Issue Brief

FHA's Impact on Increasing Homeownership Opportunities For Low-Income and Minority Families During the 1990s

FHA provides mortgage insurance to encourage lenders to make homeownership possible for people who need lower down payments and more flexible underwriting than are permitted by the private conventional market. FHA's role in expanding homeownership and its ongoing contributions to affordable lending are reviewed in this paper, which finds that low-income and minority groups continue to rely heavily on FHA for access to homeownership, even though conventional lenders substantially improved their affordable lending performance during the 1990s. Significant income and racial gaps in homeownership, combined with the fact that minorities are becoming a larger share of our population, suggest that a strong FHA is needed to ensure that all families have access to mortgage credit and the dream of homeownership.

The following sections describe: (1) the increase in homeownership during the 1990s; (2) the traditional role of FHA in serving first-time homebuyers with little cash for down payment; (3) the characteristics of borrowers who use FHA and conventional loans; (4) the market share of FHA in major segments of the mortgage market; and (5) policy initiatives that have recently strengthened the FHA single-family mortgage insurance program.

Increased Homeownership During the 1990s

There was a remarkable turnaround in homeownership during the 1990s. After declining in the early eighties and then remaining virtually unchanged through the early nineties, the homeownership rate increased from 64.0 percent in 1993 to 66.8 percent in 1999. By the third quarter of year 2000, the homeownership rate had further risen to 67.7 percent, surpassing the national homeownership goal of 67.5 percent that the Administration set in 1994. As a result of a rising homeownership rate and the nation's growing population, a total of 71.6 million families owned homes in the third quarter of 2000, which represented almost 10 million more homeowners than in 1993.

This remarkable turnaround in the homeownership rate is attributable to both broad economic factors and to specific policy initiatives. Strong economic growth and low unemployment boosted consumer confidence to record levels and encouraged many families to consider homeownership for the first time. Record low interest rates during this economic expansion made homeownership accessible to millions of Americans. The Administration reinforced these economic incentives with policy initiatives focused on broadening homeownership. The Administration's increased enforcement of the Community Reinvestment Act and the Home Mortgage Disclosure Act encouraged conventional lenders to introduce affordable lending programs targeted to low-income families and their communities. The Department of Housing and Urban Development (HUD) used its oversight of Fannie Mae and Freddie Mac to encourage those entities to reach out to low-income borrowers and underserved neighborhoods. Moreover, HUD made improvements in its Federal Housing Administration (FHA), such that a revitalized FHA substantially increased lending to African-Americans, Hispanics, and other traditionally underserved groups and, in doing so, worked to increase homeownership opportunities of these segments.

The Traditional Role of FHA

FHA's 203(b) mortgage insurance program, the centerpiece of FHA's single-family business, has helped over 30 million families purchase homes over the past six decades. The program's low-downpayment requirements and liberal income qualification guidelines combined with its flexible credit underwriting make it a unique mortgage product, particularly when compared with the more restrictive conventional programs. In fact, FHA has traditionally been the mechanism used by borrowers who have found it difficult to obtain mortgage financing in the private conventional market. FHA has long been recognized as the major source of funding for first-time, low-income and minority homebuyers. As explained later, while FHA insured one-fifth of all home purchase loans in 1999, it insured over two-fifths of home loans for African-American and Hispanic borrowers. FHA accomplishes its mission of increasing homeownership in an actuarially sound manner – the insurance premiums that it charges cover any losses due to borrower defaults. No Federal subsidy is required to operate FHA.

The continuing need for a strong FHA is reinforced by the serious gaps in homeownership that remain even after the record progress of the past six years. In 1999, the homeownership rate (46.7 percent) for African-American families was 26.5 percentage points lower than the homeownership rate (73.2 percent) for white families. The homeownership gap for Hispanic families was slightly greater, 28.7 percentage points. In 1999, households with income less than the median income had a homeownership rate (51.2 percent) that was 27.4 percentage points lower than the homeownership rate for households with above median incomes (78.6 percent). The nation's population is becoming more racially diverse, which reinforces the need for FHA to ensure that minorities are not shut out of homeownership due the difficulty of accessing mortgage credit.

FHA Focuses on Underserved Borrowers and Neighborhoods

Comparing the characteristics of FHA and conventional borrowers demonstrates the unique nature of the FHA product. Compared with a conventional loan, an FHA loan is much more likely to be a low downpayment loan originated for a low-income or minority or first-time homebuyer who possibly has a below-average credit record and lives in an underserved neighborhood.

Borrowers With Little Cash for a Down Payment. FHA benefits homebuyers who have insufficient cash to meet the downpayment and closing costs requirements of conventional lenders. Almost two-thirds of FHA borrowers make a down payment of less than five percent. Only a small percentage of conventional borrowers place less than five percent down. According to the Federal Housing Finance Board, six percent of conventional home purchase loans had down payments less than five percent in 1999.

Borrowers With a Below-Average Credit History. FHA will accept borrowers with non-traditional or slightly blemished credit history. In 1996, one-fourth of FHA borrowers had a FICO score of less than 620, compared with only 7 percent of conventional borrowers. The FICO index provides one overall measure of a person's credit history, with higher scores indicating a better payment record.

First-time Homebuyers. FHA primarily serves first-time homebuyers, who have had the least opportunity to accumulate the wealth and income necessary for purchasing a home. First-time buyers accounted for 82 percent of all home purchase loans insured by FHA during 2000. First-time homebuyers account for less than 50 percent of all home purchase loans nationwide.

FHA expanded its traditional role of helping first-time homebuyers during the 1990s. The share of FHA-insured home purchase loans going to first-time buyers increased from 67 percent in 1993 to 82 percent in 2000. In total, over this period, FHA helped 4.3 million first-time homebuyers realize their dream of homeownership.

Low-income and Minority Homebuyers. As shown in Table 1 (attached at end of paper), FHA insures low-income and minority borrowers at much higher rates than they are funded in the conventional market.[1] According to HMDA data for 1999, low-income borrowers accounted for almost one-half of FHA-insured home loans in metropolitan areas, compared with only 30 percent for the conventional conforming market.

[1] The FHA data reported in Table 1 are taken from lender reports as required by the Home Mortgage Disclosure Act (HMDA); the HMDA data are for home purchase loans originated in metropolitan areas. HMDA data, rather than FHA's own data, are used here in order to provide consistent comparisons with the conventional market data (also reported by HMDA). FHA's own data show similar percentages to those reported in this section.

FHA particularly benefits African-American and Hispanic families who face the most difficulty obtaining conventional loans. The share of FHA home purchase loans accounted for by these two groups of borrowers equaled 33.9 percent during 1999. By comparison, African-American and Hispanic borrowers accounted for only 12.5 percent of home loans originated in the conventional conforming market and for 9.2 percent of home loans purchased by the GSEs.

FHA's service to minority borrowers expanded during the 1990s. As shown in Figure 1, the share of FHA loans for African-American and Hispanic borrowers increased from 22.2 percent in 1993 to 33.9 percent in 1999. Similarly, the share for all minorities increased from 25.3 percent in 1993 to 37.7 percent in 1999 when almost two out of every five FHA loans were originated for a minority family.

Properties in Underserved Neighborhoods. A greater percentage of FHA loans finance properties in low-income and high-minority neighborhoods than conventional loans. As shown in Table 1, low-income census tracts accounted for 18.2 percent of FHA loans insured in metropolitan areas during 1999, compared with only 11.3 percent of conventional conforming loans and 8.2 percent of GSE loans. Over 40 percent of FHA loans financed properties in underserved neighborhoods, compared with only 26 percent of conventional conforming loans and 21 percent of GSE loans.

The importance of FHA in financing homeownership for traditionally underserved families can best be seen by examining market share data, which is presented next.

FHA Covers a Large Share of the Underserved Mortgage Market

The above section showed that compared with conventional borrowers, FHA's borrowers are more likely to be lower-income, a minority, or live in an underserved area. A related issue concerns FHA's share of overall lending for these disadvantaged groups, for example, does FHA account for a small or large percentage of total lending for minority borrowers. This section discusses the importance of FHA in the overall affordable lending market. Analysis of changes in FHA's market share during the 1990s is also interesting because of the substantial increase in conventional lending for underserved groups during that period.

During the 1990s, the conventional mortgage industry began offering a wide range of affordable lending programs designed to attract those who had not been adequately served through their traditional programs. The industry – including lenders, private mortgage insurers and the GSEs (i.e., Fannie Mae and Freddie Mac) -- started offering more customized products, more flexible underwriting, and expanded outreach to lower-income and minority borrowers. HMDA data suggest that these industry initiatives have increased the flow of credit to underserved borrowers. Between 1993 and 1999, conventional loans to low-income and minority families increased at much faster rates than loans to high-income and non-minority families. Conventional home purchase originations to African-American, Hispanic, and low-income borrowers more than doubled between 1993 and 1999.

Even with the substantial increase in conventional affordable lending during the 1990s, FHA has maintained – and in some cases even increased – its role in the low-income and minority mortgage market. As shown in Table 2, FHA accounted for about one-fifth of all home purchase loans originated in metropolitan areas during 1999. Its market shares for the various underserved groups, however, were much higher:

- FHA accounted for 42 percent of all home purchase loans to African-American and Hispanic borrowers in 1999, that is, two out of every five loans originated for these groups were insured by FHA;

- FHA accounted for one-third of home loans originated for all minorities during 1999; and

- FHA accounted for three out of every 10 home loans originated for low-income borrowers and for properties in underserved neighborhoods.

Figure 2 presents FHA's market shares for the years 1993 to 1999. Even with the increase in conventional lending during that period, FHA's share of the mortgage market for African-American and Hispanic borrowers actually increased, from 39.2 percent in 1993 to 42.2 percent in 1999. FHA's shares of the low-income borrower and underserved areas markets were about the same in 1999 as they were in 1993. Thus, while the conventional market has been improving its affordable lending performance, there has been no displacement of the important role that FHA has traditionally played in providing access to mortgage credit for historically underserved borrowers.

FHA Policy Initiatives

Because of the importance of FHA insurance for those groups with large housing gaps, HUD has taken a number of steps to enhance the usefulness of FHA insurance.

Lower Insurance Premiums. FHA continues to be actuarially sound. In the last actuarial review, Deloitte & Touche estimated FHA's insurance fund to have a capital ratio of 3.66 percent at the end of fiscal year 1999, which is substantially higher than the statutory minimum of two percent.[2] In addition, they projected that FHA's capital surplus would continue to grow. Because of this capital surplus, FHA decided to reduce its mortgage insurance premiums beginning in January 2001. The upfront premium requirement has been reduced from 2.25 percent to 1.50 percent, resulting in a present value savings of $750 on a $100,000 mortgage. In addition, the period over which the annual premium of 50-basis-points has been shortened. These

[2] Deloitte & Touche, *Actuarial Review of the MMI Fund as of FY 1999*. Submitted to the U.S. Department of Housing and Urban Development, 2000.

premiums will be collected only until the mortgage has amortized to a 78 percent loan-to-value ratio, which is in line with practices in the conventional private insurance market. For a $100,000 mortgage starting with a 97 percent loan-to-value ratio which is held for the full 30 years, this change reduces premium payments by an additional $844 in present value terms. Actuarial projections by Deloitte and Touche for the years 2001-2006 indicate FHA's insurance fund is expected to maintain its capital ratio significantly in excess of three percent under the new premium structure and under a variety of economic conditions.

Higher Loan Limits. Prior to late 1998, dollar loan limits on FHA mortgages were set at 95 percent of area median home sale price within a county and ranged between a statutory minimum of 38 percent of the conforming loan limit for conventional loans purchased by Freddie Mac or Fannie Mae and a statutory maximum of 75 percent of the conforming limit. At HUD's request, Congress raised the respective statutory minimum and maximum limits to 48 and 87 percent of the conforming limit, respectively.[3] This increase in loan limits made the benefits of FHA mortgage lending accessible to many more families throughout the country, particularly those in high cost areas, who had been unable to utilize the more restrictive conventional mortgage products. Currently, FHA loan limits for one-unit properties vary by the price of housing across the country and range from a nationwide minimum of $132,000 up to the statutory maximum of $239,250.

Faster Processing – FHA Service Centers. FHA used to disperse its processing of loans across 81 separate field offices throughout the country. However, over the last several years FHA has consolidated and streamlined its mortgage insurance operations and endorsement processing into four regional Homeownership Centers (HOCs), located in Atlanta, Philadelphia, Denver, and Santa Anna. The new consolidated structure has provided numerous opportunities to take advantage of economies of scale and improve consistency of FHA's operations.

Greater Flexibility in Using Gifts for Down Payments. FHA has long been more flexible in its policy on using gifts for down payments. FHA policy with respect to gifts allows a borrower to pay the entire down payment from gift funds. This policy is substantially more lenient than what is allowed in the conventional mortgage market.

Simplified Calculation of Down Payments. In late 1998, FHA persuaded Congress to authorize a simpler method for calculating the minimum down payment required for an FHA mortgage. Under the new process, the FHA borrower is required to put a minimum cash investment of 3 percent of the purchase price toward the acquisition cost of the home (price plus closing costs) and whatever additional cash is required to achieve a maximum LTV percentage that varies with loan size and whether the property is located in a state with high closing costs.

[3] Congress also switched from county specific limits within an MSA to a single MSA-wide limit equal to the limit for the county within the MSA having the highest median home sales price.

Strengthening the Appraisal Process. FHA has made substantial reforms to strengthen the appraisal process and help FHA borrowers. Recent reforms have included measures to assure that appraisals are performed more diligently as well as a requirement that appraisers notify homebuyers about any observable defects in the house. The new process also requires a notice advising the homebuyer to obtain a professional inspection.

Automated Underwriting Through Freddie Mac and Fannie Mae. FHA worked with both Freddie Mac and Fannie Mae to make available automated underwriting of borrower mortgage applications to speed the process for many borrowers and to allow for more efficient targeting of lender resources to help in qualifying more marginal FHA applicants. Automated underwriting of FHA loans has been available through Freddie Mac since March of 1998 and through Fannie Mae since August 1999.

FHA Mortgage Scorecard. FHA has been involved in developing and testing its own FHA mortgage scorecard that will be used in the Freddie Mac and Fannie Mae systems as well as any other system offering automated underwriting of borrower credit for FHA loans. FHA is on the verge of bringing its new mortgage scorecard to the market. The new scorecard will offer a uniform credit risk evaluation to identify applicants who can be credit approved without a traditional underwriter review. The scorecard is designed to accept applicants for expedited processing and documentation waivers; other applicants will be afforded a full traditional credit underwriting.

Figure 1
Minority Share of FHA Home Loans

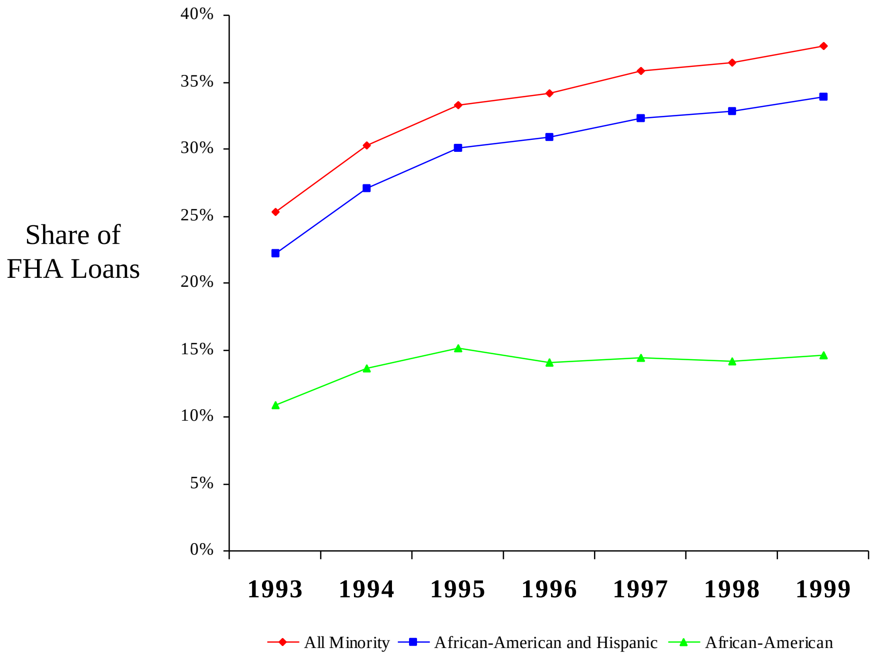
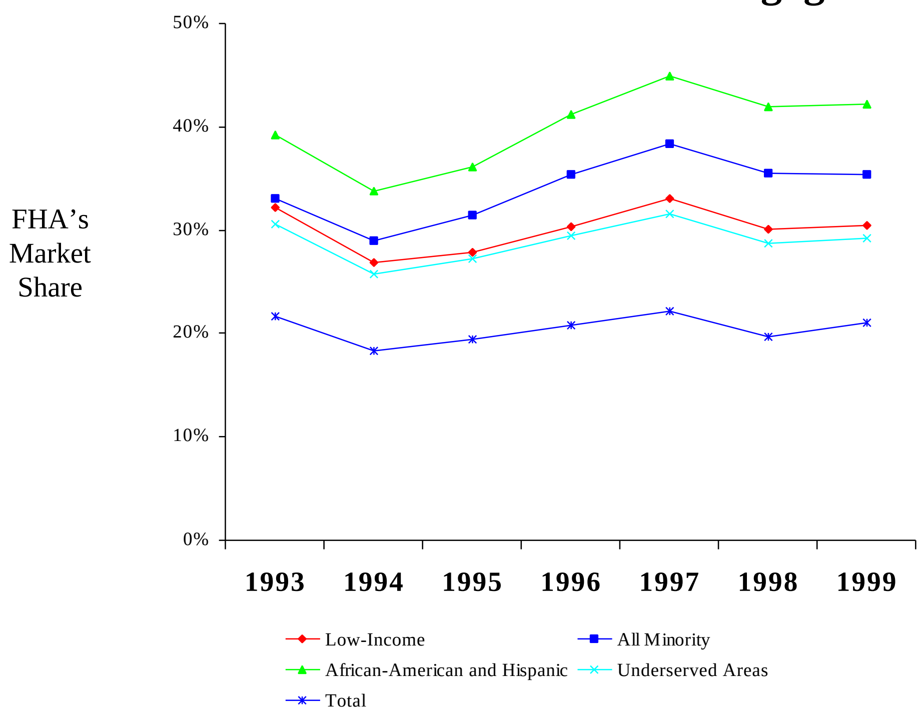


Figure 2
Trends in FHA's Share of Mortgage Market



Source: HMDA data for home purchase loans in metropolitan areas.

Table 1

Affordable Lending Shares for Major Sectors of the Home Purchase Mortgage Market in Metropolitan Areas, 1999 Borrower and Neighborhood Characteristics

	Characteristic as a Percent of:			
Borrower Characteristics	Total Market	FHA	GSEs	Conventional Conforming Market
Low-Income	34.3 %	49.5 %[1]	24.4 %	30.1 %
African American	7.9	14.6	3.4	5.4
Hispanic	9.7	19.3	5.8	7.1
African American and Hispanic Combined	17.6	33.9	9.2	12.5
Minority	23.4	37.7	16.3	19.0
Neighborhood Characteristics				
Low-Income Tract	12.7 %	18.2 %	8.2 %	11.3 %
High-Minority Tract	17.5	26.0	12.5	15.1
High African-American Tract	5.7	8.9	3.2	4.8
Underserved Areas	29.1	40.5	20.9	25.8

Notes: All the data are for home purchase mortgages in metropolitan areas as reported in HMDA (except for the GSE data which are reported by the GSEs to HUD). The "Total Market" combines the government sector (FHA and VA loans) and the conventional conforming market. Thus, it includes all loans except "jumbo" loans above the conforming loan limit which was $240,000 in 1999. "GSEs" refer to mortgage purchases by Fannie Mae and Freddie Mac. "High Minority (African-American) Tract" is a census tract where minorities (African-Americans) comprise more than 30 percent of the population. "Low-income" is defined as less than 80 percent of area median income.

[1] Each percentage represents the share of a sector's portfolio accounted for by the borrower or neighborhood characteristic. For example, 49.5 percent of FHA-insured home loans during 1999 were loans for low-income borrowers.

Table 2

FHA's Share of Home Purchase Market in Metropolitan Areas, 1999

	FHA Share of Market
Low-Income Borrowers	31% [1]
African-American and Hispanic Borrowers	42%
All Minority Borrowers	35%
Low-Income Tracts	30%
High Minority Tracts	31%
Underserved Areas[2]	29%
All Home Purchase Loans	21%

Source: 1999 HMDA data for metropolitan areas. See Table A.1 for variable definitions.

Notes: The FHA figures refer to FHA's percentage share of all home purchase loans (except jumbo loans above the conforming loan limit) that were originated in metropolitan areas during 1999. Thus the "total market" in these calculations includes all (government and conventional) home purchase mortgages originated in metropolitan areas during 1999 that were below the conforming loan limit of $240,000. The analysis assumes that HMDA's coverage is the same for both FHA and non-FHA loans.

[1] That is, it is estimated that FHA insured for 31 percent of all home purchase loans that were originated during 1999 and were for low-income borrowers in metropolitan areas.

[2] Metropolitan census tracts with (1) median income less than or equal to 90 percent of AMI or (2) minority concentration greater than or equal to 30 percent and tract median income less than or equal to 120 percent of AMI.