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the F.H.A.

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LOCAL HOUSING MARKET ANALYSIS: ITS FUNCTION AND OPERATION IN THE FHA

By Warren J. Lockwood*

UPPERMOST in the minds of mortgage lenders today is the high price at which real estate is being sold and financed. The levelling of the real estate cycle and a return to the financing of housing on the basis of sound, long-term values is a development to which builders and lenders, alike, must look forward and for which all of us in the housing business must be prepared.

The concern, as well as the responsibility, of the Federal Housing Administration in the present transition period is probably best illustrated by FHA's take in urban residential real estate which totals some 4.4 billion dollars of insured mortgages, or nearly one-fifth the outstanding institutional mortgage debt on small homes in America. 1/

It is in recognition of the need for more complete and thorough research of the economic forces supporting the mortgage debt structure of each community that the FHA is expanding its program of local housing market analysis.

By keeping ourselves adequately and currently informed of the changing position of the over-all residential real estate market and the economic forces that support the market in each community, I am convinced that each of us will have a better chance of accomplishing our individual objectives. At the same time, individual policies and actions based on judgment, which is guided by accurate facts and analysis, are bound to contribute, both locally and nationally, to a stronger and more stable housing market as a whole.

FUNCTION OF MARKET ANALYSIS

When the National Housing Act of 1934 created the Federal Housing Administration, the insurance of home mortgages was for all practical purposes an entirely new field for either government or private business. Though this activity was practically without precedent in the United States, many of FHA's problems are common to the operations of any large business organization.

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* Assistant Commissioner, Federal Housing Administration. This article, which appeared in slightly different form in FHA's Insured Mortgage Portfolio (Third Quarter 1948), was prepared with the assistance of Douglas V. Cannon, Housing Market Analyst, in the Survey and Analysis Section of the Division of Research and Statistics.

1/ The unamortized amount of mortgages on 1- to 4-family homes insured under Sec. 203 and Sec. 603 of the National Housing Act totalled $4,430,396,000 as of June 30, 1948. At the end of the same period, the Federal Reserve Board reported a record level of $32,800,000 of home mortgages debt outstanding, including the holdings of both institutional lenders and of individuals and others. (See "Real Estate and Construction Markets", Federal Reserve Bulletin, July 1948, p. 762.

A major problem that faces every businessman, operative builder, or mortgage lender is how to minimize or reduce risks, consistent with an adequate volume of business, and thereby place his enterprise on a sounder operating basis. The FHA is confronted with this same basic problem.

The organization established to carry out the responsibilities of the FHA was set up in direct line with the long-range objectives of the National Housing Act which were two-fold: (1) to encourage improvement in housing standards and conditions, and (2) to assist in establishing and maintaining a sound mortgage market by providing a system of mutual mortgage insurance. It is apparent that in creating the mutual mortgage insurance system the Congress recognized that many of the risks in mortgage lending could and must be minimized.

The Underwriting Division of the FHA has established standard criteria and techniques for assembling and evaluating certain data considered to be important in judging the extent of risk and soundness of a mortgage loan, i.e., data concerning the property, the borrower, and the neighborhood or location, as well as their relationship to one another and to the terms of the mortgage contract. 2/

To meet those objectives of the National Housing Act which call for improvement in our housing standards and conditions, the FHA has set minimum standards to assure the building of structurally sound dwellings in suitable neighborhoods; and, further, it has set certain safeguards to protect home owners from assuming mortgage obligations beyond their capacity to pay. This process of measuring and evaluating risks has come to be known as the FHA "risk rating technique".

In addition to the basic objectives of raising the Nation's housing standards, and of establishing a plan of mortgage insurance that would minimize financial risk to both borrower and lender, FHA's legislation under Title II requires that no mortgage shall be accepted for insurance unless the Commissioner finds that "the project with respect to which the mortgage is executed is economically sound". 3/ To assist the Commissioner in carrying out this responsibility, as well as other responsibilities under the Act, he is further authorized to develop "such statistical surveys and legal and economic studies as he shall deem useful to guide the development of housing and the creation of a sound mortgage market". 4/

What is the test of economic soundness as applied to an individual mortgage transaction and to a community's mortgage or housing market?

2/ For a complete description of FHA's criteria and techniques for underwriting analysis under Title II, Sec. 203 of the National Housing Act, see Federal Housing Administration, Underwriting Manual, revised January 1, 1947 (Washington, D. C.: FHA Form 2049.)
3/ National Housing Act, Title II, Sec. 203(c) and 207(c).
4/ National Housing Act, Title II, Sec. 209.

No hard and fast answer can be given to this question. Generally speaking, it may be said that an economically sound transaction or project is one that presents no evidence of a significant degree of financial risk to any of the parties in interest; one in which the property involved is structurally sound, suitably located, and designed to provide functional adequacy for prospective occupants; and one that holds promise of not having an adverse effect in its impact upon the community.

Most home builders and mortgage lenders would agree that, without an understanding of the economic forces which determine changes in demand and supply relationships and hence the price of a community's housing, a program of mortgage insurance would be a hazardous undertaking at best. It stands to reason that, however well considered individual property and neighborhood appraisals might be, or however careful might be the selection of borrowers, our knowledge of mortgage risk would be inadequate without an analysis of the stability and strength of the economic forces in the community which support the housing market.

HISTORY AND OPERATION OF MARKET ANALYSIS

To assist in the determination of economic soundness, the FHA initiated in 1936 a housing market analysis program under the direction of its Division of Research and Statistics. In the initial period of its operations, when new techniques and surveys and analyses had to be designed and tested, the program functioned out of Washington. From 1938 to the middle of 1942 the program was operated at a geographic zone level, and efforts at that time were directed mainly toward preparation of comprehensive base studies for the use of both Washington headquarters and the Administration's local insuring offices.

In July 1942, with the building industry under complete wartime priorities controls, the housing market analysis program was transferred to the National Housing Agency to assist in determining the emergency housing needs in the war production localities of the country.

With the end of the war and the termination of war housing priorities, the Federal Housing Administration reactivated its program of local housing market analysis. Perhaps at no time in the Administration's history has there been a more urgent need than at present for the type of service that this program is designed to render.

The program of market analysis aims primarily to assist FHA's administrative offices and underwriting technicians in the field, i.e., those at the local level who have the direct responsibility of selecting mortgages for insurance--mortgages selected not only on the basis of risks involved in each transaction but also from the standpoint of the risks inherent in the housing market as a whole.

Through this program, FHA's 68 Insuring Offices 5/ are provided with economic facts and analytical interpretations that aid in underwriting determinations which require consideration of conditions in the over-all housing market.

Much of the strength of the mutual mortgage insurance system, particularly the wide marketability that FHA-insured loans enjoy among mortgagees, is believed to be due in no small measure to the complete and thorough analysis of risk made by FHA field offices.

The work of FHA's housing market analysts does not end with a local survey and analysis. A local analysis serves merely as a benchmark which provides at a given time basic data pointing up economic factors and trends of importance in that locality. Because of the dynamic character of a housing market, the measurement of demand-supply relationships and of factors that influence changes in the market is a continuing process. This is true particularly in the large metropolitan areas where the complexity of economic and social forces requires almost constant observation and measurement of changes in the market.

In addition to providing direct technical assistance to FHA's field offices, the Administration's program of housing market analysis encourages the formation of local residential research committees.6/ This activity of the program rests on the conviction that the collection and assembly of data necessary to an analysis of a local housing market is a function which can be performed best through groups of local residents whose economic and social interests are directly related to the stability and sound development of their communities.

BASIC FACTORS AND TRENDS ANALYZED

Local Housing market analysis recognizes that communities and their housing markets, like people, are of diverse types. Each is supported by different resources and industries, and each is influenced by different factors and in varying degree by changes in the regional and national economy. While no community is entirely immune to major changes in the regional and national economy, experience has demonstrated that reaction to these changes varies, both in time and in intensity, from locality to locality.

Specifically, what are some of the basic factors and trends that a housing market analyst examines and reports upon when evaluating the economic position of a local housing market?7/

5/ As of December 15, 1948, FHA's operations were channelled through 68 State and District Insuring Offices, 13 Service Offices and 39 Valuation Stations.

6/ For the experience of such a committee in Los Angeles, Calif., See the FHA Insured Mortgage Portfolio, Second Quarter 1948, Vol. 12, No. 4, p.9 of this issue. For the experience of Memphis, Tenn., see V.12, No. 2 p. 5.

7/ For a complete outline of a comprehensive housing market analysis, and a listing of sources of basic data, see Federal Housing Administration, Selected Sources of Basic Housing Statistics for Use in A Local Housing Market Analysis, (Washington, D. C.: FHA, Division of Research and Statistics, May 1948)

(a) Economic support and outlook.--The economic forces on which the existence of a community depends largely determine the character and activity of the local housing market. Evaluation of these forces requires consideration of both the productive resources of the hinterland, such as mining and agriculture, and the manufacturing and trade activities in the community itself. Special consideration must be given to the degree of diversification between major industry groups, types of manufacturing (e.g., heavy, light, semidurable), and the importance of individual firms. A city's competitive advantages for industry and trade, as compared with other nearby cities, and the growth or decline of population and purchasing power in the trade area are also important considerations in determining a community's economic position and outlook.

(b) Stability of employment and income.--Trends in employment, unemployment and income are considered to be among the most far-reaching indicators of economic change in a community's housing market. Continuing high or increasing rates of unemployment, accompanied by a reduction in income and savings, may be the forerunner of vacancies, mortgage delinquencies, and foreclosures. Analysis of the distribution and trends of family income contributes to an understanding of the marketability of homes at various rent and price levels.

(c) Population growth and family formation.--Population is one of the primary factors to be considered in an analysis of housing market conditions and prospects. Of even greater direct importance in terms of pressure on the housing supply is the rate of family formation. The number and trend of families, including "doubled-up" families, suggests the potential need for dwelling units, whereas the trend of family composition suggests the need for units of various sizes and types.

(d) The housing inventory and changes in supply.--The problem of "taking inventory" of a community's housing supply is mainly one of measuring the number and physical condition of dwelling units, the types and location of structures, and the size of units added to the supply since the 1940 Census of Housing. "Guess-timates" of these changes are inadequate for market analysis purposes. Accurate community records are needed to measure the physical volume and types of residential building activity throughout all sections of a housing market area.

(e) Vacancy, occupancy, and the unsold inventory.--The level and trend of vacancy, both in the existing supply of housing and among completed but unsold new units, is one of the most significant measures of the balance or lack of balance between demand and supply of housing. Evaluation of this important factor would be incomplete, however, without a knowledge of long-term as well as short-term trends of vacancy in both singlefamily and multifamily structures. Measuring and appraising the trend of tenure, likewise, is important to a consideration of the demand for rental housing projects in a community.

(f) Rents, sales prices, and building costs.--The relation of building costs, hence prices and rents, to incomes determines to a very large extent the size of a community's market for new housing.

Normally, the higher the price of newly built houses in relation to incomes, the smaller is the segment of the population which can buy or rent them. Examination and analysis of the pattern and trend of prices and rents in relation to income will help builders to avoid saturating a market with an excess of high-priced dwellings, while at the same time undersupplying a market with houses in the medium and low-cost brackets.

CONCLUSION

In conclusion, I would like to point out that today we have what may be considered the greatest challenge in the history of the home-building industry and its related field of real estate finance.

The challenge, as I see it, is to achieve a proper balance between a "sellers' market", with accompanying inflation of property values such as we are experiencing today, and a "buyers' market", with accompanying surpluses of housing and depressed property values such as we experienced in the 30's and which we hope to avoid in the future.

I believe that the best protection to the home owner and to the mortgage lender, as well as to the residential building industry as a whole, lies in those policies which provide for a stabilized level of activity between the two extremes. The purpose of the Government's insurance of mortgages is not only to assist and protect individuals in meeting their housing and financial needs, but, beyond that, to provide such assistance in a well-considered and business-like manner with full regard for the over-all risks to each community.

For the sake of giving emphasis to this conclusion, I would like to repeat a statement made earlier in this article:

> "By keeping ourselves adequately and currently informed of the changing position of the over-all residential real estate market and the economic forces that support the market in each community, I am convinced that each of us will have a better chance of accomplishing our individual objectives. At the same time, individual policies and actions based on judgment, which is guided by accurate facts and analysis, are bound to contribute, both locally and nationally, to a stronger and more stable housing market as a whole."

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