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The Public Purpose of FHA

Roberto G. Quercia
Kevin A. Park
The University of North Carolina at Chapel Hill

Abstract

Recent reviews of the Federal Housing Administration's Mutual Mortgage Insurance (MMI) Fund find that the losses on its portfolio are projected to exceed the revenue from its existing insurance policies and its current capital resources. This article places the MMI Fund's "negative economic value" and recent draw on the U.S. Treasury in context and argues that the justification for federal mortgage insurance is the public purpose it serves by filling gaps the private sector leaves, thereby contributing to a healthy and stable housing market.

Introduction

The National Housing Act of 1934 created the Federal Housing Administration (FHA) to help stabilize the economy. In the depths of the Great Depression, up to 1,000 homes were foreclosed on *every day*, creating distress for American households and financial institutions (Wheelock, 2008). The Mutual Mortgage Insurance (MMI) Fund administered by FHA is supported through premiums that are in proportion to the outstanding loan amount and paid by the borrower. The mortgage insurance, backed by the full faith and credit of the U.S. government, provides coverage for the full amount of the loan. Relieved of the risk of loss in the event of default, lenders can more confidently extend credit at lower prices. FHA also popularized the 30-year, fixed-rate, fully amortizing mortgage that eventually became the staple of the American residential mortgage system. Along with a similar program administered by the Veterans Administration (VA), FHA insurance helped increase the homeownership rate from 43.6 percent in 1940 to 61.9 percent in 1960.[1]

[1] For a detailed history of FHA to the early 1990s, see Vandell (1995).

As a public insurance fund, FHA pools risks from where and when conventional mortgage credit is scarce, whether for underserved borrowers, regions, or time periods. For example, geographically uniform premium rates mean borrowers in thriving markets help support households in economically depressed regions. In addition, although each year's book of business is intended to be self-supporting, mandatory capital reserves in excess of projected losses allow for premiums collected from periods of growth to help compensate for unexpected losses when the market falters. FHA is currently reprising its Great Depression role with an elevated market share symptomatic of the weakness in the private conventional mortgage market. In keeping with its original purpose, FHA has maintained access to credit to stabilize the housing market.

The most recent reviews of FHA's financial position, however, found that the losses on its current portfolio were projected to overwhelm FHA's capital resources (Integrated Financial Engineering, 2012; OMB, 2013). Although FHA has struggled with managing some of its risks, these losses are primarily an indication of the enormous burden FHA has undertaken to stabilize a collapse in the national housing market unprecedented since the Great Depression.

This article outlines the importance of FHA's public purpose in maintaining an adequate supply of mortgage credit through regional and national downturns and provides context for understanding FHA's current financial condition. This article specifically examines so-called "forward" mortgages insured through the MMI Fund, as opposed to Home Equity Conversion Mortgages (HECMs), or "reverse" mortgages, which FHA also insures.[2]

The Current Financial Health of FHA

The MMI Fund stores its capital resources in two accounts: a *financing account* equal to projected costs and *capital reserves* for any remaining funds. With roughly $33 billion available to pay claims, the MMI Fund has enough capital to continue paying claims at the current rate for roughly 7 years. As U.S. Department of Housing and Urban Development (HUD) Secretary Shaun Donovan stated, "[T]his is not a cash problem; it is one of setting the right size of loan loss reserves aside" (Donovan, 2013: 6).

By contrast to cashflow accounting, the *economic value* of the MMI Fund is defined as the net present value of existing insurance policies, including projected revenue and claims during the life of those loans, and the amount of current capital resources. The federal budgeting process, overseen by the Office of Management and Budget (OMB) under the terms of the Federal Credit Reform Act of 1990, and a separate independent actuarial review required by the National Affordable Housing Act (NAHA) of 1990 determine the economic value.

NAHA also mandated that the MMI Fund maintain at least a 2-percent capital ratio, defined as the Fund's economic value as a share of its insurance-in-force.[3] These capital reserves allow for the

[2] HECMs were included in FHA's General Insurance Fund before fiscal year 2009 before being moved to the MMI Fund by the Housing and Economic Recovery Act of 2008. The actuarial reviews of the MMI Fund still analyze HECMs separately.

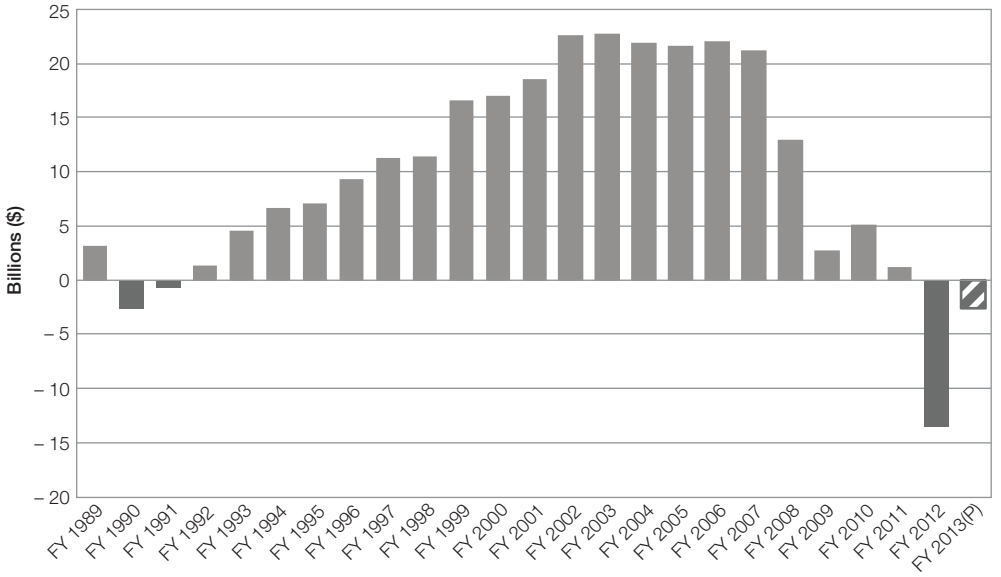
[3] NAHA instructs that the unamortized value of the insurance-in-force be used as the denominator.

Fund to weather unexpected increases in actual and projected losses on existing books of business. As recently as fiscal year (FY) 2007,[4] the Fund had a capital ratio of 6.4 percent—three times its mandated level of reserves. In the past 5 years, however, the economic value of loans endorsed by FHA has fallen by nearly $35 billion (see exhibit 1). At the same time, FHA more than tripled its level of insurance-in-force, from $332 billion to more than $1.1 trillion. The simultaneous decrease in the denominator and increase in the numerator caused the capital ratio to fall to less than 0.1 percent in FY 2011 and ultimately to -1.2 percent in FY 2012.

The last actuarial review projected losses on forward loans to eventually exceed projected revenues and current capital resources by nearly $13.5 billion. HUD's (2012) annual report to Congress noted these losses exceed those projected last year for three reasons: (1) a lower house price appreciation forecast (-$10.5 billion), (2) the continued decline in interest rates (-$8 billion), and (3) a refinement in methodology (-$10.2 billion). On September 30, 2013, FHA was required to draw $1.7 billion from the U.S. Treasury to cover losses on its forward loan and HECM portfolios (Galante, 2013b). FHA needed appropriations to cover its insurance activities for the first time in its history.

Exhibit 1

The Economic Value of the MMI Fund, FYs 1989–2013



FY = fiscal year. MMI = Mutual Mortgage Insurance. (P) = projected.

Note: Includes only forward loans.

Sources: Deloitte & Touche LLP; Integrated Financial Engineering Inc.; Szymanoski (2012)

[4] The fiscal year for the federal government begins in October of the previous calendar year (for example, FY 2013 begins on October 1, 2012).

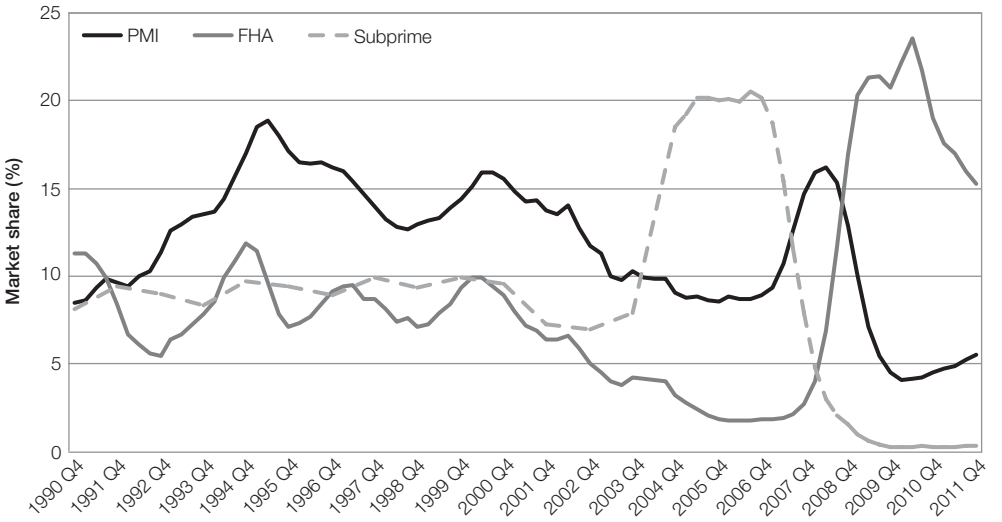
FHA in the Great Recession

As in previous recessions, FHA stepped up its operations in an effort to stabilize the housing market. Since 2008, FHA has helped 4.6 million households buy a home and nearly 3.2 million homeowners, including many who are under water, refinance to lower rates. In part, this assistance has been possible because Congress has repeatedly increased the maximum loan amount that FHA is permitted to insure. First, in 2006, Congress authorized FHA to insure loans of up to $200,160 and of up to $363,790 in high-cost housing markets. Then, in 2008, the Emergency Economic Stabilization Act and Housing and Economic Recovery Act (HERA) temporarily increased those limits to $271,050 and $729,750, respectively (HUD, 2012). These loan-limit increases allowed for FHA to serve a broader segment of the mortgage market. At the same time, private lenders substantially reduced access to conventional mortgage credit, leaving FHA as a last resort for American households. Even among mortgages of less than $200,000, FHA insured nearly four times as many loans in 2009 as it did in 2006, accounting for nearly 62 percent of the total increase in FHA endorsements in that period.[5]

The pattern of FHA's market share clearly demonstrates its countercyclical role (see exhibit 2). Between 1990 and 2003, private mortgage insurance (PMI) accounted for roughly 13 percent of the entire mortgage market by dollar volume, according to *Inside Mortgage Finance*. FHA accounted for less than 7 percent. Both types of insurers, however, lost market share during the housing bubble

Exhibit 2

Three Waves of Market Share: PMI, FHA, and Subprime, 1990–2011



FHA = Federal Housing Administration. PMI = private mortgage insurance. Q4 = fourth quarter.
Note: Four-quarter moving total by dollar volume.
Source: Inside Mortgage Finance

[5] Based on calculations of first lien purchase and refinance mortgages for owner-occupied, one- to four-unit properties using Home Mortgage Disclosure Act (HMDA) data.

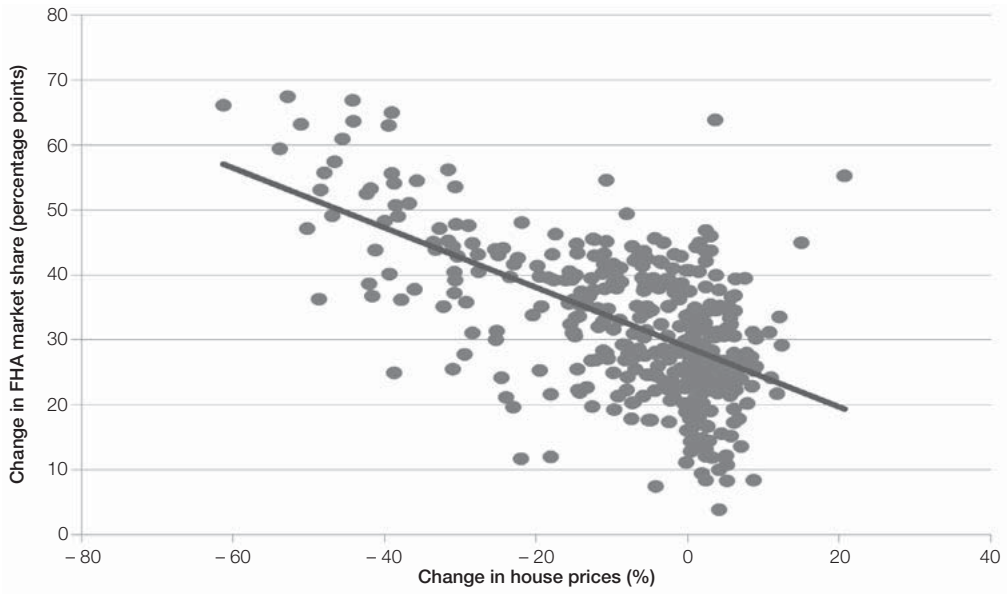
to subprime lenders that offered mortgages with high loan-to-value (LTV) ratios without mortgage insurance, sometimes using a subordinate, "piggyback" lien for the downpayment. Between 2004 and 2006, subprime lenders accounted for nearly 20 percent of new mortgage originations, whereas PMI fell to less than 9 percent and FHA to slightly more than 2 percent. As the housing market collapsed, PMI briefly regained its prebubble market share, but losses constrained its ability to continue serving the demand for new mortgage originations. Since the beginning of 2009, PMI has accounted for less than 5 percent of the market; meanwhile, FHA has accounted for as much as nearly 24 percent and for 19 percent on average.

FHA's countercyclical role is also evident from its geographical distribution. Private mortgage insurers implemented "distressed area" policies, making it almost impossible to obtain conventional mortgages with LTV ratios of greater than 90 percent in some regions of the country (Avery et al., 2009). By contrast, FHA does not vary its insurance premiums by region, creating an automatic regional stabilization policy.

A plot of FHA's market share change from 2006 to 2009 among owner-occupied home purchase mortgages reveals market share increased most in metropolitan areas that suffered the greatest decrease in house prices in the bust (exhibit 3). Although FHA typically had a very minor role in those markets during the runup, these markets were the most severely cut off from conventional credit when the crisis hit and therefore benefited most by FHA's revival. This finding is consistent with research that shows that FHA's market varies regionally by cyclical and permanent risk characteristics (Ambrose, Pennington-Cross, and Yezer, 2002; Immergluck, 2011).

Exhibit 3

FHA Lending Into "Distressed Markets," 2006–09



FHA = Federal Housing Administration.

Note: First lien home purchase mortgage originations for owner-occupied one- to four-unit properties.

Sources: Federal Housing Finance Agency; Home Mortgage Disclosure Act

By continuing to help finance mortgages even as house prices fell and unemployment rose, FHA fulfilled its public mission to step in when and where the private market fails. According to estimates by Moody's Analytics, if FHA had stopped insuring new mortgages in October 2010, by the end of 2011 house prices would have fallen another 25 percent, new and existing home sales would have fallen an additional 40 percent, and new home construction would have dropped 60 percent. As a result, the economy would have contracted another 2 percent and an additional 3 million jobs would have been lost, causing unemployment to rise to nearly12 percent (Griffith, 2012). Such a disastrous situation would inevitably have caused FHA's earlier books of business to have performed more poorly, not to mention caused significant losses for other participants in the housing and mortgage markets—PMI companies, the taxpayer-supported government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, mortgage lenders and investors, and American households.

Arguments Concerning Public Mortgage Insurance

The proper role of FHA in the modern housing finance system is a topic of much debate. When FHA's share of the market fell to less than 5 percent in the mid-2000s, some suggested that public mortgage insurance was obsolete, claiming new developments in the conventional market would suffice. Today, the cost to American taxpayers, the presence of a PMI industry, and the foreclosure rates on FHA-insured mortgages raise further questions about the value and viability of FHA. Criticisms of FHA are nevertheless often built on a misunderstanding of the public purpose of federal mortgage insurance. As FHA Commissioner Carol Galante (2013: 3) recently testified, "By design, FHA's programs are meant to complement, not supplant, private capital. They are there to combat a lack of available mortgage credit when private capital retreats or underserves markets, and to step back when private capital returns or expands to serve previously underserved populations. And because of this unique role, its business cannot and should not be evaluated on the same terms as a private firm, as such a requirement would force FHA to act as a private firm and therefore eliminate its value in providing countercyclical liquidity and credit to underserved markets." We examine some of these questions in the following section.

Cost to Taxpayers

Since using $10 million to establish the MMI Fund in 1934, FHA did not require taxpayer funds until 2013. For nearly 80 years and more than 40 million loans insured, the Fund had been self-supported on revenue from insurance premiums. Under the Federal Credit Reform Act, however, a negative economic value as determined by OMB would require FHA to supplement its capital with funds from the U.S. Treasury.[6] In the spring of 2012, OMB (2012) estimated that the Fund would require $688 million by the end of the fiscal year, but FHA was able to generate sufficient revenue to forestall the need for appropriations—aided in part by $1 billion garnered from the multibillion-dollar state and federal settlement with mortgage servicers. President Obama's last

[6] The Federal Credit Reform Act exempts several agencies, including the Federal Deposit Insurance Corporation, National Credit Union Administration, Pension Benefit Guaranty Corporation, National Flood Insurance, and Tennessee Valley Authority, but not FHA.

budget projected the Fund will need $943 million to cover expected losses during the next 30 years, largely because of the Fund's reverse mortgage portfolio (OMB 2013). As noted, at the end of fiscal year 2013, the MMI Fund ultimately required a $1.7 billion appropriation to comply with the Federal Credit Reform Act. Congressional action was not required because FHA's original legislation granted it the authority, called "permanent indefinite budget authority" under the Credit Reform Act, to draw on public funds if necessary.

The MMI Fund has had a negative economic value in the past without requiring taxpayer funds. An independent actuarial review in FY 1990 also found that projected losses overwhelmed capital resources and premium revenue. Recognizing that the Fund was in trouble, FHA and Congress implemented several reforms, including NAHA.[7] By reforming its premium structure and endorsing new books of business with positive economic values, FHA successfully achieved its mandated capital requirement in only 4 years without taxpayer dollars. A transfer from the U.S. Treasury was not required in the early 1990s because the Federal Credit Reform Act did not come into effect until FY 1992.

An important reminder is that only the MMI Fund's *existing* books of business determine its economic value. The Fund could again grow out of its current predicament without exhausting its capital resources, as it did in the 1990s. As noted, the Fund has more than $33 billion in total capital resources to continue paying claims. The last actuarial analysis estimates only a 5-percent chance that the Fund will exhaust these resources in the next 7 years, in part because new books of business are highly profitable. The most recent books of business, from FY 2010 through FY 2012, are projected to net the Fund $22.7 billion in economic value (Integrated Financial Engineering, 2012).

The first commissioned independent actuarial report for FY 1989 recognized that, although the MMI Fund should be able to withstand a moderate downturn, it would be inefficient to reserve for a "Great Depression" scenario. "[W]e assume that the social purpose of the Fund is such that it should not be expected to withstand such a calamity" (Price Waterhouse, 1990: 30).[8] Instead, FHA is intended to use the full faith and credit of the federal government to stabilize the housing market in such an event. As former FHA Commissioner, John C. Weicher (1995: 421) stated, "[T]he fact that FHA does not lose money on its home mortgage insurance is not a justification for its existence; the justification is that it serves a public purpose. Serving that purpose without losing money is an indication that FHA home mortgage insurance works reasonably well—not perfectly, but reasonably well."

[7] For an overview of issues leading up to NAHA, see Weicher (1992).

[8] The "Great Depression" scenario consisted of "four consecutive years of 10 percent nominal declines in house prices, a rise in the unemployment rate to 20 percent, and 5 percentage point declines in interest rates" (Price Waterhouse, 1990: 30). The actual experience of the housing market in the recent Great Recession approaches this doomsday scenario: 4 years of 10-percent house price declines equate to a 34.4-percent peak-to-trough decline; according to the Standard & Poor's/Case-Shiller® National Home Price Index, the country experienced a 34.7-percent decline, albeit spread over nearly 6 years. The effective federal funds rate fell more than 5 percentage points between February 2007 and December 2008 before hitting the 0 lower bound, although the decline was more muted in longer term securities. For example, the contract rate on a 30-year, fixed-rate mortgage reported by the Mortgage Bankers Association fell from 7.08 percent in the middle of June 2006 to 3.63 percent by the end of September 2012—only a 3.45-percentage-point decline. The headline unemployment rate peaked at only 10.6 percent, but the broader U-6 measure that includes workers marginally attached for economic reasons reached 18 percent in January 2010.

Competition With the Private Sector

A PMI industry was created in New York as early as the 1880s and grew substantially in the 1920s.[9] PMI was unable to weather the devastation of the Great Depression, however. It returned as a more regulated and robust industry in the 1950s, creating a state of competition with FHA. "Once it had demonstrated the viability of the FHA mortgage and mortgage insurance, FHA began to lose market share in the home mortgage market to conventional lenders and to the private mortgage insurers. This loss was only to be expected and was fully consistent with FHA's basic purpose" (Weicher, 1995: 428).

Although public and private mortgage insurance programs as they exist today differ in several technical ways,[10] the fundamental difference is that FHA mortgage insurance is backed by the full faith and credit of the federal government, whereas PMI is not. Competition with a public mortgage insurance program, which does not need to earn profits commensurate with its risk, may seem to put PMI at a disadvantage. By offering less expensive mortgage insurance and requiring stricter underwriting standards, however, PMI effectively selects the most creditworthy borrowers from the insurance pool.

Congress also prevents FHA from insuring loan amounts above certain limits, restricting its market share. Although the loan limit was high enough to cover more than 85 percent of owner-occupied homes in the 1930s, it often failed to adjust for house price appreciation, restricting FHA to lower cost segments of the housing market (Vandell, 1995). In 2006, FHA accounted for only 4 percent of the mortgage market and even less in booming housing markets.[11] The increase in FHA's market share to nearly 24 percent of the total market, including 42 percent of home purchase loans, by 2009 partly reflects the increase in its maximum loan limits. Among loans of $200,000 or more, FHA's overall market share increased from 1.1 percent in 2006 to 18.5 percent in 2009 and its home purchase market share increased from 1.4 percent in 2006 to nearly 33 percent in 2009. Even among loans of less than $200,000, however, FHA's market share also increased dramatically, rising from 6.3 to nearly 28 percent of the overall market and from 9.4 to 47.5 percent of the home purchase marketduring the same period.

The absence of the full faith and credit of the federal government means PMI companies must maintain a positive economic value at all times. An insolvent insurer will file for bankruptcy or be taken over by regulators, as was the case in the most recent downturn.[12] Even a solvent insurance

[9] For more information about the early history of PMI, see Alger (1934), Graaskamp (1967), and Gray and Terborgh (1929).

[10] For example, PMI covers only 20 to 30 percent of a mortgage, whereas FHA insures the entire amount. The first independent actuarial report explicitly states, "[T]he difference between the 20 percent per loan risk taken by [PMI companies] versus the 100 percent per loan risk taken by FHA also renders use of the [PMI companies] 4 percent capital-to-risk requirement less meaningful to FHA" (Price Waterhouse, 1990: 9).

[11] Based on calculations of first lien purchase and refinance mortgages for owner-occupied, one- to four-unit properties using HMDA data.

[12] PMI Group Inc., the parent company of PMI Mortgage Insurance Co., filed for bankruptcy in November 2011 because of losses incurred in the Great Recession. In the bankruptcy petition, PMI Group's chairman and chief executive officer, L. Stephen Smith, noted that mortgage insurance companies are "more susceptible to the cyclical nature of the economy in general, and the housing and labor markets in particular, than many other types of insurance companies" (Smith, 2011: 10).

company must maintain sufficient levels of capital, or else it may be restrained from taking new business, making a housing market recovery challenging. Several private mortgage insurers currently rely on forbearance from their regulators regarding their mandatory capital ratios to continue to endorse new business (Moody's Investors Service, 2012).

By contrast, FHA can have, as it currently does, a negative capital ratio, but it is not illiquid and does not face capital restraints. The backing of the federal government means investors will still value FHA insurance even if projected losses exceed the capital resources and expected revenue on existing books of business. In a study for Genworth Financial, another PMI company, Promontory Financial Group (2011: 58) noted FHA's powerful resiliency: "Though large contingency reserves enable PMIs to continue paying claims in highly adverse economic scenarios, they do not always permit PMIs to continue incurring additional risk. In these circumstances, the government insurers, particularly FHA, can step in to absorb the additional risk and smooth out the bottom of the cycle." As Secretary Donovan (2013: 4) stated, "FHA's current slightly elevated market share is primarily due to a substantial decrease in the size of the total mortgage market rather than exceptionally high FHA loan volumes. As the market continues to recover and private capital returns at more normal levels, FHA's role will naturally recede."

This resiliency is unique to a public insurance fund and especially important for housing finance, which is susceptible to periods of boom and bust. Because the value of a property serves as collateral for its mortgage, but that value is in part dependent on the general availability of credit, house price increases serve as the basis for an additional extension of credit or, conversely, price declines lead to a reduction in the availability of credit (Kiyotaki and Moore, 1997). House price declines are particularly destabilizing given most American homeowners' substantial degree of leverage. Mortgage debt can deepen housing downturns as homeowners are unable to prepay, refinance to a lower interest rate, or move into a new house, creating a general decrease in market liquidity (Caplin, Freeman, and Tracy 1997; Stein, 1995). The decrease in home equity that accompanies house price declines increases the risk of default among all mortgage borrowers, and any default has the effect of further depressing neighboring house values (Immergluck and Smith, 2006; Lin, Rosenblatt, and Yao, 2009; Schuetz, Been, and Ellen, 2008). Conventional risk management has difficulty with such systematic phenomena, where probabilities are not independent but correlated. By contrast, public insurance is distinctively capable of diversifying risk across time (Moss, 2004).[13]

During the housing boom, some observers wondered whether FHA needed to adopt some of the innovative "alternative" mortgage contracts used in the subprime mortgage market to maintain relevance (GAO, 2007; Jaffee and Quigley, 2007). Now that FHA's market share is unusually high, others are calling for FHA to narrow its operations to "step back from markets that can be served by the private sector" (Pinto, 2012: 42). In general, although FHA's market share ebbs and flows with economic conditions, FHA must always compete with PMI for some lower risk borrowers to

[13] The ability of FHA to pool risk across time is further enabled by the fact that, despite its name, the MMI Fund is no longer really a mutual insurance program. Before the reforms of the early 1990s, FHA would return to borrowers through "distributive shares" any income in excess of the cost of insurance after the mortgage was prepaid or insurance terminated. Now, excess premium revenue is retained as a buffer for future—and past—downturns.

offset losses from higher risk borrowers. In discussing the possibility of increasing premium rates, FHA's first actuarial report noted, "FHA will become somewhat less competitive with the private mortgage insurers. Adverse selection should be anticipated as lower risk borrowers might be able to obtain better terms from private insurers" (Price Waterhouse, 1990: 39). As lower risk borrowers find alternative sources of mortgage credit, however, the volume of FHA endorsements will fall and the average risk of the remaining endorsements will increase, requiring higher premiums to cover expected claims. Higher premiums would further discourage lower risk borrowers from using FHA. "This state of affairs … satisfies those who feel that the FHA should not compete in any way with the private sector, but it flies in the face of the requirement to keep the MMI Fund actuarially sound" (Vandell, 1995: 366). A similar argument could be made that insurance must be active through the housing cycle to build reserves in strong markets.

In addition, FHA broadens the market by providing homeownership opportunities not available in the private conventional market and offers a backstop to the market in periods of economic turmoil. In this way, FHA also complements the PMI industry.

Effect on Households and Neighborhoods

A lack of adequate funds for a large downpayment and closing costs has always been a substantial barrier to homeownership (Haurin, Hendershott, and Wachter, 1997; Linneman and Wachter, 1989; Quercia, McCarthy, and Wachter, 2003). At its inception, FHA reduced required downpayments to 20 percent, enabling more families than ever before to purchase a home. Later, as such loan products proved sustainable, FHA gradually decreased downpayment requirements to 5 percent in 1950 and to only 3 percent in 1961. The maximum term of FHA loans was extended, first to 20 years and then to 30 years in 1954, reducing the required monthly payments (Vandell, 1995). Mortgage products now called "traditional" were anything but before the creation of FHA. Indeed, the "nontraditional" mortgages that flooded the market during the recent housing bubble—interest-only and negative-amortization loans, hybrid adjustable-rate mortgages, and so on—have more in common with the products that predated FHA (Green and Wachter, 2005). By insuring the credit risk of long-term mortgages with high LTV ratios, FHA overcame the wariness of lenders to offer a loan contract that has since become the gold standard of American mortgages.

FHA insurance to support low downpayment mortgage lending is particularly important for first-time homebuyers. In 2011, new homeowners accounted for 75 percent of all FHA endorsements of home purchase loans, and FHA insured 41 percent of all first-time homebuyers (HUD, 2012). Lower income and minority households also rely more heavily on FHA-insured loans. During the housing bubble, these households were disproportionately likely to receive subprime mortgages (Apgar, Bendimerad, and Essene, 2007; Bocian, Ernst, and Li, 2008; Karikari, Voicu, and Fang, 2011), leading to elevated foreclosure rates when the bubble burst (Bocian, Li, and Ernst, 2010). As conventional mortgage credit became scarce, FHA was able to ensure some credit availability for these households. Between 2009 and 2011, more than 60 percent of purchase mortgage originations for Hispanic and African-American borrowers were insured through FHA compared with 36.5 percent of originations for non-Hispanic White borrowers (see exhibit 4). In addition, these loans have proven much more sustainable than products offered in the conventional mortgage market to similar borrowers.

Exhibit 4

Homeownership Rate and FHA Share of Originations by Race/Ethnicity and Household Income, 2009–11

	Homeownership Rate (%)	FHA Share of Originations (%)
Race/ethnicity		
Non-Hispanic White	72.6	36.5
Hispanic (any race)	47.1	62.7
African American	44.2	61.5
Household income		
$50,000 or more	79.7	34.6
Under $50,000	50.2	51.5
Total	65.4	39.8

FHA = Federal Housing Administration.

Note: First lien home purchase mortgage originations for owner-occupied, one- to four-unit properties.

Sources: American Community Survey; Home Mortgage Disclosure Act

High LTV ratios, and the possibility for negative equity if prices fall, have long been known to contribute to a greater chance of default (Quercia and Stegman, 1992); however, for 50 years, FHA has enabled homeowners to be highly leveraged while maintaining a relatively modest rate of claims in aggregate through persisting with traditional mortgages. Fully underwritten, 30-year, fixed-rate mortgages have accounted for three-fourths of FHA endorsements by volume since FY 2000 (Integrated Financial Engineering, 2012). Such *product* features have been associated with significantly lower default rates, regardless of *borrower* characteristics (Ding et al., 2011), which helps explain why FHA-insured mortgages performed significantly better than conventional subprime mortgages through the Great Recession. According to the Mortgage Bankers Association's National Delinquency Survey, the serious delinquency rate on subprime loans reached more than 30 percent in late 2009 and early 2010 and remained at nearly 22 percent through early 2012. By contrast, FHA-insured mortgages have had a serious delinquency rate of only about 9 percent since 2009. Quercia, Ding, and Reid (2012) examined loans originated between 2000 and 2008 and found that 32.3 percent of subprime conventional loans had defaulted by February 2011 by contrast with 14.4 percent of FHA-insured loans.

Pinto (2012) argued that, to protect borrowers and neighborhoods from a vicious cycle of foreclosure, FHA should never insure a loan with a projected claims rate greater than 10 percent. FHA's underwriting standards already establish implicitly an "acceptable" claims rate by setting maximum LTV and debt-to-income ratios, and so on, but any discussion of the social implications of the risk of default must also consider the effect on the access to credit. In that sense, weighing the costs and benefits of FHA's underwriting criteria parallels the debate about proposed definitions of Qualified Mortgages (QMs) and Qualified Residential Mortgages (QRMs) required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Quercia, Ding, and Reid (2012) directly compared the reduction in defaults that would have occurred from stricter underwriting with the reduction in the access to credit, particularly among lower income and minority households. The authors concluded that the reduction in foreclosures resulting from restrictions beyond the QM product requirements, such as prohibitions on low- or no-documentation, interest-only, and negative amortization loans, balloon payments, and so on, do not outweigh the costs of reducing borrowers' access. In particular, requiring higher downpayments had limited benefits when compared with the number of borrowers excluded from the market.

Recent Regulatory Changes

During the past several years, FHA and Congress have again taken steps to recapitalize the MMI Fund.

For example, seller-funded downpayment assistance programs, which are associated with high default rates and substantial losses, were banned in 2008. The Internal Revenue Service characterized these programs as "self-serving, circular financing arrangements" that skirted HUD rules against the seller's providing a gift to the homebuyer that was not subtracted from the house price (IRS 2006). Instead, FHA effectively financed downpayments through artificially high sales prices and loan amounts (Concentrance Consulting Group, 2005; Foote, 2009; GAO, 2005). Seller-funded downpayment assistance accounted for more than 20 percent of FHA loan endorsements between FY 2005 and FY 2007. Among fixed-rate, FHA-insured mortgages with LTV ratios of more than 95 percent in these years, loans using seller-funded downpayment assistance programs are expected to result in lifetime claims 2.33 to 2.51 times greater than loans with other sources for the downpayment.[14] HUD attempted to prohibit seller-funded downpayment assistance programs many times but was prevented by legal and political obstacles until HERA finally banned the practice. Those loans already on the books, however, are estimated to ultimately cost the MMI Fund $15.25 billion according to the latest actuarial review (Integrated Financial Engineering, 2012).

FHA is also actively seeking to mitigate losses on existing insurance policies. Since mid-2009, FHA has provided loss mitigation assistance to 1.4 million homeowners with FHA-insured mortgages (Szymanoski et al., 2012). FHA has scaled up initiatives offering alternatives to foreclosure (for example, short sales) for borrowers who cannot obtain a loan modification under FHA's Home Affordable Modification Program. As a result of these changes, the difference between sales prices and appraisal values of Real Estate Owned (REO) properties has decreased 62 percent, and time in the REO process has fallen 45 percent (Galante, 2013). FHA also established a Distressed Asset Stabilization Program aimed at selling seriously delinquent loans to third party investors at a reserve price of less than the outstanding principal balance of the loan. These efforts aim to reduce the loss severity on distressed loans. Further, a new Office of Risk Management, created in 2010, will help monitor and mitigate risk in the future.

Looking to the future, Secretary Donovan (2013: 1) noted, "Recent increases in FHA premium levels will boost FHA's capital reserves and increase Federal revenues." In some cases, premium increases have required congressional action. For example, the FHA Reform Act of 2010 was needed to amend the National Housing Act to enable FHA to increase annual insurance premiums over 0.55 percent. Since then, annual insurance premiums have risen to 1.35 percent (see exhibit 5). FHA premium increases since 2009 have added more than $10 billion in economic value to the MMI Fund (Galante, 2013). Further, effective in June 2013, annual premiums will be required for the life of the loan. Previous to this requirement, under a policy implemented in 2001, insurance premiums were cancelled when outstanding loan balances fell to less than 78 percent of

14 "Standards for Mortgagor's Investment in Mortgaged Property: Additional Public Comment Period," 24 CFR Part 203. Federal Register 73 (116) June 16, 2008.

Exhibit 5

FHA Insurance Premiums, October 1, 2008, to April 1, 2013

Effective Date	Upfront Premium (%)	Annual Premium (%)
October 1, 2008	1.75	0.55
April 5, 2010	2.25	0.55
October 4, 2010	1.00	0.90
April 18, 2011	1.00	1.15
April 9, 2012	1.75	1.25
April 1, 2013	1.75	1.35

FHA = Federal Housing Administration.

Note: Purchase-money mortgages and full-credit qualifying refinances of less than $625,500 with loan terms of more than 15 years and loan-to-value ratios of more than 95 percent.

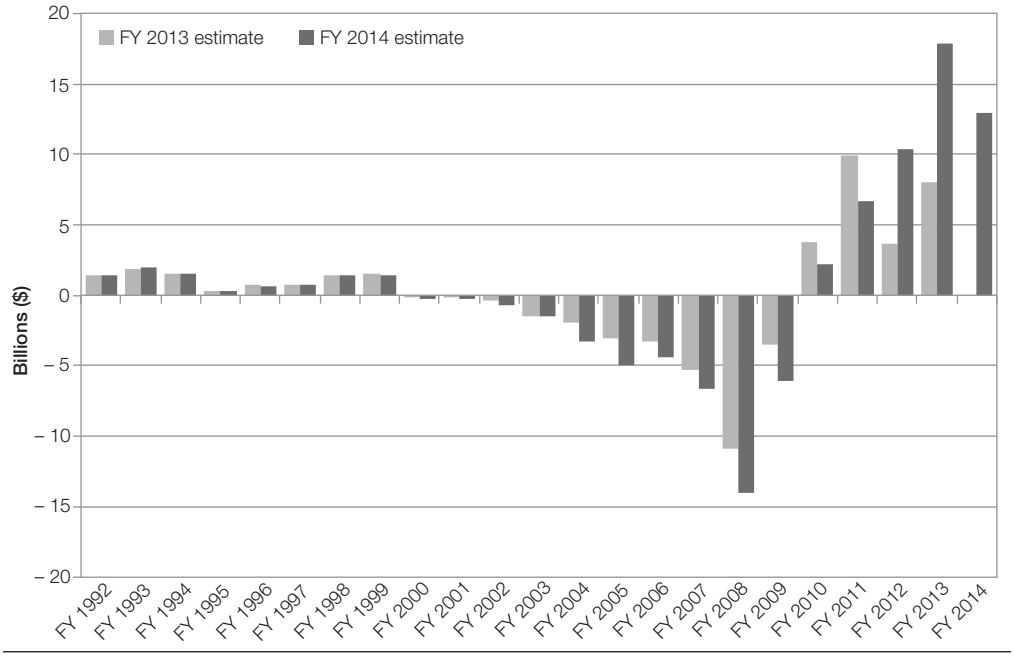
Sources: FHA Mortgagee Letters 2008-22, 2010-02, 2010-28, 2011-10, 2012-4, and 2013-04

the original balance, although FHA remained liable for the entire loan amount. Indeed, 10 to 12 percent of losses from claims have been found to occur after premiums were cancelled, resulting in $10 billion in lost revenue for the 2010 through 2012 books of business alone (HUD, 2012).

These measures are projected to save the MMI Fund more than $20 billion, and the effects are already evident in FHA's most recent loan endorsements. The latest books of business, from FY 2010 through FY 2012 (see exhibit 6), are projected to net the Fund between $19 and $23 billion in

Exhibit 6

Economic Value by Book of Business



FY = fiscal year.

Note: Includes only forward loans.

Source: Office of Management and Budget

economic value (Integrated Financial Engineering, 2012; OMB, 2013). "While the new loans being made today are profitable to FHA and we do not want to over-burden or constrict access to credit as the housing market continues to mend, we also must ensure that we are (1) rebuilding adequate reserves for the future and (2) phasing out of our counter-cyclical role by reducing FHA's footprint in the marketplace and helping to facilitate the return of private capital" (Galante, 2013: 15). Further increasing insurance premiums could reduce FHA's market share, but as its endorsement volumes fell FHA would find it more difficult to recapitalize the Fund and support the nascent housing recovery. Moreover, the likely effect would be to increase the role of the GSEs, Fannie Mae and Freddie Mac, from conservatorship—that is, as long as regulators and the GSEs continue to permit some insurance companies to endorse new business while exceeding maximum risk-to-capital regulations. Nevertheless, FHA will eventually return to a decreased market share through a combination of premium-rate increases, loan-limit decreases, and private-sector competition.

Although FHA's most recent books of business have strong economic values, FHA continues to pursue reforms. For example, FHA is proposing to reduce the maximum allowable amount of sellers' contributions toward closing costs. FHA currently allows for sellers' concessions of up to 6 percent of the sales price. Additional contributions are considered "inducements to purchase" and result in a dollar-for-dollar reduction in the sales price when calculating the loan's LTV ratio. The proposal would reduce allowable concessions to 3 percent or $6,000, whichever is greater but not to exceed actual closing costs. In addition, the proposal would narrow the definition of closing costs.[15] The FHA Emergency Fiscal Solvency Act of 2012 (H.R. 4262), which passed the House of Representatives in 2012, would authorize FHA to increase insurance premiums and punish lenders for misrepresentation or fraud, including the authority to require lenders to pay back claims on insured loans and to cancel lender approval to originate or underwrite future loans. Pinto (2012) proposed adopting practices from the VA mortgage insurance program, including reducing FHA's insurance coverage from its current 100 percent, using an appraisal board, and examining residual income in addition to debt-to-income ratios.

The future of FHA depends on these regulatory changes but also on broader housing market reforms, particularly the definition and regulation of QRM standards required by the Dodd-Frank Wall Street Reform and Consumer Protection Act and the nature of the secondary market after the GSEs.

Authors

Roberto G. Quercia is the Director of the UNC Center for Community Capital and Chair of the Department of City and Regional Planning at The University of North Carolina at Chapel Hill.

Kevin A. Park is a graduate research assistant at the UNC Center for Community Capital and a doctoral candidate in the Department of City and Regional Planning at The University of North Carolina at Chapel Hill.

[15] See "Federal Housing Administration (FHA) Risk Management Initiatives: Revised Seller Concessions." *Federal Register* 77 (36) February 23, 2012, 10695–10707.

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