at which a property can be sold.

Many community groups maintain that the FHA insurance losses represent only one of the costs of FHA activity in older urban areas and that another potentially serious cost has been the

accelerated deterioration in the housing stock which the provision of FHA insurance may induce by encouraging neighborhood instability and racial transition.* The 223(e) premium subsidy, combined with FHA's use of a "physical life" underwriting standard, can result in an appraised value well in excess of the true value of a dwelling. This has two effects. Frist, a buyer purchasing the home for more than its real value, with the minimal FHA-required downpayment, is likely to be in a negative equity position

*This position is taken, for instance, by the Chicago Area Stabilization Committee (CASA) and Chicago Metropolitan Alliance for Housing Action (MAHA). Similar views have been expressed with respect to FHA activity in Baltimore, St. Louis, and New York.

as soon as he moves in, increasing the likelihood of later foreclosure or abandonment. Second, the resulting artificially high prices may encourage nearby middle-income families, who might otherwise have remained, to sell their homes and leave the neighborhood. These middle-income families often are replaced by lower-income occupants with less equity in their homes, fewer resources to maintain the houses, and little investment in the community. It is sometimes asserted that this process of economic transition (filtration) ultimately leads to abandonment and blight.

A large percentage of the Section 223(e) business and, perhaps, some of the older urban area portions of the Sections 221(d)(2) and 203(b) business is in neighborhoods in which racial or economic transition is taking place. This does not prove that FHA insurance contributes to that transition, but it is possible that liberal underwriting practices and a subsidized premium, by artificially increasing sales prices, can accelerate the process of downward neighborhood transition in such areas.

B. Subsidized Mortgage Insurance

It may be argued that inner-city mortgage insurance should be subsidized because reducing the cost of capital could provide more funds for maintenance of the affected dwellings. Available evidence suggests, however, that even

if an owner devotes this savings to upgrading his individual unit, there is little effect on the remainder of the neighborhood. In addition, the subsidy may be reflected in artificially high sale prices which, in turn, accelerate neighborhood transition and decline.

It has also been argued that the Section 223(e) subsidized premium should be allowed as a government response to private "redlining" -- compensating for the private sector's over-estimation of the risk of default associated with the uncertain property values in racially or economically transitional neighborhoods. There is evidence to indicate that some conventional lenders do not lend in neighborhoods which exhibit such characteristics as racial transition, declining property values and high vacancy rates. But, if "redlining" is the result of overestimation of risk by lenders, then the provision of mortgage insurance need not involve a subsidy since actual risk should be less than perceived risk.

The arguments for providing subsidized Section 223(e) mortgage insurance in all older urban areas are not strong enough to justify a departure from the principle of actuarial soundness. Rather, mortgage insurance in older urban neighborhoods should be provided through an actuarially sound program.

The ultimate rise in premiums necessary to provide insurance in older urban areas on an unsubsidized basis

should be far less than the 2.75 percent currently necessary to make Section 223(e) actuarially sound.

C. FHA Underwriting in Older Urban Areas

One step necessary to improving FHA's inner-city insurance programs and reducing the premiums required is to reduce the large average loss per foreclosure. Currently, the average loss per foreclosure in Section 223(e) is over 90 percent of the remaining mortgage balance and there are some field offices for which the average loss per foreclosure is in excess of 100 percent of the remaining mortgage balance. There appears to be substantial room for improvement in either underwriting or property disposition practices, or both.

In underwriting, one step that almost certainly would reduce losses is to shift from Section 223(e)'s unrealistic standard of three-fourths of the "physical life" of the unit to the "economic life" standard used in all other FHA insurance programs, to determine the allowable term of the mortgage. The "physical life standard" originally was introduced to aid prospective homeowners in Section 223(e) areas, by making it possible for them to obtain longer-term financing, hence lower monthly payments than would have been available under the more conservative "economic life" standard. The "physical life" standard is believed by FHA underwriters to have contributed to inflated house prices, overappraisals

and high losses. Returning to an "economic life" standard would shorten available mortgage terms somewhat, thereby reducing losses and the premiums required to achieve actuarial soundness.

Once FHA insurance in older urban areas is made actuarially sound, including through a shift to an "economic life" underwriting standard, it is indistinguishable from the Section 203(b) program. Moreover, given the minimal current level of activity in the 223(e) program, its elimination should not be disruptive.

Recommendation:

Generally, mortgage insurance in older urban areas should be provided on an actuarially sound basis, pursuant to Section 203, rather than under Section 223(e).

C. Role of Coinsurance

The coinsurance concept could be particularly useful for FHA mortgage insurance in inner-city areas. Coinsurance reduces FHA overhead, and may improve the quality of underwriting by shifting a proportion of risk back to the originator. Coinsurance also might make it possible for FHA to reduce the premium required to provide insurance on an actuarially sound basis in urban areas. A coinsurance program for inner-city areas may be particularly attractive to lenders in view of the increasing pressure on mortgage lending

institutions, such as savings and loan associations, to invest in mortgages on properties located in the urban areas from which they draw funds.

HUD's current coinsurance program, by regulation, cannot be used in older urban areas. Moreover, it is carefully tailored to the thinly capitalized mortgage banking industry and requires a relatively small share of the risk to be borne by the originator. Because of the serious risks posed by insuring mortgages in inner-city areas, another coinsurance experiment should be developed which imposes a more substantial risk on the originating lender. For example, the lender could be required to bear a 5% top end loss and a 10% pro rata share of the remaining loss. The savings and loan industry already has expressed interest in such a coinsurance scheme in discussions with the Federal Home Loan Bank Board.

Recommendation:

A new coinsurance program should be considered to assist lending institutions in undertaking mortgage lending activities in older urban areas. This program should require the loan originator to bear a significant share of losses.

E. Neighborhood Preservation

Preservation of urban neighborhoods has become a pressing public and private concern as a result of an increasing demand for and need to utilize the existing housing stock in our inner cities. Energy shortages and inflation have

resulted in a reduction in new construction activity, making preservation of the existing stock even more essential. Increased transportation costs and the increase in household formations by single person and childless couples have contributed to renewed interest in central city living.

In response to this changing environment, Federal housing policy and local decisionmakers have put increased emphasis on better utilization of the existing housing stock. Because of the close relationship between a housing unit and the neighborhood in which that unit is located, there also has been a greater focus on the phenomenon of neighborhood decline and on comprehensive strategies for neighborhood preservation or revitalization.

Many communities are capitalizing on the shift of both private and public interest back to the city by committing significant resources to neighborhood preservation. For example, twenty-one percent of community development block grant funds in FY 76 were devoted to efforts in neighborhood preservation and rehabilitation. Many cities are attempting to attract private financing and to enlist citizen groups to participate in concentrated preservation efforts in specified neighborhoods.

The neighborhood preservation movement is a promising approach to achieving the maximum practical utilization of the existing housing stock and to attracting middle income families back into the cities. Although the evidence is not conclusive, the experience of the Urban Reinvestment Task Force shows that urban decline can be stemmed when a joint commitment by citizens, financial institutions and local government is concentrated in a target neighborhood.

FHA insurance can be a useful element in such a neighborhood preservation strategy. For example, by encouraging the entry of new capital, FHA insurance can facilitate the upgrading or preservation of an area's housing stock. But, mortgage insurance alone cannot turn a neighborhood around; it also takes an effective demand for housing and a coordinated approach to public and private reinvestment in the target area.

Accordingly, it is recommended that FHA provide a special program of mortgage insurance, with more liberal underwriting requirements and a subsidized premium, if necessary, in locally designated neighborhood preservation areas. This mortgage insurance should be provided only where there is a demonstrated, tangible public commitment to the neighborhood. Increased public services, local rehabilitation loan programs, public works or clearance projects -- all currently being funded by many localities with their Community Development Block Grant funds -- would evidence such a commitment to a target neighborhood. HUD's Section 810 Urban Homesteading Demonstration and local private/public neighborhood conservation programs such as the Urban Reinvestment Task Force's Neighborhood Housing Services are additional examples. The common thread which runs through all of these examples is a local commitment of public and private resources to a carefully delineated neighborhood. It is only in such an environment, where federally subsidized mortgage insurance is one tool among many in a comprehensive preservation

effort, that FHA insurance (with a subsidized premium) is justified and the problems previously associated with Section 223(e) insurance are likely to be avoided.

The losses arising from such a program should be less than those experienced under the current Section 223(e) program. Risk per case would be reduced because neighborhood preservation activities generally are not directed at already blighted neighborhoods and because the required local government and community efforts to improve the neighborhood should support property values.

Localities, rather than HUD, would designate the preservation areas in which this special insurance would be provided and local governments could be asked to be risk-sharers on either a portfolio or individual loan basis. Section 203 mortgage insurance would continue to be available, on an actuarially sound basis, in other parts of the city.

Recommendation

A special program of mortgage insurance for neighborhood preservation areas should be developed to encourage greater local efforts to conserve the existing stock of housing.

E. Multi-family Insurance in Older Urban Areas

The basic rationale underlying this report's recommendations with respect to FHA single family mortgage insurance for older urban areas also can be applied to FHA's role in insuring mortgages on existing multifamily dwellings. Even in areas which are declining,

these projects often provide needed housing, but conventional lenders are reluctant to lend on such projects because of the perceived risks. By providing a practical form of financing for such projects, Section 223(f) mortgage insurance responds to one of the factors which causes the deterioration of multifamily projects in older urban areas.

In declining neighborhoods, the most efficient "maintenance" strategy for many owners is to permit depreciation of their property. In the absence of available refinancing, owners of projects which cannot meet debt service and operating costs and still provide a return may attempt to recover their equity by accelerating depreciation, by deferring maintenance, or by tax delinquency, thereby leaving the lender with a structure whose market value is much less than the outstanding debt. FHA Section 223(f) mortgage insurance can avoid this problem by allowing a project's financing to be restructured to provide a realistic return to the owner.

However, there are significant problems with the use of Section 223(f) to refinance existing multifamily projects in older urban areas. First, underwriting is difficult because of the limited number of comparables by which to assess value. Where neighborhood transition has caused rapid property value changes, one would expect some anticipation of this decline in the sales prices of properties sold within the year preceding the decline. While there may be several single family sales in this

period, which can be used to predict the trend in market values, there often are no multifamily transactions. Even where a transaction has taken place, the seller often has extracted a sales price, which does not reflect the status of the neighborhood, in return for providing financing to the buyer.

Second, lender diligence is essential to ensuring adequate property maintenance and upkeep, but FHA insurance removes one incentive for careful loan management.

Third, the willingness of lenders and owners to use Section 223(f) in older urban areas cannot be predicted.

Finally, as has been mentioned with regard to single family insurance in older urban areas, the "spill-over" effects of upgrading an individual project on the rest of the neighborhood may be minimal, unless the project's improvement is part of a broader neighborhood preservation program.

In sum, Section 223(f) may provide a useful insurance tool in older urban areas but only if cautiously applied.

Recommendation

It is recommended that FHA pursue a go-slow experimental approach in utilizing Section 223(f) in older declining urban areas. Limiting program use to well-defined neighborhood preservation areas may be appropriate.

VII. FHA Insurance to Provide Financing for Subsidized Multifamily Rental Housing

Housing lower income persons is both an income and a mortgage insurance problem. For example, the Section 236 program coupled

full assumption of default risk with a substantial interest subsidy on project mortgages. In effect, FHA was in the position of removing nearly all risk from the private lending sector and, at the same time, operating an income transfer vehicle by providing interest subsidies to mortgagees on behalf of low-income tenants. FHA mortgage insurance still appears to be a necessary prerequisite to financing most subsidized new construction and substantial rehabilitation for lower-income families.

Private lenders are generally unwilling to finance subsidized housing without FHA default insurance for a number of reasons. First, private lenders are reluctant to accept the default risks associated with low income households, the primary beneficiaries of subsidized housing. HUD's own program experience indicates that these risks are both high and uncertain.

Second, even if private lenders could be persuaded to make long-term funds available to low-income housing, the incentives necessary to attract developers and investors into the programs often would be inconsistent with the terms under which the lenders would make such funds available. Without government assumption of the default risk, private lenders would require higher equity investments and shorter maturities, because of the risk involved, than potential developers would be willing to bear, because such terms significantly reduce the rate of return and other incentives to the investors.

Third, Section 8 rental assistance (which is now the Federal Government's primary rental subsidy program) provides assurances of subsidies for a time period shorter than the typical mortgage term. Private lenders express concern that, when the term of the subsidy is exhausted, they will be left holding loans on projects in which the tenants can no longer afford the rents.

A new source of non-FHA insured financing for subsidized housing has emerged in recent years through the creation of State Housing Finance Agencies (HFAs) and their utilization of tax exempt bonds to finance housing. These HFAs financed 100,000 units in HUD's Section 236 program on a non-insured basis. HFA bonds are usually backed by the project itself and the state's moral obligation to pay off the debt service.

Recently, problems in the bond market limited this source of financing. A year ago, increased borrowing costs, caused by New York City's fiscal problems and unmitigated by Federal backing for HFA bonds, was inhibiting HFAs from becoming a significant source of financing for low-income housing -- particularly Section 8. FHA co-insurance of HFA financing was intended to rekindle investor interest in HFA bonds by adding a partial Federal guarantee but no additional subsidy. The market for HFA bonds now seems to have improved. Nonetheless, the production capacity of HFAs is likely to remain limited by competing State financing needs, and the HFAs' tax exempt bonds makes this form of financing particularly expensive to the Federal Government.

In view of the lack of interest in conventional financing for low-income housing and the difficulties faced by State HFAs, financing for subsidized rental housing, if it is to be produced, probably will continue to require Federal default insurance. Thus, the provision of mortgage insurance for subsidized housing is an important function for FHA.

FHA's underwriting system was designed for unsubsidized housing, however, with premiums originally assigned to each FHA program sufficient to achieve actuarial soundness. When legislation to support lower income subsidized housing programs included changes in the definition of acceptable risk, FHA selectively reduced its underwriting standards and ventured into a relatively unknown and high risk market. The unexpectedly high claims and loss rates experienced in financing this subsidized housing, resulted in a new type of Federal subsidy -- an implicit default insurance premium subsidy. Among the factors which led to the previous Administration's moratorium on subsidized housing programs was this considerably higher than expected FHA loss experience. The present Section 8 Rental Assistance program, in which the rental subsidy is designed to keep pace with inflation and changes in recipient households' incomes, should avoid the high default rates HUD suffered under previous subsidized housing programs. The cost of an actuarially sound premium should be reflected in the Section 8 subsidy.

One serious problem currently plaguing the provision of FHA insurance for subsidized housing is the term of Section 8 Rental Assistance contracts. To provide insurance on a forty year mortgage, lenders seek assurance at the outset that there is a market for the units for at least forty years. But, except for State agency financed projects, the contract for Section 8 subsidies, by statute, is permitted to run only twenty years. Conventional lenders have displayed little interest in financing Section 8 projects, in part for this reason.

For assisted projects to remain viable after the expiration of the Section 8 contract often will require an "upward filtering" of the units. That is, when assisted tenants leave, the units must prove attractive to a higher income segment of the market which can afford to pay full market rents. Our experience suggests that this is not likely, which places FHA in a tenuous position as an insurer of the financing for these projects.

Recommendation

FHA must continue to provide insured financing for subsidized rental housing, but on an actuarially sound basis.

IX. FHA's ROLE IN SUPPORTING INNOVATIVE FINANCING TECHNIQUES

As new types of mortgage financing instruments evolve, Federal support is often required before market acceptance

can be achieved. A major constraint inhibiting innovation and experimentation in the private sector is the aversion of private lenders to relatively unknown risks. In terms of the mortgage instrument, default risk is primarily dependent on the individual borrower's equity position. Because this equity position is determined over the life of the loan by the time path of the outstanding mortgage balance and the value of the property securing the loan, new and untried financing techniques influence default risk to an unknown extent. Where there is little or no actuarial experience on which to judge default risk, lenders are likely to be extremely cautious. This reluctance can be at least partially overcome by the provision of default insurance by FHA. FHA insurance may also provide a degree of "legitimacy" to experimental techniques that encourages their market acceptance.

The most obvious example of FHA's historical role in supporting such innovation is the influence that Federal default insurance coverage had on the popularization of the longer term, lower downpayment, fully amortized mortgage in the late 1930's and the early 1940's. Because of current interest in mortgage innovation and the introduction, by some lenders, of new mortgage instruments, the remainder of this section focuses on FHA's future role in innovative mortgage finance.

A. Problems With Traditional Level Payment Mortgages

In the current inflationary environment, the traditional mortgage instrument -- the level payment mortgage -- has several shortcomings. The level payment mortgage is a long-term asset financed primarily by institutional lenders which issue short-term liabilities. These lenders are faced with a profit squeeze whenever short-term rates exceed their average return from mortgages. When the interest on the mortgage exceeds the average deposit rate over the life of the loan, the lender receives a bonus only to the extent that borrowers are unable to refinance their loans at a lower rate. On the other hand, if the lender underestimates the average short-term deposit rate it loses money. This dilema has three implications. First, lenders are reluctant to decrease mortgage interest rates when short-term rates fall or deposit flows increase, for fear of future decreases in deposit rates. Second, a premium, based on expectations of inflation, is built into the mortgage rate because of the asymmetrical nature of the lenders' risk. Finally, attempts by Federal regulatory agencies to hold down deposit rates increase savings disintermediation in times of rising rates and contribute to instability in the flow of mortgage credit.

Moreover, in an inflationary world, the level payment mortgage "tilts" the burden of mortgage payments, making these payments a greater portion of income initially and a lower portion of income later than would be the case without inflation. This

is particularly onerous to young families with a good potential for income growth, since their ability to convert that anticipated income growth into present purchasing power is constrained.

B. Alternative Mortgage Instruments

There are alternatives to the standard mortgage which address these problems.

a. The Graduated Payment Mortgage (GP)

Under this approach, the rate of interest on the mortgage is constant, as in the level payment mortgage, but the monthly mortgage payment increases at a specific rate of graduation. Although the monthly payment in the early years of the mortgage may be lower than necessary to provide for full amortization of the loan, the periodic payment rises in such a manner that the mortgage is fully amortized by the end of its fixed term.

This graduated repayment schedule avoids forcing young borrowers to commit a relatively large share of their income to monthly payments early in the life of the mortgage. Thus, the GP mortgage allows borrowers, with expectations of rising incomes to choose a pattern of mortgage payments more closely paralleling their anticipated growth in income.

b. The Variable Rate Mortgage (VRM)

In a VRM, the interest rate applicable to the loan balance is determined by reference to an index of market interest rates and allowed to fluctuate with those rates. Tying the interest rate to an index, which reflects the trend in current market rates, provides the lender with a return that keeps pace with its cost of money. Thus, the VRM allows primary lenders, which originate mortgages for their own portfolios, to match rates earned on mortgages with the rates they pay on their short-term savings deposits. Because the VRM portfolio yield rises with the market interest rate, it provides some protection to the lender against disintermediation. Also, in a mortgage market made up of both standard and VRM mortgages, homebuyers would have increased choice.

On the other hand, a mortgagor's payments obligation would be relatively unstable in both the short and long run and interest rate increases could increase default risks.

c. The Price Level Adjusted Mortgage (PLAM)

This type of mortgage provides for periodically recasting the principal amount of the mortgage as price levels change. The interest rate on the loan would be fixed at some modest level, excluding any inflation premium, but this rate would be applied to a changing principal. The PLAM addresses the problem of inflation for the lender by allowing the mortgage debt to change with the rate of inflation.

Because income levels tend to rise with prices, the PLAM also would permit borrowers to match rising mortgage payments to rising income levels. This implies a lower monthly payment early in the mortgage, and a relatively constant payment in real terms over its full life.

On the other hand, the rate of inflation may exceed increases in borrower income or the appreciation rate in the property and both factors would contribute to increased default risk.

C. Possible Role for FHA

As in the 1930's, when FHA pioneered in the use of a long-term fully amortized loan, FHA should again seek to demonstrate the viability of new debt instruments to bring homeownership within the grasp of more moderate income families. One of the problems faced by young families attempting to purchase their first homes is that although they can expect their incomes, hence their capacity to make monthly payments, to increase over time, the current mortgage instrument requires the same monthly payment in each of the 30 years of the mortgage term. In an inflationary world, where incomes can be expected to rise, the level payment mortgage tilts the burden of mortgage payments towards the earliest years of that mortgage, a phenomenon particularly onerous to young families with a good potential for income growth.

The graduated payment mortgage is a particularly promising mechanism to allow families to convert their future earnings into

present purchasing power and to reduce the monthly payments required to support a mortgage in its early years. Under such an instrument, the monthly mortgage payment increases at a specified rate of graduation, hence monthly payments in the early years of the mortgage are considerably lower than under the present mortgage instrument and somewhat higher in its later years. In early 1974, the Federal Home Loan Bank Board issued regulations allowing Federal savings and loans to offer a GP mortgage, but one limited only to interest payments during the first five years and fully amortized thereafter. To date, only three associations (in Ohio, Louisiana and California) have made such loans. Lenders were reluctant to utilize this instrument because it was an unknown quantity, posed an increased default risk, and allowed only a small change in payment size. FHA insurance of graduated payment mortgages can remedy these problems. FHA insurance will eliminate the lender's increased default risk and make possible a more substantial change in payments.

Section 245 of the National Housing Act permits FHA to insure graduated mortgages, with provisions for "varying rates of amortization corresponding to anticipated variations in family income," if those loans (1) have promise for expanding housing opportunities or meeting special needs, (2) include safeguards for mortgagors or purchasers necessary to offset special risks of such mortgages, and (3) have a potential for acceptance in the private market. Up to one percent of the amount of mortgages and loans insured by FHA during Fiscal

Years 1975 and 1976 may be insured pursuant to this experimental financing provision. In the Fall of 1975, HUD published a general invitation to lenders and others to submit proposals for innovative financing plans to be insured by FHA under Section 245. The plans submitted were reviewed and, in November 1976, HUD issued regulations authorizing FHA insurance for five different GPM plans which vary the rate at which monthly payments increase -- from 2% to 7 1/2% per year -- and the number of years over which the payments increase before leveling off -- either 5 or 10 years. (See Table 17).

Two statutory provisions presently inhibit the use of this innovative mortgage instrument. The first is the limitation on the number of loans that can be insured under Section 245. The second limits the outstanding balance on GPM to the amount which would have been insurable under a level payment mortgage. In the early years of a GPM, payments are less than the interest due and the unpaid interest is capitalized. Thus, the limitation on the outstanding balance of a GPM requires a greater downpayment for a GPM than for a similar level payment mortgage. Although the outstanding balance on the GPM should not exceed the original acquisition cost, the current loan-to-value limitation is unnecessarily stringent.

The VRM mortgage also has received some acceptance in those states permitting its use. A number of large state-chartered savings and loans in California have adopted the VRM, in some

Table 17

3% 10-year GRADUATED PAYMENT MORTGAGE

(A) $45,000 - 8-1/2% 30-year Loan - Monthly Payments

Year	Level Payment Loan	GPM	Difference
1	346	287	-59
2	346	295	-51
3	346	304	-42
4	346	313	-33
5	346	323	-23
6	346	333	-13
7	346	342	-4
8	346	352	6
9	346	363	17
10	346	374	28
11+	346	385	39

(B) $35,000 - 8-1/2% 30-year Loan - Monthly Payments

Year	Level Payment Loan	GPM	Difference
1	269	223	-46
2	269	230	-39
3	269	237	-32
4	269	244	-25
5	269	251	-18
6	269	259	-10
7	269	266	- 3
8	269	274	5
9	269	282	13
10	269	291	22
11+	269	300	31

Source: U.S. Department of Housing and Urban Development

cases, to the virtual exclusion of the standard mortgage. The Federal Home Loan Bank Board, under threat of legislative prohibition, however, has not permitted the use of VRM's by federally chartered thrifts.

The potential value of FHA's Section 245 authority is similarly limited. Only variations of the graduated payment mortgage appear to be acceptable under this legislative authority except that, unlike loans permitted under the FHLB regulation, a Section 245 insured loan can include a period of negative amortization to mitigate the "tilt" effect of standard mortgages.

Conclusion

A traditional mission of FHA is the promotion of innovative financing techniques designed to increase mortgage credit availability. Since mortgage insurance for new mortgage instruments requires difficult actuarial projections and involves uncertain risks, it is generally unattractive to private insurers. FHA should, therefore, actively pursue programs to provide insurance in connection with the use of these innovative debt instruments.

Recommendation

For the immediate future, it is recommended that FHA seek expanded statutory authority to insure a greater volume of graduated payment mortgages with higher loan-to-value ratios and to experiment with a wider variety of innovative loan instruments, including variants of the VRM and PLAM.

X. THE ROLE OF FHA IN THE SECONDARY MARKET

The term secondary market refers to transactions involving the sale, transfer or pledge of mortgage loans after they have been originated by a primary lender. Primary lenders include savings and loan associations, mutual savings banks, and commercial banks, which for the most part originate loans for their own accounts. Mortgage companies are a specialized group of mortgage originators which make loans not for their own accounts, but rather for sale through the secondary market. Traditionally, the principal investors in secondary market mortgages have been life insurance companies, pension funds, savings institutions and Federally-sponsored agencies such as the Federal National Mortgage Association (FNMA).

During the early seventies, about one-third of all home mortgages were acquired through secondary market purchases. These secondary market transactions increase the flow of mortgage credit and facilitate the transfer of funds from areas having more savings (capital accumulations) than are demanded in those areas to other areas which have excess demands for housing investment. Housing demand in the last twenty years has been heaviest in the West and South, and consequently the largest transfer of funds through the secondary market have been from the East and the Northeast to the West and South. A significant factor influencing the total volume of

secondary market transactions over time has been Federal agency mortgage purchases designed to stabilize overall mortgage credit flows and to ensure a minimum level of mortgage credit availability.

A. The Historical Role of FHA in the Secondary Market

Today, Federally underwritten mortgages, including VA, Farmers Home Administration, and FHA loans, account for about 65 percent of all loans sold or transferred in the secondary market (see Table 18). Conventional loans account for the remaining 35 percent. This represents a significant shift from the situation of a few years ago. In 1970, for instance, Federally underwritten loans represented over 90 percent of all secondary market activity. Currently, FHA-insured loans constitute some 23 percnet of home mortgages acquired in the secondary market, down from 54 percent in 1970.

Over two-thirds of all FHA secondary market activity involves sales of FHA loans to a Federally-sponsored agency, such as FNMA, or transfers into pools of mortgages to support GNMA-backed securities (see Table 19).

Thus, the use of FHA financing today involves, to a large extent, a piggy-backed arrangement in which FHA provides individual loan underwriting and default insurance while another Federally related agency is the conduit through which investment funds are generated in the

TABLE 18

Role of FHA in The Secondary Mortgage Market
(Millions of Dollars)

	1970			1975		
	Total Mortgages Made	Acquired through Secondary Market: Total	Acquired through Secondary Market: Fed. Agency Supported	Total Mortgages Made	Acquired through Secondary Market: Total	Acquired through Secondary Market: Fed. Agency Supported
Single-Family						
FHA	$ 8,770	$ 7,275	$4,107	$ 6,410	$ 8,806	$ 6,685
VA	3,845	3,341	1,474	9,182	8,756	6,609
FHDA	936	1,492	1,492	2,167	454	454
Conventional	22,036	1,297	140	60,183	13,915	8,151
Total	$35,587	$13,406	$7,213	$77,942	$31,931	$21,899
Multifamily						
FHA	$ 1,917	$ 465	$ 301	$ 2,154	$ 1,197	$ 764
FHDA	30	25	25	240	32	32
Conventional	6,837	837	88	8,283	2,446	1,822
Total	$ 8,784	$ 1,327	$ 414	$10,677	$ 3,675	$ 2,618

Note: FNMA acquisitions of multifamily loans are classified as secondary market purchases for the purposes of this table.

Source: Department of Housing and Urban Development.

TABLE 19

FINANCING OF FHA INSURED MORTGAGES
BY TYPE OF INSTITUTION, 1974

No. of Mortgages	Total	National Bank	State Bank	Mortgage Company	Insurance Company	Savings & Loan	Savings Bank	Federal Agency	All Others
Home Programs	195715	10363	5493	157678	983	20947	4826	614	811
% Distribution	100.0	5.3	2.8	77.5	.5	10.7	2.5	.3	.4
Project Programs	635	83	54	411	4	25	10	30	18
% Distribution	100.0	13.1	8.5	64.8	6	3.9	1.6	4.7	2.8
	HOLDINGS OF FHA INSURED MORTGAGES BY TYPE OF INSTITUTION, 1974								
Home Programs	4852962	384310	185119	592660	653854	842339	1025708	1014956	148302
% Distribution	100.0	7.9	3.8	12.2	13.5	17.4	21.2	20.9	3.1
Project Programs	14359	650	528	2300	2115	696	1567	5008	1495
% Distribution	100.0	4.5	3.7	16.0	14.7	4.9	10.9	34.9	10.4
	PURCHASE OF FHA INSURED MORTGAGES BY TYPE OF INSTITUTION, 1974								
Home Programs	153142	2008	2574	37518	4573	21002	12796	45390	26684
% Distribution	100.0	1.3	1.7	24.6	3.0	13.8	8.4	29.7	17.5
Project Programs	2183	47	29	250	48	88	90	1575	56
% Distribution	100.0	2.2	1.3	11.5	2.2	4.0	4.1	72.1	2.6

Source: Tables 143, 144, 145 of 1974 HUD Statistical Yearbook.

secondary market. If it were not for the generation of funds through FNMA and through GNMA-backed securities, the volume of FHA-insured loans could diminish to less than one-third of its already reduced current level.

The same patterns hold true for FHA project mortgage loans. During 1974, private lenders acquired for their own portfolios only 25% of all FHA project mortgage loans closed. Two-thirds of all such loans ended up either in GNMA pools or in FNMA's portfolio.

The reasons for the traditional predominance of federally insured loans in the secondary market were their use of nationally standardized mortgage contracts and documents, their use of standardized appraisal and credit procedures, Federal insurance or guarantees to underwrite the default risk, and a prior statutory restriction limiting FNMA to the exclusive purchase of FHA and VA-insured loans. Since the late sixties, however, significant changes have occurred in the character of the secondary market which have reduced the market's dependence on federally insured mortgages.

Beginning with the Emergency Home Finance Act of 1970, an attempt has been made by the Federal Government to free the secondary mortgage market from its dependence on FHA's decreasing primary market activity. This act created the Federal Home Loan Mortgage Corporation (FHLMC) to provide a secondary market for conventional and privately insured mortgages and authorized the Federal National Mortgage Association (FNMA) to purchase, hold, and sell such mortgages.

During the early seventies, these two agencies launched successful campaigns to standardize conventional loan documents and to establish procedures for the purchase and sale of conventional home mortgages, which now represent over 12 percent of total secondary market purchases (see Table 20).

In 1971, FHLMC began issuing a mortgage backed security collateralized by conventional and privately-insured mortgages. Until 1973, these FHLMC securities were direct "pass-throughs" of principal and interest, which were classified as investments in mortgages for tax purposes and, because of the agency guarantee, presented little risk for the investor. However, like standard mortgages, they included monthly payments and uncertain life spans. The mortgage-backed security was improved in 1973, when FHLMC developed and first issued Guaranteed Mortgage Certificates, securities backed by conventional mortgages but including semi-annual interest payments, annual guaranteed principal payments, and a guarantee by the Agency to repurchase the certificate at 100% of the unpaid balance after fifteen years.

Table 20

Secondary Market Activity - 1-4 Family Home Loans

1970-1974

(Millions of dollars)

Lender Group/Insurance Status	1970		1971		1972		1973		1974	
	Purchases	Sales	Purchases	Sales	Purchases	Sales	Purchases	Sales	Purchases	Sales
All lenders - Total[a]	$13,406	$13,579	$18,292	$18,534	$25,076	$24,129	$22,573	$23,789	$23,046	$23,111
FHA-insured	7,275	7,320	9,704	9,956	10,327	9,920	7,428	8,262	5,493	5,257
VA-guaranteed	3,341	3,514	4,852	4,949	7,490	7,182	6,464	6,502	7,526	7,585
Conventional	2,789	2,744	3,736	3,630	7,259	7,027	8,681	9,025	10,026	10,269
Private lenders - Total[b]	6,194	11,828	10,613	16,484	15,324	20,175	10,997	19,039	7,940	19,883
FHA-insured	3,169	7,302	5,146	9,725	5,588	8,828	2,938	6,246	1,728	4,989
VA-guaranteed	1,868	3,513	3,305	4,802	5,424	7,080	3,246	6,113	1,793	7,451
Conventional	1,158	1,014	2,160	1,956	4,313	4,264	4,813	6,678	4,420	7,444
Federal agencies - Total[c]	5,371	1,631	3,733	1,853	4,996	3,799	7,396	4,315	8,801	2,534
FHA-insured	3,825	18	2,390	230	3,104	1,092	2,877	2,016	1,933	268
VA-guaranteed	1,406	2	908	146	1,203	102	2,199	388	3,260	134
Conventional	140	1,611	434	1,476	689	2,605	2,320	1,911	3,608	2,132
FNMA - Total	4,811	20	2,742	326	2,596	160	4,163	13	4,746	*
FHA-insured	3,524	18	2,068	196	1,776	117	1,537	13	1,303	*
VA-guaranteed	1,287	2	674	130	766	42	1,687	--	2,314	--
Conventional	--	--	--	--	55	--	939	--	1,128	--
FHLMC - Total	358	--	692	98	1,217	329	1,151	351	1,956	39
FHA-insured	240	--	294	33	414	50	185	1	144	--
VA-guaranteed	118	--	234	16	416	41	151	*	117	--
Conventional	--	--	163	48	387	239	814	350	1,695	39
GNMA - Total	61	--	27	--	936	945	1,516	2,390	1,315	402
FHA-insured	61	--	27	--	914	922	1,155	2,002	486	268
VA-guaranteed	*	--	*	--	21	23	361	388	828	134
Conventional	--	--	--	--	--	--	--	--	--	--
Federally Supported Pools - Total[d]	1,841	119	3,947	197	4,756	157	4,178	436	6,305	692
FHA-insured	282	--	2,167	--	1,634	--	1,612	--	1,833	--
VA-guaranteed	68	--	638	--	863	--	1,018	--	2,473	--
Conventional	1,492	119	1,142	197	2,258	157	1,548	436	1,998	692

a/ Includes eleven identifiable lender groups.
b/ Includes commercial banks, mutual savings banks, savings and loan associations, life insurance companies, private non-insured pension funds, mortgage companies, mortgage investment trusts, state and local retirement funds and state and local credit agencies.
c/ Includes home mortgage transactions of FHA, FNMA, GNMA, FHDA, FHLMC and VA.
d/ Includes GNMA mortgage-backed securities, FHDA blocks and FHLMC participation certificates.
* Less than $500,000.
Source: U. S. Department of Housing and Urban Development.

Mortgage-backed securities have become a major factor in the secondary market, but still rely heavily on FHA insurance. Net increases (in millions of dollars) for both GNMA and FHLMC pass through securities are shown below.

	1970	1971	1972	1973	1974	1975
(millions)						
GNMA Pools						
FHA-insured	$ 280	2105	1623	1488	1615	3710
VA-guaranteed	67	622	806	898	2254	2778
FHLMC Securities (Conventional and PMI-insured)	$ --	64	377	325	(-9)	2674

Another major secondary market development occurred in 1975 when the Federal Home Loan Bank Board (FHLBB) authorized member savings and loans to issue mortgage-backed bonds collateralized by their own loan portfolios. While experience with this particular security is very limited, the mortgage-backed bond constitutes a potentially valuable source of long-term capital useful in improving the balance between an institution's asset and liability maturities. The mortgage-back bond, for example, should be attractive to private pension funds, state and local government retirement funds, and other institutional investors who traditionally seek safe, long-term and stable income producing investments.

These innovations and changes have enhanced the overall capacity of the secondary market to attract funds for mortgage investment and, at the same time, have expanded the market's ability to utilize conventional mortgages. Despite all these

changes, however, the secondary mortgage market has continued to exhibit a preference for the Federally-underwritten loans. Even as other institutional constraints are removed, certain investors may continue to demand "full faith and credit" federal backing for their purchases.

B. The Implications of FHA's Declining Role in the Primary Market

FHA has played a significant role in increasing the supply of mortgage funds through the operation of the secondary market. First, the elimination of default risk has increased the attractiveness of the mortgage instrument as an investment alternative for secondary market purchases not themselves prepared to originate mortgages or to evaluate risks on individual loans. As a result, the demand for mortgages as an investment asset has been increased and the supply of funds to mortgage originators has been expanded. Second, by increasing the demand for mortgages as an investment asset, FHA insurance coverage increases the liquidity of the mortgage obligations held by originating institutions in the primary market. This, in turn, improves the flexibility of these institutions in responding to market developments and increases their willingness to commit funds to this category of long-term obligations.

FHA's inability to attract customers in the primary market in recent years could have an adverse impact on its ability to facilitate secondary market transactions. One recent study

conducted for HUD suggested that a continuing diminution of FHA activity in the primary market would have a negative impact on the volume of investor activity at the secondary market level, thereby reducing the supply of mortgage credit to potential mortgagors.* Two approaches are available to forestall such an occurrence. First, policies implemented to assure a reasonable volume of insurance activity in the primary market can be used to assure investor interest in the secondary market. Second, alternatives may be found for reducing default risk to the secondary market investor, which do not depend upon the level of FHA activity in the primary market.

If investment activity at the secondary market level can be encouraged without subsidized FHA activity in the primary market, FHA can function in a fashion that complements the private market. In addition, FHA's capacity to stimulate secondary market investments could be freed from the constraints of having to write insurance on individual loans in the primary market.

C. Reasons for Secondary Market Reliance on FHA

The secondary market's continuing preference for federally-insured mortgages stems from two sources. First, payment on FHA

*Semer and Zimmerman, "The Changing Role of FHA Mortgage Insurance in the Mortgage Market and the Secondary Market," prepared for the Office of the Assistant Secretary for Policy Development and Research, January 1975.

insured loans is guaranteed by the "full faith and credit" of the Federal Government. In contrast, there is some degree of uncertainty regarding the financial capacity of the private mortgage insurance firms to meet their future obligations. The coverage provided by these firms is not perceived as equivalent (on a per unit of coverage basis) to that provided by FHA to secondary market investors.

Second, the apparent preference for FHA insured mortgages stems from the greater coverage provided on these loans (100 percent as opposed to the top 20 percent coverage on privately insured loans). Since the secondary market investor is unlikely to have any expertise in the origination of mortgage loans or in the evaluation of default risk, the extra protection provided by the complete coverage offered on FHA insured loans may carry greater value in the secondary market than in the primary market. In the primary market, the mortgage originator can exercise caution in selecting the property, mortgagor, and financing terms which will virtually assure him that expected default loss will not exceed the 20 percent coverage provided by PMIs. The secondary market investor, however, is not generally capable of exercising such control and may, therefore, place a relatively large value on the additional coverage provided by FHA.

We cannot be certain, at this time, of the relative importance of these factors in the secondary market's preference for FHA

insured loans. Both are important, however, because both substantially reduce the investor's need to inquire into the risk posed by the loan. The Federal Government could contravene these preferences and encourage a greater volume of secondary market activity without increasing FHA insurance in the primary mortgage market.

D. Counteracting the Secondary Market's Fear of PMI Failure

FHA could provide private mortgage insurers with reinsurance coverage for catastrophic losses in order to remove from the secondary mortgage market the risk of failure of these firms. Such a program would have several benefits. First, it could encourage an increase in secondary market activity in privately insured loans because the re-insurance of the PMI's would effectively place the full faith and credit of the Federal Government behind these loans. The actual increase generated would depend, however, on the value of this factor in the secondary market, which cannot be determined on an a priori basis. Second, by removing the risk of catastrophic loss from the private mortgage insurers, reinsurance should increase the willingness of the PMI's to insure higher risk loans. Mortgagors who are currently being denied PMI coverage, but are at the margin, could become insurable.

Third, FHA reinsurance could encourage new entrants, hence increased competition in the PMI industry. With the Federal Government providing catastrophic coverage, the overall investment

risk in the industry would be lowered and contingency reserve requirements could be decreased. To the extent that both risk and reserve accumulations represent barriers to entry, reinsurance should stimulate new investments and increase competition in this industry. Consumers should reap the benefits of this new competition through reduced premium levels.

The problems in implementing FHA reinsurance for the private mortgage insurance firms, include, for example, the question of whether the PMI should be declared bankrupt and its outstanding (and future) claims paid by the Federal Government in the event of a claim or whether the firm should be insured against bankruptcy.

Also, determining the appropriate level of premiums to be charged for reinsurance involves the estimation of expected insurance claims to FHA which depend upon the probability distribution of insurance claims to private insurers, their contingency reserve levels, and other program design features. Since there is little experience on which to base such estimations, setting an appropriate premium level for an FHA reinsurance program would be exceedingly difficult.

An alternative to Federal reinsurance of PMIs is the incorporation of mortgage insurance firms into insurance pools. This has the advantage of allowing funding on a post-assessment (as opposed to a reserves) basis; that is, the obligations of a bankrupt PMI firm would be met by funds in the pool and these

funds would then be replenished by billing the remaining participants in the pool. One recent study suggests that, if there were an adequate number of participants, a PMI pool scheme could provide the reinsurance function at a lower cost to the participating firms than Federal reinsurance operated on a preassessment basis.

E. Counteracting the Secondary Market's Apparent Aversion to Coinsured Loans

Two potential mechanisms exist for counteracting secondary market investors' present reluctance to trade in conventional uninsured or privately insured loans. Either approach would allow FHA to eliminate any risk faced by the secondary market investor, thereby providing him with complete insurance protection. Since the secondary market investor exercises no control over the underwriting or foreclosure phase of mortgage servicing, he is not subject to a moral hazard. But, some degree of risk exposure should continue to be imposed on the loan originator in order to counteract the potential moral hazard that would result if complete coverage also were being provided to the entity originating the loans.

The first approach would be for FHA to provide insurance to the secondary market investor, on an individual loan basis, for that portion of default risk left uncovered by private mortgage insurance. The PMIs provide coverage against loss up to 20 or 25 percent of the mortgage amount. The originator could

then purchase FHA insurance to cover the residual risk. Insurance premiums would be modest since FHA's exposure would be only on the bottom portion of the loan. The premium would be collected from the originator of the loans, since he would benefit from the resulting increased liquidity of the insured loans, and the originator would agree to indemnify FHA for a part of its loss should a claim be made, to avoid any moral hazard.

The most important feature of this kind of reinsurance scheme is that the secondary market investor would face no default risk on the loan. And, if insurance were marketed to the originator, he could be held accountable to FHA for a portion of its losses to assure careful underwriting. The increase in secondary market activity that would result depends upon the strength of that market's aversion to partially insured loans.

The second approach would be to provide federal insurance or guarantees on a group of privately insured loans purchased in the secondary market. By enabling individual mortgage contracts to be pooled in portfolios and the investors to be insured against default loss, the secondary mortgage market would more closely approximate a government securities market in its operation. The resulting greater volume in this market could be translated into an increased supply of mortgage funds.

The key element of such a program is the level of insurance provided on the portfolio. If the portfolio is not fully insured, some degree of default risk remains for the investor

and the return required to attract an equal volume of investment is higher. The actual level of risk faced by the investor would be determined by the level of risk on the individual loans within the portfolio -- itself determined by individual insurance coverages, loan terms, appraisal qualities etc. -- except that investors' unfamiliarity with the individual loans in the portfolio would prohibit their being able to evaluate that residual risk. On the other hand, if FHA provides 100 percent coverage against loss on the portfolio, the investor absorbs no default risk and the portfolio should be equivalent to a high grade bond and very marketable.

The problem is that, which the market will demand a 100 percent guarantee, the mortgage originator's exposure to some degree of default risk should be preserved to avoid moral hazards. Originators could be screened to mitigate the moral hazard, with the threat of expulsion from future participation in the program providing the necessary incentive. Such ex post facto sanctions are rarely effective, however. An alternative might be an agreement by the originator to indemnify the federal government for a significant portion of the losses on the portfolio.

Two mortgage portfolio guarantee programs already exist. One is provided by the Federal Home Loan Mortgage Corporation (FHLMC) in the form of Guaranteed Mortgage Certificates (GMCs). These are interest bearing bonds secured by a pool of conventional mortgages upon which the FHLMC guarantees the payment of principal and interest. This guarantee represents a form of portfolio insurance, and the bonds are expected to provide an increased secondary market for conventional mortgages. This program has seen little use, however, primarily because the bonds do not carry the full faith and credit of the United States.

The primary portfolio guarantee mechanism is the GNMA pass-through security, which provides a 100 percent guarantee of the timely payment of principal and interest on a portfolio of mortgage loans. The resulting security is not absolutely equivalent to a bond, because payments are made on these securities as mortgagors make payments on the underlying loans, but the effect is similar, allowing secondary market investors to commit funds to a pool of loans without knowledge of the underwriting quality of the individual loans involved. In the past, the loans comprising the portfolios against which GNMA has issued securities have been FHA and VA insured. Consequently, the insurance coverage GNMA provides on the portfolio is marginal, since the residual risk on these loans is quite small. Only those conventional mortgages held in GNMA's own portfolio have benefitted from this device.

GNMA mortgage-backed securities could be a vehicle for the provision of a portfolio guarantee by extending the program to conventional, PMI insured loans. The advantages of such an approach are that the GNMA security is a true security, with a fixed yield and maturity -- unlike a whole mortgage -- and the timely payment of principal and interest on this security is guaranteed by the Federal government. These securities

are highly liquid and there is already an established market for them. However, GNMA would be faced with the same dilemma of a market demand for 100% insurance and the moral hazard posed by removing entirely the originators risk of loss on the underlying mortgages. This problem might be mitigated by requiring an indemnification of GNMA by the originator for a significant proportion of the initial losses on the portfolio, but there has been little experience with such indemnity schemes.

Conclusion

Although market conditions have changed significantly in recent years, reducing the traditional importance of FHA insurance to the secondary market, there appears to be a continuing need for HUD to monitor secondary market performance and to be prepared to intervene with new forms of secondary market support.

Recommendation:

HUD should begin now to develop direct secondary market insurance programs to improve that market's responsiveness to residential mortgage needs, without dependng on FHA's primary market activity. Specific consideration should be given to developing a GNMA conventional mortgage backed securities program to foster the development of the secondary mortgage market as a true securities market and thus to increase the flow of mortgage credit.

XI. FHA'S ROLE IN PURSUING SOCIAL GOALS NOT DIRECTLY RELATED TO INCREASING THE AVAILABILITY OF MORTGAGE CREDIT

Since 1934, FHA has incorporated into its procedures features which may be considered consumer protection requirements. To some extent, these features originated as elements of the underwriting system. For example, land planning requirements, subdivision analysis, minimum property standards, appraisals, inspections, and mortgage credit analysis were perceived as necessary features of an underwriting process which would assure that fundamentally sound loans were being insured.

Additional requirements were added in the late 1960s, which had the effect of directing the FHA insurance programs toward serving goals not necessarily related to the maintenance of sound underwriting and not directly related to increasing the availability of mortgage credit. FHA began to assess the environmental consequences of housing development financed with FHA mortgage insurance under the National Environmental Policy Act and to ensure that housing development under FHA programs was consistent and coordinated with other development activities in the area through a local government review process.

There has been considerable controversy over the extent to which FHA should be used to promote such non-mortgage lending goals. FHA insurance programs were developed originally to provide a vehicle for mortgage finance transactions, not

to be environmental protection or urban planning programs. Nor was FHA initially cast in the mold of a consumer protection agency. Some of FHA's present critics argue that there is an inherent inconsistency between these goals and the objective of providing mortgage credit to as many families as possible. It may be, for example, that FHA single family mortgage insurance is now used predominately for existing housing to some extent because of the burdens and "red tape" these requirements impose on new construction.

Similar objections have been raised to FHA's efforts to promote equal opportunity by requiring the affirmative marketing of housing to minorities. These requirements, however, bear directly upon the availability of homeownership opportunities and adequate housing for members of minority groups. They are only discussed in this section because of the frequency with which they are included in the list of burdens associated with participation in FHA programs.

The proliferation of complex non-underwriting oriented FHA requirements, particularly with respect to project mortgages, has led to a processing system which is seen as unmanageable by many participants. This is at the heart of many of the perceived negative effects of the social goal requirements (See Table 21). A recent study comparing FHA

Table 21

Requirement	Applies to: Single	Applies to: Multi	Cost Associated with	Cost borne by: Developer	Mortgagee	Consumer*	HUD
Subdivision Analysis	X		Processing time for plan review; delays of up to six months. May require developer to hire engineer/ planner for special problems.	X			
A-95 Review	X	X	Processing delays. Additional HUD staff work.	X			X
Affirmative Marketing	X	X	Processing delays. Additional paperwork for participant.	X			
Environmental Clearance	X	X	Processing delays. Additional paperwork for participant. Possible hiring of consultant. HUD staff time may be increased enormously.	X			X
MPS	X	X	Possible increased costs of housing because of standards.			X	
Davis-Bacon		X	Increased labor costs. Processing delays in making determinations. HUD staff time in making initial surveys and compliance reviews.	X		X	X
Mortgage credit analysis	X	X	For single family: may be delay in approving mortgagor. Mortgagor may find more expensive financing elsewhere attractive because of faster approval. Mortgagee paperwork required; reviews duplicated by HUD.		X	X	

* It can reasonably be assumed that many costs, such as those borne by developers and mortgagees from delays, will be borne indirectly by consumers.

procedures with those of conventional lenders, private mortgage insurers, and state housing agencies indicated that FHA programs generally involve more processing steps, more internal reviews, more elapsed processing time between basic development stages, and more administrative costs.

A definitive and comprehensive articulation of the costs and benefits of these requirements has not been made. However, there is evidence that developers, realtors, and loan originators often seek alternative sources of mortgage credit before subjecting themselves to the FHA processing requirements, with the result that FHA ends up insuring primarily higher risk business. Moreover, the costs and delays arising from FHA's social goal requirements make economically feasibly projects more difficult to package. It has been estimated that every month's delay adds 2 percent to the total cost of a multifamily project.* Delays also contribute to a reduction in the rate of return on an investor's equity -- since the investor must wait longer to realize his return. As a result, many FHA units are built only at higher costs or are not built at all. Thus, both the consumer and FHA may be adversely affected.

* See Booz Allen and Hamilton, Final Report: Comparative Analysis of Federal and Non-Federal Government Housing Program Procedural and Managerial Implementation, Department of Housing and Urban Development (Wash. D.C.) 1973.

The problems caused by imposing these requirements only on FHA insured housing is most graphically illustrated in the multifamily sector. It is estimated that FHA processing requirements can raise the price of an FHA project up to 20% above its conventional equivalent. Yet, for underwriting purposes, the project is required to have rents comparable to those for similar projects in order to assure its marketability. These conflicting requirements put the sponsor in an untenable position. To some extent, the effect of these higher costs on monthly outlays are mitigated by the longer term of an FHA mortgage (40 years), as compared to the more typical twenty-five to thirty year term of conventional financing. Not suprisingly, however, many projects are still either infeasible with FHA insurance or are feasible only if FHA underwriting standards are very liberally construed. In the former case, FHA is disabled from assuring the availability of credit and, in the latter, the underwriting process is unnecessarily compromised.

On the other hand, it has been suggested that FHA should be the vehicle through which various social objectives could become generally accepted in the private market. For example, the efforts of HUD-FHA in establishing and adhering

to voluntary affirmative marketing plans is useful in encouraging acceptance of the voluntary affirmative marketing concept in the conventional market. But, FHA does not, and probably never again will, have the market influence it once did. The purpose of the role suggested for FHA is to serve that portion of the market which cannot obtain credit through conventional channels. This role is not suited for the long term objective of demonstrating social innovations to the conventional market.

An approach more consistent with FHA's proposed new role would be for FHA to focus on its primary goal of expanding the availability of mortgage credit. Under this approach, many of the social goal requirements applied to FHA should be applied to all mortgage credit transactions. Some of those requirements, not of sufficient consequence to be applied to all mortgage lending, should not be applied to FHA either -- if to do so would hinder significantly FHA's capacity to assure mortgage credit availability to those not adequately served by the private market.

Moreover, many social goals can be accommodated by FHA's normal underwriting procedures without the imposition of special purpose requirements. For example, a case can be made that traditional FHA practices directly addressed

some of the specific concerns of the more recent NEPA and local government review processes. In undertaking technical subdivision analysis and making site appraisals, FHA staff already take into account many of the environmental factors now thought to require separate review pursuant to NEPA. As another example, the normal process of building under FHA programs typically serves some of the functions of the local government review, since local coordination is assured when the builder-developer secures zoning and building permits and develops subdivision plans in accord with local practices.

Accordingly, it is recommended that FHA's requirements, based on social goals not directly related to increasing the availability of mortgage credit, be reviewed to minimize identifiable sources of delay and inefficiency which seriously hinder FHA in achieving its primary goal of assuring mortgage credit availability.

A. Minimum Property Standards/Subdivision Analysis

Minimum Property Standards (MPS) and subdivision analysis are designed to assure the basic soundness and quality of the property for which a mortgage is to be insured, in terms of both its construction quality and its location.

Minimum Property Standards cover minimum requirements in design, livability, use of materials, and construction. More recently, these standards have addressed energy, environmental, and life-safety issues as well. Projects are reviewed individually for conformance with MPS requirements, and the HUD field office may demand changes should plans be determined deficient. It is asserted that MPS give support and credence to the effort to consolidate local codes and practices and, over time, have introduced new practices and new materials to home building, with the result that the quality of housing has probably improved. Also, the MPS decrease FHA's risk exposure by increasing the durability and marketability, hence long-term value, of insured housing.

The negative aspect of MPS is alleged to be that they are too rigid. In some cases, their inflexibility is asserted to result in the exclusion of certain new materials; in others, unneeded amenities or space may be required. Each effect raises costs, but no comprehensive analysis of the cost impact of the MPS exists, since such an assessment might be possible only on a project by project basis. Even in the absence of firm data, however, the tentative conclusion can be drawn that there are cases in which MPS do contribute to increased costs.

FHA subdivision analysis assures that FHA insured development occurs on well-planned, sound sites. Subdivision analysis involves both market and technical analysis of the subdivision, including an assessment of the site, soil, drainage and other factors. The analysis also encompasses reviews and inspections of subdivision construction. Significant coordination between FHA field offices and local communities normally occurs with regard to community standards for sewers, streets, utilities and drainage. Where localities either lack a planning capability or possess only rudimentary standards, FHA has helped the local government to develop their own subdivision standards or planning requirements. Furthermore, FHA has provided some leadership with regard to particular types of development, such as planned unit developments. Subdivision analysis can take considerable time, however, hence be costly to a developer. Although it currently is carried out without charge to the developer, FHA should consider imposing a fee to cover its administrative costs.

Although Minimum Property Standards and Subdivision Analysis are necessary underwriting tools, the content and administration of these requirements should be streamlined and modified:

1. The MPS and their relation to local building codes and practices should be examined to determine whether complaints regarding MPS are justified. FHA is currently examining proposals from the industry involving waivers of MPS, the exemption of certain developments from subdivision analysis, and modifications to FHA inspection procedures.

2. Under accelerated subdivision processing procedures instituted several years ago, FHA reduces its oversight in developments located in communities with sound planning and subdivision regulations. Staffing problems prevented this system from realizing its potential, but the initiative should be resurrected on a priority basis.

B. Local Government Review Under OMB Circular A-95

The purpose of the A-95 review requirement is to assure that housing development is coordinated with other state or local activities. As originally proposed, A-95 would have applied only to subsidized housing. At HUD's request, however, unsubsidized programs also were included, primarily because of the difficulty involved in identifying Section 235 subsidized single family units at the time the review is to be carried out. (For example, units often were not designated as Section 235 units until the final stage of FHA mortgage insurance processing.)

The review itself is accomplished in the field at the time the participant submits an application for subdivision analysis or project feasibility. Copies of the application are sent to designated clearinghouses for comments on the proposal's consistency with areawide development plans and its environmental impact. While such local coordination of Federal programming is desirable, the A-95 review process has been plagued by poor performance of overworked clearinghouses, processing delays, and, to some extent, duplications of effort.

Approaches to improving the A-95 review include:

1. HUD could take steps to encourage sponsors to complete the A-95 clearance process prior to submission of an application to FHA.

2. For subsidized housing development that is described in a Community Development Block Grant Application (Housing Assistance Plan), the A-95 review carried out by the locality in connection with that application should be allowed to obviate the need for any further A-95 clearance.

C. Environmental Review

Enactment of the National Environmental Policy Act of 1969 ultimately caused serious FHA processing problems, including increased and burdensome sponsor submissions, lengthy delays, and problems of interpretation of the law. Although FHA altered its environmental procedures in 1974, they still constitute a significant disincentive to participation in FHA programs.

Environmental clearances have been the source of substantial processing delays for the developers of large FHA insured single-family subdivisions and FHA insured projects. Processing delays of up to 2 years have occurred, pending completion of Environmental Impact Statements. Such delays impose substantial costs on both HUD and developers and are a major deterrent to program participation. Moreover, less stringent environmental requirements in other federal housing programs (VA and FmHA) have created incentives for developers increasingly to use those alternatives to FHA financing.

It has been suggested that FHA unsubsidized programs should be exempted from NEPA on the grounds that mortgage insurance for unsubsidized housing is merely an activity supplemental to normal mortgage market transactions and those quantifiable environmental factors which should be considered already are, or can be, built into FHA underwriting procedures.

On the other hand, it is appropriate for public agencies to be required at least fairly to consider the environmental consequences of their actions. Hence, administrative approaches to rationalizing present environmental requirements should be pursued, including:

1. Coordination with other Federal housing agencies (e.g., VA and FmHA) to ensure that these agencies' environmental procedures are consistent with one another and that inter-agency differences do not influence activity levels.

2. Exploring the possibility of coordinating environmental review procedures with Section 701 funded housing or land use planning or other HUD assisted areawide activities.

D. Davis-Bacon Requirements

Construction wages for insured or subsidized multifamily housing are governed by prevailing wage determinations made by the Department of Labor pursuant to the Davis-Bacon Act. These Davis-Bacon "prevailing wage" requirements are asserted to increase substantially the costs of FHA insured construction, although the extent to which this is true varies from locality to locality. Several independent studies have concluded that the imposition of Davis-Bacon prevailing wage requirements not only increases the cost of the affected housing construction but also exerts a general inflationary pressure on construction costs.*

* A. Thieblot, the Davis-Bacon Act, Report No. 10 of the Labor Relations and Public Policy Series, Industrial Research Unit, the Wharton School, University of Pennsylvania, pp. 77-100, 170-73; see John P. Gould, "Davis-Bacon Act: The Economics Prevailing Wage Laws, Special Analysis No. 15" (Washington, D.C. American Enterprise Institute, 1971), p. 28-9.

Davis-Bacon impacts directly on construction costs by requiring payment of wages higher than a contractor might otherwise negotiate and indirectly by imposing special apprenticeship and job classification requirements. There is also a general inflationary impact on construction labor costs, because Davis-Bacon wage requirements create a price inelastic demand for labor in projects involving the government, bidding away labor from the private sector. A conservative estimate placed the annual cost of Davis-Bacon to the federal government at $1.5 billion.** GAO conservatively placed the annual excess for housing resulting just from improper administration of the Act at $60 million.***

The excess costs imposed on FHA insured housing by the Davis-Bacon requirements are magnified by mortgage interest rates, increasing their inflationary impact and the likelihood that increased costs will make project rents non-competitive. Furthermore, the Act imposes an administrative burden on HUD with regard to both the surveys undertaken in the field by HUD personnel to determine wage rates and the compliance reviews by HUD personnel undertaken at the project site. HUD is currently undertaking a study to assess more definitively the costs of Davis-Bacon compliance for FHA insured housing construction.

** A. Thieblot, op. cit., at p. 170

*** U.S. Comptroller - General, Report to the Congress: Construction Costs for Certain Federally Financed Housing Projects Increased Due to Inappropriate Minimum Wage Determinations. (B-146842), (GAO 1970), p. 9-10.

The Davis-Bacon Act was originally enacted in 1931 "to protect local construction wage standards from predatory itinerant contractors who were taking advantage of the oversupply of labor (relative to the depressed business conditions of the period) by importing workers at very low wage rates to work on government jobs."**** The economic conditions which spawned the act have long since disappeared. Construction industry labor no longer needs protection from the itinerant contractors and migrant unskilled workers against whom the Act was directed.

Despite the fact that the Davis-Bacon Act appears to be an anachronism, may be the single most costly of the FHA non-underwriting requirements, and is inflationary as well, attempts to repeal or substantially to amend the Act have been unsuccessful.

Accordingly, HUD should explore the following reforms to mitigate the impact of Davis-Bacon, if proposals for repeal are not made:

1. Increase in Davis-Bacon threshold amounts.

2. Improvements in HUD/DOL cooperation in determining applicable wage rates, including the distinctions between high-cost urban area prevailing wage rates and the rates for nearby rural or suburban areas.

3. Streamlining procedures in labor standards violation actions.

4. Reexamination of the Department of Labor's policy of deferring to state prevailing wage laws where such rates are higher than the federally established prevailing wage rates.

**** A Thieblot, op. cit. at p. 167

E. Affirmative Marketing

The equal opportunity provisions of Title VIII of the Civil Rights Act of 1968 apply to all housing. Pursuant to Title VIII, HUD has developed specific procedures for affirmatively marketing housing units insured by FHA. Thus, FHA builders/developers not only must comply with the anti-discrimination provisions of Title VIII, which are applicable to all housing, but also must face additional affirmative marketing procedures unique to HUD. These procedures entail submission of an affirmative marketing plan to the HUD field office, indicating special outreach efforts and marketing goals.

Affirmative marketing is a requirement which would be as desirable for the conventional market as for FHA. To this end, voluntary areawide affirmative marketing agreements have been developed in several SMSAs. Such agreements often are subscribed to by local building associations and realtors and are applicable to conventional as well as to FHA housing.

Affirmative marketing requirements respond to an important social objective yet entail only minimal costs. HUD should continue to support this important fair housing requirement, with the following modifications to improve its effectiveness and to streamline its administration:

1. Coordinate FHA procedures with other Federal housing agencies so that affirmative marketing procedures are comparable.

2. Make expanded use of the voluntary, areawide affirmative marketing plan concept. This is already a Departmental priority. It would appear that such plans offer a prime vehicle for transferring the concept of affirmative marketing to the private market. Moreover, the voluntary plan format is more efficient than project-by-project compliance activities.

XII. Conclusion

Many of its critics point to FHA's decreased volume as evidence of its decreasing effectiveness. On the contrary, the decline in FHA's activity suggests that it has been successful in meeting its initial goal of increasing homeownership opportunities. Seventy-five percent of American families today own their own homes, largely as a result of FHA's innovative role in mortgage finance. Homeownership has been made possible for millions of American families because the fully amortized, long-term, low-downpayment mortgage which FHA pioneered has gained universal acceptance. FHA's role in creating and expanding the secondary mortgage market also has contributed to our high levels of housing production and homeownership, by increasing the flow of mortgage credit. Thus, the fact that the private market has emulated FHA's innovations and is now successfully competing with FHA indicates that FHA has succeeded, not failed, in meeting its goal of increasing homeownership opportunities.

The decreasing uniqueness of its service does not mean that FHA should recede into a passive role. Rather, FHA should make an aggressive stance in expanding the availability of mortgage credit to those areas of the country and to those families who are still not being adequately served by the private market, in continuing to support programs for subsidized housing, and in demonstrating innovative approaches to mortgage finance. By aggressively seeking to expand the availability of mortgage credit, rather than by competing

to serve families already adequately served by conventional lenders and private mortgage insurers, FHA can continue to play a significant role in the production of housing and the growth in the proportion of American families who own their own homes.

APPENDIX A

INFORMATION ON SELECTED HUD/FHA HOUSING PROGRAMS

Single-family--unsubsidized

Program: Section 203(b)--Basic Mortgage Insurance Homes.

Authorization: National Housing Act, 1934.

Purpose: To help families undertake homeownership on a sound basis.

Type of assistance: Insured loans.

Coverage: Loans may be used to finance the purchase of proposed, under construction, or existing one- to four-family housing, as well as to refinance indebtness of existing housing.

Maximum Terms: Maximum insurable loans for an occupant mortgagor are as follows: one family, $45,000; two or three family, $48,750; four family $56,000. The maximum amount of the loan is 100 percent of the first $25,000 of the estimated value and closing cost, 90 percent of the next $10,000 and 85 percent of the amount over $35,000. The term is 30 years.

Subsidy: None.

Number of units insured (000):

Before 1960 =	4,542
1960 - 1969 =	3,827
1970 - 1975 =	1,317
Total	9,686

Insurance in force (12/31/75):

$60,059 million
3,807,049 cases

Insurance Reserve position 1/: $672 million

Program: Section 221(d)(2)--Mortgage Insurance-homes for low and moderate income families.

Authorization: National Housing Act, as amended in 1954.

Purpose: To make homeownership more readily available to families displaced by urban renewal or other government actions as well as other low-income and moderate-income families.

Type of assistance: Insured loans.

Coverage: Loans may be used to finance the purchase of proposed or existing low-cost one- to four-family housing or the rehabilitation of such housing.

Maximum Terms: Maximum insurable loans for an occupant mortgagor are, $21,600 for a single family home, or up to $25,000 for a single-family home in high cost areas. For a large family (five or more persons) the limits are $25,200 for a single-family home, or up to $28,800 for a single-family home in high cost areas. Higher mortgage limits are available for two- to four-family housing. Maximum term is usually 30 years. However, in special cases, the term may be 35 to 40 years.

Subsidy: None

Number of units insured (000):

Before 1960 =	13
1960 - 1969 =	341
1970 - 1975 =	374
Total	842

2 (cont.)

Insurance in force (12/31/75):

$7,071 million
489,373 cases

Insurance Reserve position 1/: 2/

Program: Section 223(e)--Mortgage Insurance-Housing in Older, Declining Areas.

Authorization: National Housing Act, as amended in 1968.

Purpose: To help families purchase or rehabilitate housing in older, declining urban areas.

Type of assistance: Insured loans.

Coverage: Loans may be used to finance the purchase, repair, rehabilitation, and construction of housing in older, declining urban areas where conditions are such that certain normal eligibility requirements for mortgage insurance under a particular program cannot be met. The property must be an acceptable risk giving consideration to the need for providing adequate housing for low- and moderate-income families.

Maximum Terms: The maximum amount of the loan, the downpayment, and other mortgage terms vary according to the HUD/FHA program under which the mortgage is insured.

Subsidy: None

Number of units insured (000):

Before 1960	--
1960 - 1969	51
1970 - 1975	113
Total	164

Insurance in force (12/31/75):

$1,483 million
101,422 cases

Insurance Reserve position 1/: $-394 million.

Program: Section 235(i)--Interest Subsidy-Homes for Lower Income Families.
Single-family - Subsidized

Authorization: National Housing Act, as amended in 1968.

Purpose: To make homeownership more readily available to lower income families by providing interest reduction payments on a monthly basis-payments to lenders on behalf of the lower income families.

Type of assistance: Insured loans; direct interest reduction payments for specified use.

Coverage: Loans may be used to finance the purchase of new or substantially rehabilitated single-family dwellings or condominium units approved prior to beginning of construction or beginning of substantial rehabilitation.

Maximum terms: Maximum insurable loans for an occupant mortgagor are as follows: 3-bedroom home, $21,600, or up to $25,200 in high cost areas. For a large family, the limit for a 4-bedroom home is $25,200, or up to $28,800 in high-cost areas.

3 (cont.)

Subsidy: Direct interest reduction payments, which under current regulations can reduce the homeowner's interest rate down to 5 percent.

Number of units insured (000):

Before 1960 =	--
1960 - 1969 =	23
1970 - 1975 =	434
Total	457

Insurance in force (12/31/75):

$6,547 million
360,824 cases

Insurance Reserve position 1/: $-741 million (includes small amount under Section 235(j))

Multifamily-unsubsidized

Program: Section 207--Basic Mortgage Insurance-Rental Housing.

Authorization: National Housing Act, as amended in 1938.

Purpose: To provide good quality rental housing.

Type of Assistance: Insured loans.

Coverage: Insured mortgages may be used to finance the construction or rehabilitation of rental detached, semidetached, row, walk-up, or elevator type structures with 8 or more units.

Maximum terms: The unit mortgage limits for non-elevator apartments are as follows: efficiency $13,000; one bedroom, $18,000; two bedrooms, $21,500; three bedrooms, $26,500; four or more bedrooms, $30,000. Limits per family unit are somewhat higher for elevator apartments. In areas where cost levels so require, limits per family unit may be increased up to 75 percent. The maximum maturity is 40 years.

Subsidy: None.

Number of units insured (000):

Before 1960 =	111
1960 - 1969 =	123
1970 - 1975 =	48
Total	282

Insurance in force (12/31/75):

$2,203 million
142,697 cases

Insurance Reserve position 1/: $-137 million

Program: Section 202--Housing for the Elderly and Handicapped.

Authorization: Housing Act of 1959, as amended by the Housing and Community Development Act of 1974.

Purpose: To provide for rental or cooperative housing and related facilities (such as central dining) for the elderly and handicapped.

4 (cont.)

Type of assistance: 40 year direct loans.

Coverage: Direct loans may be used to finance the construction or rehabilitation of rental or cooperative detached, semidetached, row, walk-up or elevator-type structures.

Maximum terms: The unit mortgage limits for non-elevator structures are as follows: efficiency, $12,300; one bedroom, $17,188; two bedroom, $21,525. The unit mortgage limits for elevator structures are as follows: efficiency, $13,975; one bedroom, $20,025; two bedroom, $24,350. In areas where cost levels so require, limits per family unit may be increased up to 75 percent. Maximum term is 40 years.

Subsidy: Subsidy payments under Section 8 housing assistance payments program. Tax incentives through rapid depreciation.

Number of units insured (000):

Before 1960 =	--
1960 - 1969 =	29
1970 - 1975 =	15
Total	44

Loans Outstanding (12/31/75):

$574 million
43,010 cases

Insurance Reserve position 1/: N.A.

Program: Section 213 Management Type--Mortgage Insurance-Management Type Cooperative Projects.

Authorization: National Housing Act, Section 213; Housing Act of 1950.

Purpose: To make it possible for nonprofit cooperatives to acquire housing projects to be operated as management-type cooperatives.

Type of assistance: Insured loans.

Coverage: Insured mortgages may be used to finance construction, acquisition of existing, or rehabilitation of detached, semi-detached, row, walk-up, or elevator type housing consisting of five or more units.

Maximum terms: The unit mortgage limits are as follows: efficiency, $13,000; one bedroom, $18,000; two bedrooms, $21,500; three bedrooms, $26,500; four or more bedrooms, $30,000. Limits per family unit are somewhat higher for elevator apartments. In areas where cost levels so require, limits per family unit may be increased up to 75 percent. Maximum maturity is 40 years.

Subsidy: None.

Number of units insured (000):

Before 1960 =	31
1960 - 1969 =	54
1970 - 1975 =	2
Total	87

Insurance in force (12/31/75):

$9,178 million
70,230 cases

Insurance reserve position 1/: $-33 million (includes all Section 213 projects).

Program: Section 221(d)(3) Market Rate--Mortgage Insurance-Rental Housing for Low and Moderate Income Families.

Authorization: National Housing Act, as amended in 1954.

Purpose: To provide good quality rental or cooperative housing within the price range of low- and moderate-income families.

Type of assistance: Insured loans.

Coverage: Insured mortgages may be used to finance construction or rehabilitation of rental or cooperative detached, semidetached, row, walk-up, or elevator structures, or to finance the purchase of properties which have been rehabilitated by a local public agency. Such housing must have five or more units.

Maximum terms: The unit mortgage limits for non-elevator apartments are as follows: efficiency, $11,240; one bedroom, $15,540; two bedrooms, $18,630; three bedrooms $23,460; four or more bedrooms, $26,570. Unit mortgage limits are somewhat higher for elevator-type structures. In areas where cost levels so require, limits per family unit may be increased up to 75 percent. Most rent supplement projects are built under this program although this program is also used independently of rent supplement. Maximum maturity is 40 years.

Subsidy: None.

Number of units insured (000):

Before 1960 =	4
1960 - 1969 =	66
1970 - 1975 =	261
Total	331

Insurance in force (12/31/75):

$3,697 million
261,931 cases

Insurance reserve position 1/: 2/

Program: Section 221(d)(4)--Mortgage Insurance-Rental Housing for Moderate Income Families.

Authorization: National Housing Act, as amended in 1959.

Purpose: To provide good quality rental housing within the price range of moderate income families.

Type of assistance: Insured loans.

Coverage: Insured mortgages may be used to finance construction or rehabilitation of detached, semidetached, row, walk-up, or elevator-type rental housing containing 5 or more units.

Maximum terms: The unit mortgage for non elevator apartments are as follows: efficiency, $12,300; one bedroom, $17,188; two bedrooms, $20,525; three bedrooms, $24,700; four or more bedrooms, $29,038. Unit mortgage limits are somewhat higher for elevator-type structures. In areas where cost levels so require, limits per family unit may be increased up to 75 percent. Rental rates must permit occupancy by moderate income families. The maximum maturity is 40 years.

Subsidy: None.

6 (cont.)

Number of units insured (000):

Before 1960 =	--
1960 - 1969 =	26
1970 - 1975 =	183
Total	209

Insurance in force (12/31/75):

$2,406 million
159,964 cases

Insurance reserve position 1/: 2/

Program: Section 234(d)--Mortgage Insurance-Construction or Rehabilitation of Condominium Projects.

Authorization: National Housing Act, as amended by the Housing Act of 1964.

Purpose: To enable sponsors to develop condominium projects in which individual units will be sold to home buyers.

Type of assistance: Insured loans.

Coverage: These loans may be used to finance the construction or rehabilitation of multifamily housing structures by a sponsor intending to sell individual units as condominiums, which also would be eligible for the benefits of mortgage insurance under this program.

Maximum terms: Maximum insurable loans are as follows: efficiency, $13,000; one bedroom, $18,000; two bedrooms, $21,500; three bedrooms, $26,500; four or more bedrooms, $30,000. Unit mortgage limits are somewhat higher for elevator-type structures. In areas where cost levels so require, the mortgage limits may be increased up to 75 percent. Mortgage term is 40 years.

Subsidy: None

Number of units insured (000):

Before 1960 =	--
1960 - 1969 =	3
1970 - 1975 =	31
Total	34

Insurance in force (12/31/75):

$12 million
1,402 cases

Insurance reserve position 1/: $-7 million.

Multifamily-subsidized

Program: Section 236--Interest Reduction Payments-Rental and Cooperative Housing for Lower Income Families.

Authorization: National Housing Act, as amended in 1968.

Purpose: To provide good quality rental and cooperative housing for persons of low- and moderate-income by providing interest reduction payments in order to lower their housing costs.

Type of assistance: Direct interest reduction payments; insured loans.

7 (cont.)

Coverage: Insured mortgages may be used to finance the construction or rehabilitation of rental or cooperative detached, semi-detached, row, walk-up, or elevator-type structures.

Maximum terms: The unit mortgage limits are as follows: efficiency, $11,240; one bedroom, $15,540; two bedrooms, $18,630; three bedrooms, $23,460; four or more bedrooms, $26,570. Unit mortgage limits are somewhat higher for elevator type structures. In areas where cost levels so require, limits per family unit may be increased up to 75 percent. Maximum term is 40 years.

Subsidy: Interest reduction payments that reduce interest rate to as little as 1%; tax incentives through rapid depreciation.

Number of units insured (000):

Before 1960 =	--
1960 - 1969 =	12
1970 - 1975 =	436
Total	447

Insurance in force (12/31/75):

$6,766 million
400,353 cases

Insurance reserve position 1/: $-636 million.

N. A. = Not available.

1/ Reserve position as of June 30, 1975 (excess of insurance reserves over estimated reserve requirements), in millions of dollars.

2/ Excess of reserves over estimated reserve requirements for the Section 221 program was $-1,784 million* as of June 30, 1975. The following is a breakdown within the Section 221 housing insurance program shown in millions of dollars:

Section 221 Housing Insurance	Est. Reserve Requirements	Insurance Reserves Available
Section 221 - Homes	$192.6	$ -668.8
Section 221h - Homes	.5	
Section 221 - Projects Market	231.4	-606.7
Section 221 - Projects Below Market	92.4	
Section 221h - Projects Below Market	.5	
Total Section 221	$517.6	$-1,275.5

*Includes an adjustment of $9.7 million for unearned premiums as of June 30, 1975.

Mortgages Insured by FHA 1-4 Family Homes
1970-1975
(Units)

	1970	1971	1972	1973	1974	1975
Total (All Programs)	518,337	608,166	452,747	251,636	205,166	266,994
Sec. 203	303,773	332,495	230,484	135,281	151,212	226,230
203(K)	33	28	11	2	3	5
213	3	3	--	--	--	--
220	220	136	77	17	27	25
220(h)	--	--	--	--	2	--
221	94,499	115,407	87,587	50,669	34,625	28,045
221(h) BMR	845	327	61	41	7	13
221(i) Condo.	--	2	2	1	1	2
222	7,766	8,841	7,036	3,073	2,845	3,932
233	30	30	30	27	56	26
234	3,058	4,292	6,232	3,399	1,647	2,310
235(i)	106,895	144,612	119,524	58,034	14,119	5,912
235(j)	170	821	649	370	197	90
237	827	906	816	631	371	278
240	3	1	--	--	--	--
809	215	265	238	91	54	126

Source: Department of Housing and Urban Development.

Multifamily Projects Insured by FHA
1970-1975
(Units)

	1970	1971	1972	1973	1974	1975
Total (All Programs) 1/	**200,922**	**222,685**	**188,224**	**120,414**	**54,820**	**38,044**
Sec. 207	15,905	14,167	10,034	4,513	2,084	1,449
207 Mobile	(15,604)	(27,050)	(10,695)	2,807	1,265	(862)
213 Management	1,004	140	--	171	42	10
220 Rental	1,734	3,597	1,892	1,163	935	731
220(H) Imp. Loans	--	--	--	--	--	--
221 Market Rate	44,853	79,222	61,570	42,401	19,060	14,349
221 BMR	19,250	6,687	1,218	86	--	--
221-H Rehab Sales	889	129	13	--	84	--
223(d) 2-Year Opr. Loss Loans	(121)	--	--	(200)	(631)	(969)
231	190	190	775	783	600	621
232	(12,748)	(11,605)	(10,439)	(7,051)	(5,356)	(6,409)
233	202	2,073	724	333	--	354
234	3,722	7,461	8,999	6,386	2,741	1,277
235(i)	725	668	229	135	35	5
236	112,448	108,351	102,770	64,443	29,239	18,840
241 Supp. Loans	(790)	(988)	(321)	(671)	(755)	(368)
242	(2,378)	(4,491)	(4,887)	(5,154)	(4,112)	(3,691)
Title X	(15,382)	(1,595)	(255)	--	--	(762)
Title XI	(125)	(41)	(138)	(105)	--	(343)
213(j) Supp. Loans	(223)	--	--	--	(384)	--
207 Nursing Homes	(191)	--	--	--	--	--
223(f)	--	--	--	--	--	408

1/ Figures in parentheses are not included in total units since they represent spaces in mobile home courts, beds in nursing homes and hospitals, urban land development and supplemental loans.

Source: Department of Housing and Urban Development.

DATE DUE

NOV	1991		