Summer 2016

Underwriting Sustainable Homeownership: The Federal Housing Administration and the Law down Payment Loan

David Reiss
Brooklyn Law School, david.reiss@brooklaw.edu

Recommended Citation
50 Ga. L. Rev. 1019 (2015-2016)

GEORGIA LAW REVIEW

VOLUME 50 SUMMER 2016 NUMBER 4

ARTICLES

UNDERWRITING SUSTAINABLE HOMEOWNERSHIP: THE FEDERAL HOUSING ADMINISTRATION AND THE LOW DOWN PAYMENT LOAN

*David Reiss**

TABLE OF CONTENTS

* Professor, Brooklyn Law School. The author would like to thank Michele Cotton, Mark Willis and the attendees of the Federal Reserve Bank of Cleveland's 2013 Policy Summit on Housing, Human Capital, and Inequality; the 2013 AALS Workshop on Poverty, Immigration and Property; the 2012 AALS Sections on Real Estate Transactions and Property Annual Meeting; the 74th International Atlantic Economic Society Conference; and a Brooklyn Law School Summer Brown Bag session for helpful comments. The author also acknowledges the support of the Brooklyn Law School Summer Research Stipend Program. Thanks to Jason Gang, Adnan Mirza, Marc Shavitz, Arthur Torkiver, Cameron Weil, Clarissa Wertman, and Dominika Wilk for excellent research assistance.

I. INTRODUCTION

The secondary mortgage market stands on three legs. The first leg, created in the early 1930s, is made up of government instrumentalities like the Federal Housing Administration (the FHA) and the Government National Mortgage Association (Ginnie Mae). The second leg, which was created in the 1930s and took off in the 1970s, is made up of public/private hybrids like the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). The third leg, which was created in the 1970s but did not take off until the 1990s, is the private-label market which is made up of private companies that package mortgage-backed securities that have no guarantee, explicit or implicit, from the federal government. Each of these legs buckled during the Great Recession.[1] This Article primarily addresses the buckling of the first leg, but in broad historical context.

Today's FHA suffers from many of the same unrealistic underwriting assumptions that have done in so many other lenders during the 2000s.[2] It has also been harmed, like other lenders, by a housing market as bad as any seen since the Great Depression. As a result, the federal government announced in

[1] *See generally* KATHLEEN C. ENGEL & PATRICIA A. MCCOY, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS (2011) (addressing the failure of the private-label market); David Reiss, *Fannie Mae and Freddie Mac and the Future of Federal Housing Finance Policy: A Study of Regulatory Privilege*, 61 ALA. L. REV. 907 (2010) (addressing the failures of Fannie Mae and Freddie Mac).

[2] "Underwriting" refers to the process of evaluating the likelihood that the principal and interest due on a loan will be repaid. Mortgage lenders typically consider the three "Cs" when underwriting: credit reputation, capacity, and collateral. Credit reputation is often summarized by a credit score. Capacity evaluates the borrower's existing debt as a proportion of her income, as well as accounting for other factors such as savings. Collateral evaluates the property to determine whether the lender can recoup what it is owed if the borrower fails to pay back the loan. *See* FREDDIE MAC, *The 3 Cs of Underwriting Factors Used in Loan Prospector's Assessment*, http://www.freddiemac.com/corporate/au-works/factors.html (last visited May 29, 2016).

2013 that the FHA would require the first bailout in its history.[3] At the same time that it has faced these financial challenges, the FHA has also come under attack for the poor execution of some of its policies to expand homeownership. Leading commentators have called for the federal government to stop employing the FHA to do anything other than provide liquidity to the low end of the mortgage market. These critics' arguments rely on a couple of examples of programs that were clearly failures, but they fail to address the FHA's long history of undertaking comparable initiatives.[4] This Article takes the long view and demonstrates that the FHA has a history of successfully undertaking new homeownership programs. At the same time, the Article identifies flaws in the FHA model that should be addressed in order to prevent them from occurring if the FHA were to undertake similar initiatives in the future.

This Article first provides a basic introduction to the FHA. Part II then sets forth the dominant critique of the FHA. Relying on often overlooked primary sources, Part III provides a textured history of the FHA and charts its ever-changing roles in the housing-finance sector. Part IV concludes that the FHA can responsibly address objectives other than the provision of liquidity to the residential mortgage market.

The Article brings together the scholarly literature regarding the history of race and housing policy as well as the economics literature regarding the role that down payments play in the appropriate underwriting of mortgages in order to give a more detailed picture of the federal government's role in housing finance for low- and moderate-income households. It ultimately proposes that FHA homeownership goals should be more explicitly tied to a rational underwriting process, one that is designed to make sure that people can afford their mortgages over the long-term. This improved underwriting process would both protect the financial

---

[3] Margaret Chadbourn, *U.S. Federal Housing Administration to tap $1.7 bln in taxpayer funds*, REUTERS, Sept. 27, 2013, http://reuters.com/article/usa-housing-bailout-idUSW1N0G702P20130927.

[4] *See generally infra* Part III.B.5, III.B.9.

health of the FHA and ensure that new homeowners are able to afford their homes for the long term—that is, become sustainable homeowners.

The FHA has a storied history, notwithstanding its many problems. The *New York Times* noted in 1934, the year that the FHA started up, that there "is no New Deal agency which is being more widely discussed behind the scenes in Washington these days than the Federal Housing Administration. It is no secret that President [Franklin Delano] Roosev[e]lt holds the highest hopes for this housing program . . . ."[5] Nearly fifty years later, a Commission on Housing, appointed by small-government-proponent President Ronald Reagan, praised the FHA even while calling for extensive reforms:

> Few pieces of social invention from the 1930s have reverberated so loudly through the corridors of time as the FHA-insured, level-payment, self-amortizing, long-term mortgage. Supplemented by VA mortgage guarantees after the war, this piece of paper and its acceptance—first by homebuyers and banks, later by insurance companies and an organized secondary market—made homeownership possible for tens of millions of Americans who would otherwise have lived out their days in rented quarters.[6]

---

[5] Frank L. Kluckhohn, *Housing Programs Give High Hopes*, N.Y. TIMES, Sept. 23, 1934, at E6. *See also* Thomas W. Phelps, *Cheap Housing Is Broadest Socialistic Step New Deal Has Proposed – Amount Undecided*, WALL ST. J., Nov. 30, 1934 ("Decision of the Roosevelt Administration to provide the underprivileged masses with housing they can't afford under private capitalism is philosophically just another triumph of human values over property values.").

[6] PRESIDENT'S COMM'N ON HOUS., THE REPORT OF THE PRESIDENT'S COMMISSION ON HOUSING, at xxiv (1982), http://www.huduser.org/portal//Publications/pdf/HUD-2460.pdf. Indeed, one recent unpublished study, Matthew Chambers et al., *Did Housing Policies Cause the Postwar Boom in Homeownership?*, 5–7 (Nat'l Bureau of Econ. Research, Working Paper No. 18821, 2013), found that the thirty-year fixed-rate mortgage popularized by the FHA accounted for a significant portion of the increase in homeownership in the United States during the middle of the twentieth century. *But see* John L. Goodman, Jr. & Joseph B. Nichols, *Does FHA Increase Home Ownership or Just Accelerate It?*, 6 J. HOUS. ECON.

Mortgage insurance is a product that is paid for by the *homeowner* but that protects the *lender* if the homeowner were to default on the mortgage. The insurer pays the lender for the losses that it suffers from any default and foreclosure by the homeowner.[7]

The FHA provides mortgage insurance on mortgage loans for single-family homes and multifamily buildings; it "is the largest government insurer of mortgages in the world."[8] Like much of the federal housing infrastructure, the FHA has its roots in the Great Depression.[9] The private mortgage insurance (PMI) industry, like many others, was decimated in the early 1930s.[10] Its companies began to fail as almost half of all of the mortgages in the nation defaulted.[11] The PMI industry did not revive until the 1950s.[12]

184, 184 (1997) (concluding, in a relatively short-term longitudinal study, that "to the extent that FHA has any influence on homeownership, it is mostly to accelerate home purchase, not to enable it among households that otherwise would never be able to buy").

[7] MARSHALL W. DENNIS & THOMAS J. PINKOWISH, RESIDENTIAL MORTGAGE LENDING: PRINCIPLES AND PRACTICES 153 (5th ed. 2004).

[8] FED. HOUS. ADMIN., ANNUAL MANAGEMENT REPORT FISCAL YEAR 2010, at 3 (2010), http://www.hud.gov/offices/hsg/fhafy10annualmanagementreport.pdf. The FHA also insures certain healthcare facilities and manufactured housing. *Id.* *See* U.S. GEN. ACCOUNTING OFFICE, GAO/RCED-97-93, HOMEOWNERSHIP: POTENTIAL EFFECTS OF REDUCING FHA'S INSURANCE COVERAGE FOR HOME MORTGAGES 16 (1997), http://www.gao.gov/archive/1997/rc97093.pdf (listing the country's primary mortgage insurers and noting that the Section 203(b) Single-Family Mortgage Insurance Program is the FHA's primary program).

[9] The Federal Home Loan Bank System was authorized under the Federal Home Loan Bank Act of 1932. Federal Home Loan Bank Act, Pub. L. No. 72-304, 47 Stat. 725 (1932). The Home Owners' Loan Corporation was established by the Home Owners' Loan Corporation Act of 1933. Home Owners' Loan Corporation Act of 1933, Pub. L. No. 37-43, 48 Stat. 128 (1933). The Federal National Mortgage Association (now known as Fannie Mae) was initially created to establish a secondary market for FHA-insured loans in 1938 by the Reconstruction Finance Corporation. David Reiss, *The Federal Government's Implied Guarantee of Fannie Mae and Freddie Mac's Obligations: Uncle Sam Will Pick up the Tab*, 42 GA. L. REV. 1019, 1029 n.30 (2007). There were some antecedents that predated the Great Depression. Congress established the Federal Farm Loan System in 1916 which offered "relatively long-term, amortized mortgages with equal payments throughout the loan term. No parallel system was set up for nonfarm residential loans, however." PRICE V. FISHBACK ET AL., WELL WORTH SAVING: HOW THE NEW DEAL SAFEGUARDED HOME OWNERSHIP 13 (2013); *see also* Kenneth A. Snowden, *The Anatomy of a Residential Mortgage Crisis: A Look Back to the 1930s* (Nat'l Bureau of Econ. Research, Working Paper No. 16244, 2010) (discussing federal housing finance infrastructure of the early twentieth century).

[10] *See infra* Part III.B.*1*.

[11] *See infra* Part III.B.*1*.

The idea for a government alternative to private mortgage insurance came from the National Emergency Council as part of its proposal to address a broad array of problems in the real estate sector.[13]

One of the key programs to arise from this proposal was a system of federally-financed mortgage insurance, the FHA.[14] The FHA proposal was incorporated into the National Housing Act. The FHA was

> charged with the duty of encouraging improvement in housing standards and conditions by making improved credit facilities available to the owners and prospective owners of homes and other property. In accordance with the National Housing Act, it extends Government support by means of credit insurance covering private credit transactions. Hence, in achieving the desired results, chief reliance is placed upon private capital and initiative.[15]

The FHA's first full year of operation was 1935.[16] The FHA initially insured mortgages originated by private lenders that were (1) short-term repair loans; (2) long-term mortgages for single-family home loans (which actually covered buildings with one to four units);[17] and (3) mortgages for large multi-family projects.[18] The FHA's goals for insuring residential mortgages were to make "a sounder investment for the lender" and to extend "the

---

[12] *See infra* Part IV.B.*3*.

[13] Arthur M. Weimer, *The Work of the Federal Housing Administration*, 45 J. POL. ECON. 466, 466–67 (1937). Weimer was an economist at the FHA from 1934–1937.

[14] *Id.*

[15] FED. HOUS. ADMIN., FIRST ANNUAL REPORT OF THE FEDERAL HOUSING ADMINISTRATION 3 (1935) [hereinafter FIRST ANNUAL REPORT].

[16] FED. HOUS. ADMIN., SECOND ANNUAL REPORT OF THE FEDERAL HOUSING ADMINISTRATION 1 tbl.1 (1936) [hereinafter SECOND ANNUAL REPORT]. FHA began insuring a small number of loans in August of 1934, and its rate of growth was exponential through the end of 1935. *Id.* at 2, Chart 1.

[17] For a discussion of the meaning of "single family," *see infra* note 63.

[18] SECOND ANNUAL REPORT, *supra* note 16, at 1.

practicable range of borrowers and of home-mortgage loans."[19] Over time, Congress gave the FHA a variety of additional policy mandates that were intended to help the federal government achieve other policy goals. These goals ranged from supporting the war effort during World War II to increasing the number of minority homeowners during the early 2000s.[20]

Although conventional wisdom says that the FHA had one mission during the Great Depression—increasing liquidity—it actually had many missions.[21] After its second full year of operation, the FHA set forth the following nine missions:

1. To expedite recovery in the building and allied industries.
2. To aid and encourage private capital investments in the home-mortgage field.
3. To secure a more uniform flow and wider distribution of home-mortgage funds.
4. To secure a lower and more uniform interest rate on home-mortgage securities.
5. To improve mortgage-lending practices.
6. To raise building standards.
7. To protect the owners of small homes.
8. To encourage the creation of private limited-dividend companies to finance housing developments for persons of low income.

---

[19] *Id.* at 3.

[20] *See infra* Part III.B.

[21] *See, e.g.*, Richard K. Green & Susan M. Wachter, *The American Mortgage in Historical and International Context*, 19 J. ECON. PERSP. 93, 95 (2005) ("The combination of HOLC [Home Owners' Loan Corporation] and the FHA represented a piece of early 'financial engineering' that allowed illiquid financial institutions to become liquid again."); Anthony Pennington-Cross & Anthony M. Yezer, *The Federal Housing Administration in the New Millennium*, 11 J. HOUS. RES. 357, 358 (2000) ("The original purpose of FHA as part of the economic recovery program was to restore mortgage lending and fill the gap created by the failure of private mortgage insurance.").

9. To develop essential statistical and economic data on real estate and housing.[22]

These goals ranged broadly from the oft-cited liquidity rationale, to supporting industries relating to housing, to consumer protection. The FHA's role in reducing systemic risk was also explicitly acknowledged early in its history. In the FHA's second annual report, the Administrator notes that it was initially designed to "help to stabilize the whole real-estate market; to give warning of the periods of inflated prices when many families are apt to purchase homes with small equities; and to help maintain an orderly home real estate market during periods of depression."[23]

Over its lifetime, the FHA has insured over 40 million mortgages, helping to make home ownership available to a broad swath of American households.[24] The overwhelming portion of its resources is devoted to one to four unit houses.[25] And indeed, the FHA mortgage was central to America's transformation from a nation of renters to homeowners.[26] The early FHA really created the modern American housing finance system, as well as the look and feel of postwar suburban communities.[27]

The FHA has also had many other missions over the course of its existence and a varied legacy to match.[28] Beginning in the

---

[22] SECOND ANNUAL REPORT, *supra* note 16, at 1–2.

[23] *Id.* at 6.

[24] DEP'T OF HOUS. & URBAN DEV., ANNUAL REPORT TO CONGRESS REGARDING THE FINANCIAL STATUS OF THE FHA MUTUAL MORTGAGE INSURANCE FUND FISCAL YEAR 2014, at 60 (2014). The FHA has also insured tens of thousands of multifamily and healthcare projects. FED. HOUS. ADMIN., ANNUAL MANAGEMENT REPORT FISCAL YEAR 2013, at 5 (2013), http://portal.hud.gov/hudportal/documents/huddoc?id=fhafy13annualmgmntrpt.pdf.

[25] FED. HOUS. ADMIN., *supra* note 8, at 6 (noting that such loans account for 86.3% of its insurance-in-force).

[26] KENNETH T. JACKSON, CRABGRASS FRONTIER: THE SUBURBANIZATION OF THE UNITED STATES 205 (1985).

[27] *Id.* at 205, 215.

[28] Some acknowledged this early on. *See, e.g.*, MILES L. COLEAN, THE IMPACT OF GOVERNMENT ON REAL ESTATE FINANCE IN THE UNITED STATES 150–51 (1950) (noting that housing finance policy "was used to accomplish ends not strictly germane to the credit

1950s, the FHA's role changed from serving the entire mortgage market to focusing on certain segments of it.[29] This changed mission had a major impact on everything the FHA did, including how it underwrote mortgage insurance and for whom it did so.[30]

In recent years, the FHA has come under attack for its poor execution of some of its attempts to expand homeownership, and leading commentators have called for the federal government to stop assigning such mandates to the FHA.[31] They argue that the FHA should just focus on providing liquidity for the portion of the mortgage market that serves low- and moderate-income households.[32] These critics rely on a few examples of programs that were clearly failures, but they do not address the FHA's long history of undertaking similar initiatives. These critiques sometimes seem to reflect an anti-government ideology more than a particularized critique of the FHA itself because the arguments are so broad that they would apply to many other government programs as well. This Article takes the long view and demonstrates that the FHA has a parallel history of successfully undertaking new mandates.[33] At the same time, it identifies operational failures that should be addressed in the design of future initiatives.[34] In particular, it proposes that the FHA

---

transaction, such as the improvement of housing standards, the influencing of land planning, and the regulation of wages paid to construction workers").

[29] *See infra* Part III.B.*3*.

[30] *See infra* Part III.B.*3*.

[31] *See, e.g.*, JOSEPH GYOURKO, AM. ENTER. INST., RETHINKING THE FHA 1 (2013) (arguing that the FHA has failed to achieve key policy goals and should ultimately be terminated); EDWARD J. PINTO, AM. ENTER. INST., HOW THE FHA HURTS WORKING-CLASS FAMILIES AND COMMUNITIES 41 (2012) (arguing that the FHA uses "practices that result in a high proportion of families losing their homes").

[32] *See* PINTO, *supra* note 31, at 41 ("[T]he FHA needs to return to its traditional mission of being a targeted provider of mortgage credit for low- and moderate-income Americans and first-time home buyers.").

[33] *See* PRESIDENT'S COMM'N ON HOUS., *supra* note 6, at 162 ("FHA has performed an important role as an innovator over the years, successfully gaining market acceptance for new types of home mortgage instruments.").

[34] Make no mistake, the FHA has been dogged by complaints of every day operational incompetence and venality for much of its existence, but this Article does not focus on these more pedestrian problems of the type faced by nearly every government instrumentality at one time or another. For examples of these more pedestrian problems, see *FHA Indicts*

undertake a rulemaking that requires it to balance the goal of broad access to credit with the need for households to be able to make their mortgage payments over the long term. The FHA needs to achieve this balance in order to protect the financial health of itself and its borrowers alike.

II. THE FAILURES OF THE FHA

The FHA is an understudied topic despite having a massive impact on the built environment of the United States.[35] This lack of scholarship is particularly unfortunate because it has had some serious failures that mar its long history of success as a provider of liquidity, stability, and access to the residential mortgage market. Because of those failures, the leading commentators on the FHA have indicted its initiatives to encourage homeownership. The

---

Eight for Fund Misuse, N.Y. TIMES, June 2, 1939; George E. Cruikshank, *Housing Report Calls FHA Activities in 1946–'50 Full of "Corruption;" Ousted Aide is Main Target*, WALL ST. J., Sept. 13, 1954, at 2; *FHA Concedes Office Can't Keep up with Mortgage Requests*, WALL ST. J., Oct. 7, 1954, at 8; Emanuel Perlmutter, *18 Arrested Here in 5-Million Fraud in Housing Loans*, N.Y. TIMES, Oct. 8, 1961, at 1; Richard F. Janssen, *FHA Reappraisal: Housing Agency Strives to Curb Criticism of Some of Its Operations*, WALL ST. J., July 1, 1963, at 1; *Six Concerns Charged with Fake Applications for U.S. Home Loans*, WALL ST. J., Nov. 10, 1965, at 9; *Former FHA Chief in Philadelphia Named in 2 U.S. Indictments*, WALL ST. J., May 12, 1972, at 2; Edward Foldessy & Timothy Shellhardt, *Backing Off: Lenders Sharply Cut Writing of FHA Loans as Red Tape Mounts*, WALL ST. J., May 14, 1973, at 1. There have also been a number of studies about operation deficiencies at the FHA. *See, e.g.*, GOV'T ACCOUNTABILITY OFFICE, GAO-13-542, FEDERAL HOUSING ADMINISTRATION: IMPROVING DISPOSITION AND OVERSIGHT PRACTICES MAY INCREASE RETURNS ON FORECLOSED PROPERTY SALES (2013); GOV'T ACCOUNTABILITY OFFICE, GAO-12-15, FEDERAL HOUSING ADMINISTRATION: IMPROVEMENTS NEEDED IN RISK ASSESSMENT AND HUMAN CAPITAL MANAGEMENT (2011); NAT'L CTR. FOR HOUS. MGMT., REPORT OF THE TASK FORCE ON IMPROVING THE OPERATION OF FEDERALLY INSURED OR FINANCED HOUSING PROGRAMS: VOLUME 1: SINGLE-FAMILY HOUSING 3–28 (1973).

[35] Modern comprehensive studies of the FHA may be counted on one hand. *See* Pennington-Cross & Yezer, *supra* note 21, at 358 (noting the variety of purposes the FHA serves); Kerry D. Vandell, *FHA Restructuring Proposals: Alternatives and Implications*, 6 HOUS. POL'Y DEBATE 299, 301–33 (1995) (providing a detailed history of the FHA and its accomplishments and failures). There are many articles that address narrow aspects of the FHA's performance. *See, e.g.*, Marsha J. Courchane et al., *The Downs and Ups of FHA Lending: The Government Mortgage Roller Coaster Ride*, 24 J. HOUS. ECON. 39, 41–43 (2014) (providing review of recent FHA literature).

absence of a vibrant scholarly exchange regarding the FHA stands in the way of responsibly charting its future course.

Robert Van Order and Anthony Yezer, the authors of the FHA Assessment Report, write that "the lesson that we should take away from" the FHA's recent history of looser underwriting standards is that the "FHA, as currently organized, should not be used as an *experimental* program to encourage homeownership."[36] However, they further note that this is nonetheless unavoidable because "there are powerful political forces willing to push FHA to allow very unsound lending practices."[37] Given that Yezer is the co-author of one of the handful of comprehensive studies of the FHA, this is a damning assessment indeed.[38]

The few policy analysts who make a close study of the FHA agree in the main with Yezer and the other scholars who have given the FHA their sustained attention. The American Enterprise Institute's Edward Pinto, the author of the *FHA Watch*, writes that, "Government insurance programs suffer from three fundamental flaws: (1) the government cannot successfully price for risk; (2) government backing distorts prices, resource allocation, and competition; and (3) political pressure and congressional demands for a *quid pro quo* inevitably arise, politicizing the programs."[39] Housing economist Joseph Gyourko

---

[36] ROBERT VAN ORDER & ANTHONY YEZER, GEORGE WASHINGTON UNIVERSITY CTR. FOR REAL ESTATE & URBAN ANALYSIS, FHA ASSESSMENT REPORT: THE ROLE OF THE FEDERAL HOUSING ADMINISTRATION IN A RECOVERING U.S. HOUSING MARKET 9 (2011), http://business.gwu.edu/wp-content/uploads/2014/02/FHA2011Q2.pdf.

[37] *Id.*

[38] *See* Pennington-Cross & Yezer, *supra* note 21, at 357–58.

[39] EDWARD J. PINTO, AM. ENTER. INST., TRUTH IN GOVERNMENT LENDING IS LONG OVERDUE (Mar. 20, 2012), http://www.aei.org/article/economics/financial-services/housing-finance/truth-in-government-lending-is-long-overdue/. *See generally* Mark Calabria, *Fixing Mortgage Finance: What to Do with the Federal Housing Administration?* (Cato Inst., Briefing Paper No. 123, 2012), http://www.cato.org/publications/briefing-paper/fixing-mortgage-finance-what-do-federal-housing-administration (arguing the FHA has no net benefit and should be "eliminated"). *See also* Pennington-Cross & Yezer, *supra* note 21, at 370 ("Since the 1940s, FHA has had programs targeted to housing finance needs of specific groups: veterans, residents of urban renewal areas, service personnel, residents impacted by military bases, and residents of rehabilitation projects. The sheer number of programs enacted suggests that the ability to support such efforts appears to be a politically attractive feature of FHA."). David

is more succinct, but equally pessimistic: the FHA "has failed by any reasonable metric."[40]

Much data exists to support these characterizations of the FHA, but I will demonstrate that they cherry-pick from the historical record to make their case, focusing on disastrous policies of the early 1970s and the 2000s. By failing to address the FHA's other initiatives over its eighty years of operation, these commentators fail to make a convincing case that the FHA's history is a history of failed government action.

Commentators are greatly concerned that the FHA will face high losses because of its supposed divergence from its original mission. These losses look like they will be measured in the billions of dollars in the medium term.[41] Robert Van Order and Anthony Yezer's policy prescription for the FHA is "that over time the FHA should revert to its previous role: helping first-time and low- to moderate-income homebuyers purchase homes, allowing the private sector to shoulder more of the risk associated with insuring larger loans."[42] Van Order and Yezer, like many other commentators, tend to focus on just one aspect of the FHA's original mission—providing liquidity to a frozen market—and bestow it with an essential quality: *this is what the FHA truly is about.* But the historical record is much more complicated, both at the FHA's origin and over the course of its long history. This is not to say that concerns about the FHA are unfounded: there is great reason to be concerned for the financial health of the FHA.

Min, recently of the Center for American Progress and consistently at odds with Pinto on housing finance policy, also agrees that the FHA needs major reform although he has not yet set forth why. *See* David Min, *What Should Replace Fannie and Freddie?* (PowerPoint presentation given at the American Enterprise Institute, Jan. 25, 2011), http://S3.amazons.com/Zanrah_storage/www.aei.org/files/2011/01/25/Min.pdf.

[40] GYOURKO, *supra* note 31, at iii. Gyourko further argues, "Not only is its main mortgage insurance guarantee fund insolvent in the sense that it does not have sufficient capital resources to cover expected losses, but it is also failing far too many of its intended program beneficiaries in helping them achieve sustainable homeownership." *Id.*

[41] *See infra* text accompanying notes 48–52 (discussing the financial situation of the FHA).

[42] VAN ORDER & YEZER, *supra* note 36, at 2.

Empirical studies bear this out. Housing economist Joseph Gyourko demonstrates that the FHA's reserves became precarious soon after the Great Recession.[43] In 2011, Gyourko wrote:

> For the past two years, it has been in violation of its most important capital reserve regulation, under which it is supposed to hold sufficient reserves against unexpected future losses on its existing insurance-in-force. To be barely compliant with this rule would have required just over a $12 billion capital infusion in fiscal year 2010, and that presumes that future losses are not being underestimated by FHA. This report suggests that they are by many tens of billions of dollars, so that the recapitalization required will be at least $50 billion, and likely much more, even if housing markets do not deteriorate unexpectedly.[44]

Another study by Diego Aragon and others was consistent with Gyourko's findings. It found that the Mutual Mortgage Insurance (MMI) Fund's rapid growth since 2007 has led to major losses, with its reserves dropping from $15.8 billion to $2.73 billion from 2008 to 2009.[45] The same study estimated that "[a]bsent new revenues from future books of business, the recent annual audit estimates that the [FHA's] capital ratio is down to 0.53 percent, below its required 2 percent level."[46] The Aragon study identified various warning signals that indicated that funding will in fact be necessary.[47]

---

[43] Joseph Gyourko, *Is FHA the Next Housing Bailout?* 1 (Am. Enter. Inst., Working Paper No. 2011-06, 2011).

[44] *Id. But see* Sarah Rosen Wartell & John Griffith, *Too Early to Sound the FHA Alarm*, CTR. FOR AM. PROGRESS (Dec. 12, 2011), http://www.americanprogress.org/issues/housing/report/2011/12/12/10787/too-early-to-sound-the-fha-alarm/ (arguing that Gyourko and others have exaggerated FHA's losses).

[45] Diego Aragon et al., *Reassessing FHA Risk* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 15802, 2010), http://www.nber.org/papers/w15802.

[46] *Id.* at 2, n.3.

[47] *Id.* at 2–3. The warning signs were: (1) many FHA-insured borrowers owe more than their house is worth; (2) FHA-insured homes are worth significantly less than the FHA

Although the FHA denied that it would need additional funding after the Gyourko study was released, the critics turned out to be right.[48] The FHA received a nearly $1.7 billion infusion from the Treasury in 2013.[49] Also, the FHA's single-family mortgage guarantees made between 1992 and 2012 will have "a net federal budgetary cost of about $15 billion . . . ."[50] Indeed, actuaries have estimated the economic value of the main FHA program to be **negative** $13.5 billion in 2012.[51] This estimate was expected to improve over time, and in fact it has, but this was a financial low for the FHA.[52] There is no question that these policy critiques and

---

believes them to be; (3) FHA ignores negative information about currently delinquent mortgages and improperly underwrites its streamline refinanced mortgages; and (4) many FHA-insured borrowers were able to put down effectively no money for their purchase because they can finance FHA's up-front premium and because first-time homebuyers were eligible for a tax credit that offset the expenditures made to purchase the house. *Id.*

48 Raphael Bostic, *The Continued Strength of the FHA*, THE HUDDLE (Nov. 18, 2011), http://blog.hud.gov/index.php/2011/11/18/continued-strength-fha/ (providing HUD's rebuttal to Gyourko's study by then-HUD Assistant Secretary for Research and Policy Development).

49 FED. HOUS. ADMIN., *supra* note 24 (noting in the unpaginated *A Message from the Commissioner* that "FHA was required to take a mandatory appropriation of $1.68 billion from the U.S. Treasury to close its FY [fiscal year] 2013 books"). Note that the FHA has also sent billions of dollars to the Treasury's general fund pursuant to the Federal Credit Reform Act and, furthermore, that accounting for the FHA's budgetary impact is not so straightforward. *See generally* CONG. BUDGET OFFICE, FAIR-VALUE ESTIMATES OF THE COST OF SELECTED FEDERAL CREDIT PROGRAMS FOR 2015 TO 2024 (2014); CHAD CHIRICO & SUSANNE MEHLMAN, CONG. BUDGET OFFICE, FHA'S SINGLE-FAMILY MORTGAGE GUARANTEE PROGRAM: BUDGETARY COST OR SAVINGS? (2013), http://www.cbo.gov/publication/44628; JAMES M. BICKLEY, CONG. RESEARCH SERV., R42632, BUDGETARY TREATMENT OF FEDERAL CREDIT (DIRECT LOANS AND LOAN GUARANTEES): CONCEPTS, HISTORY, AND ISSUES FOR THE 112TH CONGRESS (2012).

50 CHIRICO & MEHLMAN, *supra* note 49, at 1.

51 INTEGRATED FIN. ENG'G, INC., ACTUARIAL REVIEW OF THE FEDERAL HOUSING ADMINISTRATION MUTUAL MORTGAGE INSURANCE FUND FORWARD LOANS FOR FISCAL YEAR 2012, at i (2012) (excluding FHA reverse mortgages). Since 1990, the MMI Fund's financial health "has been assessed by measuring the Fund's economic value — its capital resources plus the net present value of future cash flows — and the related capital ratio . . . ." GEN. ACCOUNTING OFFICE, GAO-02-671T, MORTGAGE FINANCING: ACTUARIAL SOUNDNESS OF THE FEDERAL HOUSING ADMINISTRATION'S MUTUAL MORTGAGE INSURANCE FUND 2 (2002).

52 The MMI Fund had an estimated negative value of $7.9 billion in 2013. INTEGRATED FIN. ENG'G, INC., ACTUARIAL REVIEW OF THE FEDERAL HOUSING ADMINISTRATION MUTUAL INSURANCE FUND FORWARD LOANS FOR FISCAL YEAR 2013, at i (2013) (excluding FHA reverse mortgages). *Id.* (excluding FHA reverse mortgages). The MMI Fund had an estimated *positive* value of $5.93 billion in 2014. INTEGRATED FIN. ENG'G, INC., ACTUARIAL

budgetary concerns must be addressed to chart a responsible course for the FHA going forward.

III. THE ROLE OF THE FHA IN THE RESIDENTIAL MORTGAGE MARKET

The FHA's role in the mortgage market can best be understood as "a specialized insurance company that guarantees the payment of mortgages made by private lenders (banks and other mortgage lenders) who provide loans to developers and homebuyers."[53] The FHA was created in 1934, at a time when the mortgage market for one to four-family homes was split among individuals and other non-institutional lenders; commercial banks; mutual savings banks; savings and loan associations; and life insurance companies.[54] While savings and loans associations had a significant share of the market and pretty attractive terms, other types of lenders offered much less consumer-friendly products.[55] Commercial lenders, for

---

REVIEW OF THE FEDERAL HOUSING ADMINISTRATION MUTUAL MORTGAGE INSURANCE FUND FORWARD LOANS FOR FISCAL YEAR 2014, at i (2014) (excluding FHA reverse mortgages).

[53] FED. HOUS. ADMIN., ANNUAL MANAGEMENT REPORT FISCAL YEAR 2007, at 3 (2007), http://www.hud.gov/offices/hsg/fhafy07annualmana gementreport.pdf.

[54] LEO GREBLER ET AL., CAPITAL FORMATION IN RESIDENTIAL REAL ESTATE: TRENDS AND PROSPECTS 207 tbl.55 (1956). For a good review of the literature about the housing market preceding the Great Depression, see Chambers et al., *supra* note 6, at 5–6 (describing the importance of commercial banks after 1913, the changed structure of mortgages, and the lack of federal regulation in the residential housing market).

[55] GREBLER ET AL., *supra* note 54, at 231 tbl.66. More than 90% of savings and loan (S&L) mortgages were amortized, and many of those were fully amortized. *Id.* Fixed terms were, however, significantly shorter than those of FHA mortgages. *See* COMMS. ON FIN. & TAXATION, HOME FINANCE AND TAXATION 26 (1932) (report of The President's [Hoover] Conference on Home Building and Home Ownership); B.H. McCormack, *FHA Has Shown Banks Amortization Practice Is Best Policy for Home Owners' Mortgages; Several Federal Requirements Are Criticized*, WALL ST. J., June 30, 1938, at 5 (describing advantages and disadvantages of FHA Title II loans). S&Ls had a 39% of the market for one to four family homes from 1925–1930. GREBLER ET AL., *supra* note 54, at 207 tbl.55. One commentator noted that there "had been a trend toward a gradual liberalization of mortgage credit terms (interest rates on loans, length of contract maturities, and loan-to-value ratios) from 1920 to 1934, but in 1935 [the FHA's first full year of operation] the change was greatly accelerated." R.J. SAULNIER, URBAN MORTGAGE LENDING BY LIFE INSURANCE COMPANIES 43 (1950). Before the 1930s, S&Ls were often referred to as building & loan (B&L) associations. Jonathan Rose & Kenneth A. Snowden, *The New Deal and the Origins of the*

instance, typically required a loan-to-value (LTV) ratio of 50% to 60% of the property's market value, with a term of three to five years.[56] These mortgages typically required a large balloon payment at the end of the term, a payment that almost always required the borrower to refinance.[57] But even savings and loans associations required relatively low LTV ratios and relatively short terms.[58]

The housing markets faced problems in the Great Depression that were similar in kind to those faced in the late 2000s. These

---

Modern American Real Estate Loan Contract 1 n.2 (Nat'l Bureau of Econ. Research, Working Paper No. 18388, 2012). Rose and Snowden describe innovations in the building and loan industry from the 1880s through the 1930s. *Id.* at 1–3. For a contemporary view of the real estate finance industry in the 1920s, see RICHARD T. ELY & EDWARD W. MOREHOUSE, ELEMENTS OF LAND ECONOMICS 207–33 (1924).

[56] SECOND ANNUAL REPORT, *supra* note 16, at 27. Life insurance mortgages were similar. A large, albeit not representative, study of single-family mortgages originated by life insurance companies found that the LTV was typically between 40%–65%. SAULNIER, *supra* note 55, at 43 n.6. To be sure, savings and loan associations were much more likely to originate fully amortizing loans than commercial banks before the FHA was created. *See* GREBLER ET AL., *supra* note 54, at 231 tbl.66 (displaying the distribution of amortized loans from 1920–1947). Mortgages from thrifts could differ in some meaningful ways from the modern standard mortgage. FISHBACK ET AL., *supra* note 9, at 101 (describing how traditional B&L loans "did not truly pay off the principal each month, instead allowing borrowers to buy equity shares in the B&L"). *See generally* Chambers et al., *supra* note 6, at 5–7 (reviewing mid-twentieth century market share and contract terms of various types of lenders).

[57] *See* Dwight M. Jaffee & John M. Quigley, *Housing Policy, Mortgage Policy, and the Federal Housing Administration*, *in* MEASURING AND MANAGING FEDERAL FINANCIAL RISK 97, 105 (Deborah Lucas ed., 2010) (discussing the default rates and liquidity problems of the 1930s). The FHA was created pursuant to the National Housing Act, Pub. L. No. 73-479, 48 Stat. 1246 (1934). *See also* FIRST ANNUAL REPORT, *supra* note 15, at 3 ("A large proportion of the institutions, representing millions of small savings depositors, were not able because of law or tradition, or both, to make mortgage loans of more than 50 or 60 percent of the appraised value, whereas the most urgent demand is for first mortgages of from 60 to 80 percent of the appraised value of the property."); GREBLER ET AL., *supra* note 54, at 207 tbl.55 (noting that commercial banks had a 14% market share from 1925–1930 and individuals and other non-institutional lenders had a 26% share).

[58] COMMS. ON FIN. & TAXATION, *supra* note 55, at 25–26 (noting that savings institutions limited their mortgages to 40% to 60% of the appraised value and that long term mortgages typically had terms of eleven to fifteen years). Many borrowers ended up getting second mortgages with much less attractive terms to make up the difference if they were short of equity. *Id.* at 9–11. The report noted that "Experienced mortgage men . . . indicate that the greatest deterrent to sound home ownership may be found in the second mortgage field." *Id.* at 28.

problems include rapidly falling housing prices; widespread unemployment and underemployment; rapid tightening of credit; and, as a result of all of those trends, much higher rates of default and foreclosure.[59] The FHA noted in its second annual report that the "shortcomings of the old system need no recital. It financed extensive overselling of houses at inflated values, to borrowers unable to pay for them . . . ."[60] Needless to say, the same could be said of our most recent housing bust.

The FHA had an explicit mission of providing "a thorough reform in the home financing structure."[61] In fulfilling that mission, it helped to make a consumer-friendly, single-family mortgage mainstream during the Great Depression.[62] This type of mortgage combined a small down payment with a long-term and a fully amortized payment schedule—and this type is now dominant in the residential mortgage market.[63] The FHA was following the lead of

---

[59] *See* Green & Wachter, *supra* note 21, at 94 ("[D]uring the Great Depression in the early 1930s, property values in the United States declined by 50 percent relative to peak values . . . . A wave of foreclosures resulted—typically 250,000 per year between 1931 and 1935.").

[60] SECOND ANNUAL REPORT, *supra* note 16, at 28.

[61] FIRST ANNUAL REPORT, *supra* note 15, at 4.

[62] *See* McCormack, *supra* note 55, at 5 ("Virtually all those people who have had anything to do with the Federal Housing Administration since its inception four years ago agree that its greatest contribution has been to make the real estate world amortization conscious. FHA, of course, did not introduce regularized repayments on mortgages. Some savings banks and building and loan associations had followed such a practice, at least in part, for years and years. But today the unamortized mortgage on individual residences is the exception rather than the rule."). It is worth noting that the FHA, like many organizations, exaggerates its own successes and minimizes its failures. In the context of the 1930s, the FHA exaggerated how radically it changed the typical contract terms of the mortgage market. Some scholars seemed to have taken the FHA's word at face value, *see, e.g.*, Green & Wachter, *supra* note 21, at 93, while others have looked at different sources, which have told a more nuanced story about the development of the contract terms that we are familiar with in today's mortgage market. *See infra* note 64 (citing instances where academics and officials have reviewed alternate sources). The leading example of the FHA's minimization of its failures would be its characterizations of its history of redlining, discussed below. *See infra* Part III.B.*1–3*.

[63] Section 203(b) of Title II of the National Housing Act of 1934, Pub. L. No. 73-479, 48 Stat. 1246 (codified as amended at 12 U.S.C. § 1709(b)), authorized these mortgages for one to four family homes. These are often colloquially referred to as "FHA Loans" or "FHA single-family" loans or mortgages even though they may be secured by homes with up to four units. *See, e.g.*, BRUCE E. FOOTE & PAMELA HAIRSTON, CONG. RESEARCH SERV., 98-421, RAISING THE FHA

the Home Owners' Loan Corporation, the first of the New Deal initiatives designed to address the crisis in the housing markets.[64]

The FHA touted many other benefits for lenders and homeowners. The FHA believed that lenders also benefited from its mortgage insurance system because (1) it protected them from credit risk, the risk that borrowers would not repay their loans; (2) it made illiquid mortgages very liquid such that they could be sold or used as collateral; and (3) it standardized due diligence for mortgages because the FHA itself vetted them before agreeing to issue insurance.[65] The first benefit is quite dramatic, as credit risk is historically the most important of all risks that lenders face.

The second benefit of mortgage insurance for lenders was that it allowed lenders to sell their mortgages to secondary mortgage market investors.[66] To advance this even further, the federal government created Fannie Mae in 1938 to create a secondary

---

MORTGAGE LIMIT: ISSUES AND OPTIONS 2 (1998), http://www.cq.com/graphics/crsreports/98-42 1_1998-11-03.pdf (discussion of the characteristics of a Section 203 loan). *See also* David Reiss, *Landlords of Last Resort: Should The Government Subsidize The Mortgages of Privately-Owned, Small Multifamily Buildings?*, 31 W. NEW ENG. L. REV. 915, 915 n.1 (2009) (noting that as a result of historical accident, one to four family homes are typically referred to as "single-family" homes while buildings with five or more units are typically referred to as "multifamily" buildings). I use this nomenclature here.

[64] Home Owners' Loan Corporation (HOLC) loans had fifteen year terms with equal monthly payments, amortization, and 80% LTV. FISHBACK ET AL., *supra* note 9, at 86 tbl.8.1. *See* PRESIDENT'S COMM'N ON HOUS., *supra* note 6, at 118 ("FHA patterned its long-term, direct-reduction loan after the model established by the Home Owners' Loan Corporation, which required such contracts under its purchase programs. This step led to widespread acceptance of the fully amortized, fixed-rate, level-payment mortgage that has become the dominant mortgage instrument."). *See also* Michael S. Carliner, *Development of Federal Homeownership "Policy,"* 9 HOUS. POL'Y DEBATE 299, 306 (1998) ("Many of the innovations that have often been attributed to the FHA, such as the long-term self-amortizing loan, had already been in fairly widespread use, but the FHA, along with the Home Owners Loan Corporation, caused more lenders to use that type of loan."); Peter M. Carrozzo, *A New Deal for the American Mortgage: The Home Owners' Loan Corporation, the National Housing Act and the Birth of the National Mortgage Market*, 17 U. MIAMI BUS. L. REV. 1, 13–24, 37–40 (2008) (reviewing the roles of HOLC and FHA).

[65] SECOND ANNUAL REPORT, *supra* note 16, at 23.

[66] GEN. ACCOUNTING OFFICE, GAO/RCED-96-123, HOMEOWNERSHIP: FHA'S ROLE IN HELPING PEOPLE OBTAIN HOME MORTGAGES 18 (1996), http://www.gao.gov/archive/1996/rc 96123.pdf.

market for FHA mortgages.[67] Fannie Mae spun off Ginnie Mae in 1968 to securitize FHA mortgages while Fannie securitized mortgages that were not insured by the federal government.[68] Ginnie Mae is a wholly-owned government corporation that is situated within the Department of Housing and Urban Development (HUD).[69] Ginnie Mae insures mortgage-backed securities (MBS) that are secured by FHA and other government-insured or guaranteed mortgages like those of the Department of Veterans Affairs (VA).[70] Ginnie Mae MBS are the only mortgage-backed securities that are explicitly backed by the federal government's full faith and credit.[71]

The federal government's guaranty makes Ginnie Mae MBS very attractive to investors who are willing to pay a premium over comparable mortgage-backed securities from other issuers.[72] This premium thus reduces the interest rates paid by homeowners on the mortgages underlying Ginnie Mae mortgage-backed securities.[73]

---

67 Reiss, *supra* note 9, at 1028–29.

68 *Id.* at 1029.

69 12 U.S.C. § 1723. "A government corporation is generally a federally chartered entity created to serve a public function of a predominantly business nature." GOV'T ACCOUNTABILITY OFFICE, GAO-13-682, FEDERAL HOUSING ADMINISTRATION: ANALYSIS OF OPTIONS FOR MODIFYING ITS PRODUCTS, MARKET PRESENCE, AND POWERS 3 n.5 (2013).

70 *See* 12 U.S.C. §§ 1716–1723 (codifying Title III of the National Housing Act and enumerating Ginnie Mae statutory authority). *See* GINNIE MAE, REPORT TO CONGRESS FISCAL YEAR 2010, at 1–10, http://www.ginniemae.gov/ReportToCongress/ (discussing Ginnie Mae's purpose and products). Ginnie Mae MBS can also include mortgages guaranteed or issued by the Department of Agriculture's Rural Development and HUD's Office of Public and Indian Housing. *See, e.g.*, USDA, *About Rural Development*, USDA.GOV, http://www.rurdev.usda.gov/AboutRD.html (last visited May 29, 2016) (listing Rural Development's goals and summarizing its loan portfolio). Nearly all FHA and VA mortgages are securitized by Ginnie Mae. GEN. ACCOUNTING OFFICE, GAO/RCED-97-93, HOMEOWNERSHIP: POTENTIAL EFFECTS OF REDUCING FHA'S INSURANCE COVERAGE FOR HOME MORTGAGES 2 (1997).

71 GINNIE MAE, REPORT TO CONGRESS FISCAL YEAR 2007, at 2, http://www.ginniemae.gov/about/ann_rep/ReportToCongress07.pdf. Contrast these Ginnie Mae MBS with the securities of Fannie and Freddie which were long understood to have the implicit backing of the federal government. *See generally* Reiss, *supra* note 1, at 910.

72 *See* GINNIE MAE, *supra* note 70, at 3 ("The Ginnie Mae guaranty . . . makes Ginnie Mae securities highly liquid and attractive to domestic and foreign investors of all types."); THOMAS P. LEMKE ET AL., MORTGAGE-BACKED SECURITIES § 2:4 (2015) (discussing how Ginnie Mae allows lenders to charge a lower interest rate for loans).

73 GINNIE MAE, *supra* note 70, at 1.

The attractiveness of the guaranty to investors also creates an extraordinarily liquid market for Ginnie Mae securities.[74] Thus, because of the federal government's guaranty, Ginnie Mae can continue to provide liquidity even when credit is drying up elsewhere in the credit markets.[75] This benefit has been readily apparent during the Great Recession.[76]

At the same time that the FHA touted its benefits to lenders, it also promoted itself as a protector of consumers. For instance, it heralded standardization as "essential in the first real major offensive in the history of our people against an impracticable mortgage lending system unsuited to actual conditions and too often unsafe for the inexperienced borrower who merits security and protection in his dealings."[77]

Homeowners would benefit from a standard mortgage form, one that would protect "the borrower against ambiguous or 'trick' clauses . . . ."[78] The FHA designed its procedures to "prevent borrowers from attempting to buy beyond their means. In the past, many persons have lost their savings because they lacked knowledge of the expenses involved in home ownership; if they had been better informed they could have succeeded in owning more modest homes."[79] Thus, the FHA was designed from the outset with consumer protection, along with liquidity, stability and standardization, as its core values. The FHA's original

---

[74] LEMKE ET AL., *supra* note 72, § 2:6 ("[T]he federal guarantee has made the Ginnie Mae MBS the most marketable of all the secondary mortgage market instruments.").

[75] *See* GINNIE MAE, *supra* note 70, at 3–4 (describing the capital flow cycle of these securities).

[76] *Id.*

[77] SECOND ANNUAL REPORT, *supra* note 16, at 24.

[78] *Id.* at 25; *cf.* David Reiss, *Message in a Mortgage: What Dodd-Frank's "Qualified Mortgage" Tells Us About Ourselves,* 31 REV. BANKING & FIN. L. 717, 723–24 (2012) (discussing QM rule's consumer protection provisions).

[79] SECOND ANNUAL REPORT, *supra* note 16, at 6. *See also* FED. HOUS. ADMIN., UNDERWRITING MANUAL para. 318 (1936) ("Ability to Pay is the most heavily weighted feature in the Rating of Borrower category because, in the final analysis, the satisfactory payment of the mortgage loan is largely dependent on the borrower's financial ability to meet the prescribed monthly installments . . . . It is obvious that default is inevitable if the borrower's resources will not enable him to comply with all the contractual obligations created by the mortgage and mortgage notes which he signs.").

underwriting requirements also mandated that borrowers' ability to repay be documented notwithstanding the fact that the home provided sufficient security to ensure that the loan would be repaid, thereby barring equity-based lending.[80]

Early on, the FHA took credit for a qualitative change in the housing market that resulted from its policies and practices: "In view of the low monthly payments required to amortize a long-term mortgage, it appears that the single-mortgage system has brought new homes within reach of many families previously unable to acquire them."[81] While the FHA's assessment of its own performance is not always merited, it was in this case.[82]

In order to move away from the unsustainable practices that preceded it, the FHA initially set the maximum term for a mortgage that it would insure at twenty years and the maximum LTV ratio at 80%.[83] At its creation, the FHA served a broad swath of the residential mortgage market, given that it could insure mortgages with principal amounts as high as $16,000 (meaning that a home could be valued as high as $20,000 with a maximum LTV of 80%) when the median price for a house in the United States was a bit more than $5,000.[84] Interest rates were capped in order to equalize rates among local markets and to limit the effects of restricted capital.[85]

---

[80] SECOND ANNUAL REPORT, *supra* note 16, at 25. *Cf.* David Reiss, *Consumer Protection Out of the Shadows of Shadow Banking: The Role of the Consumer Financial Protection Bureau*, 7 BROOK. J. CORP., FIN. & COM. L. 131, 135 n.26 (2012) (discussing Dodd-Frank's Ability-to-Repay rule).

[81] SECOND ANNUAL REPORT, *supra* note 16, at 21.

[82] *See supra* note 62 (discussing how the FHA often exaggerates its successes while minimizing its failures).

[83] *See* Jaffee & Quigley, *supra* note 57, at 105 (noting FHA policies at the time of its creation).

[84] *Id.* Only 3.4% of homes in 1930 were valued at more than $20,000. FISHBACK ET AL., *supra* note 9, at 37. That proportion surely sank by the time the FHA was authorized in 1934. The VA uses slightly different nomenclature. Instead of calling itself a mortgage insurer, it calls itself a mortgage guarantor.

[85] FIRST ANNUAL REPORT, *supra* note 15, at 4 (discussing how the activities of the FHA were centered around the need for more capital to use in real property). The capped interest rate changed over time in response to market pressures and was circumvented by the charging of points at origination to compensate the lender for a below-market capped

A. MORTGAGE INSURANCE EXPLAINED

Mortgage insurance is typically required for borrowers with limited funds for down payments.[86] Lenders, not borrowers, are the direct beneficiaries of mortgage insurance.[87] Depending on the insurer, mortgage insurance will pay some or all of a lender's loss upon default or foreclosure of the loan.[88] The FHA has long been the dominant mortgage insurer.[89] Other significant providers are the VA[90] and private companies, known as private mortgage insurers (PMIs).[91]

---

interest rate. *See, e.g.*, NAT'L CTR. FOR HOUS. MGMT., *supra* note 34, at 11–13 (noting that the actual yield on FHA insured mortgages is close to conventional mortgages because of the added points).

[86] GEN. ACCOUNTING OFFICE, *supra* note 66, at 16. Substitutes for mortgage insurance do exist. Portfolio lenders can self-insure against higher losses from loan down payment loans. Another alternative is for the borrower to take out two mortgages at the time of purchase. The first mortgage would have an 80% LTV while the second mortgage, known as a piggyback mortgage, would cover 10% to 20% of the remainder. FED. HOUS. FIN. AGENCY, STATE OF THE PRIVATE MORTGAGE INSURANCE INDUSTRY: IMPLICATIONS FOR U.S. MORTGAGE MARKETS AND THE ENTERPRISES 2 (2009) (Mortgage Market Note 09-4).

[87] Diana G. Browne, *The Private Mortgage Insurance Industry, the Thrift Industry and the Secondary Mortgage Market: Their Interrelationships*, 12 AKRON L. REV. 631, 631 (1979).

[88] *See id.*

[89] *See id.* (explaining that the government provided mortgage insurance through the FHA after the Great Depression and that PMIs came back on the scene in the late 1950s).

[90] Until 1988, the VA was known as the Veterans' Administration. Department of Veterans Affairs Act of 1988, Pub. L. No. 100-527, § 2, 102 Stat. 2635 (1988).

[91] The body of literature about PMI is not large. *See* GOV'T ACCOUNTABILITY OFFICE, GAO-13-722, FHA MORTGAGE INSURANCE: APPLICABILITY OF INDUSTRY REQUIREMENTS IS LIMITED, BUT CERTAIN FEATURES COULD ENHANCE OVERSIGHT 9–11 (2013) (contrasting PMI and FHA insurance); Quintin Johnstone, *Private Mortgage Insurance*, 39 WAKE FOREST L. REV. 783, 808–31 (2004) (discussing regulation of PMIs); Roger Blood, *Mortgage Default Insurance: Credit Enhancement for Homeownership*, 16 HOUS. FIN. INT'L 49, 49–51 (2001) (providing an overview of mortgage insurance in the U.S.); Kristin Chen, *The Role of Mortgage Insurance in Risk Management*, 1 INT'L J. REAL EST. FIN. 8 (2000); Glenn Canner & Wayne Passmore, *Private Mortgage Insurance*, 80 FED. RES. BULL. 883, 891–99 (comparing PMI providers); Browne, *supra* note 87, at 633–39 (describing the history of the PMI sector); ARTHUR D. LITTLE, INC., *The Arthur D. Little Study of the Private Mortgage Insurance Industry* (Nov. 1975); Joseph E. Johnson & George B. Flanigan, *Regulation of Private Mortgage Insurance*, 27 C.P.C.U. ANNALS 92 (1974); CHESTER RAPKIN ET AL., THE PRIVATE INSURANCE OF HOME MORTGAGES: A STUDY OF MORTGAGE GUARANTY INSURANCE CORPORATION (1967) (comparing and contrasting the FHA and Mortgage Guaranty Insurance Corporation in the modern era); James Graaskamp, *Development and Structure of Mortgage Loan Guaranty Insurance in the*

Mortgage insurance works as follows: When a borrower purchases a home with a small down payment, the lender may require that she purchase mortgage insurance at the same time to protect the lender, *not* the borrower, from a default.[92] The lender may do this to transfer some of the risk of loss to the insurer but also to make the loan eligible for purchase by Ginnie Mae, Fannie Mae, or Freddie Mac.[93] These entities can then securitize pools of mortgages and insure the owners of the securities against late payments and nonpayments.[94] If the borrower does default and the property is foreclosed upon, the lender can look to the insurer to make up some or all of the difference between the foreclosure sale price and the outstanding amount due on the loan (consisting of unpaid principal and interest as well as all of the other costs that may be due under the mortgage, such as those relating to the foreclosure itself).[95] By doing this, the lender has offloaded some or all of the risk of default to the insurer. If there were no mortgage insurance, that entire credit risk would remain with the lender or its successor.[96]

Mortgage insurers charge a premium to the borrower for the insurance.[97] PMIs generally charge a monthly premium.[98] The VA guarantee fee is an up-front charge, but it can be financed as part of the mortgage.[99] The FHA charges an up-front premium

United States, 34 J. RISK & INS. 47, 60–67 (1967) (describing the mortgage guaranty process and related regulation).

[92] *See* Browne, *supra* note 87, at 635 (describing the function of modern mortgage insurance companies).

[93] Canner & Passmore, *supra* note 91, at 887.

[94] *See* GEN. ACCOUNTING OFFICE, *supra* note 66, at 18 (explaining how the entities use mortgage pools). Fannie Mae and Freddie Mac have their own statutory requirements relating-to-loan to value ratios with which they must comply. These requirements may be waived if there is mortgage insurance in place. *See* Reiss, *supra* note 9, at 1032 (referencing the requirements and their effects).

[95] *See* GEN. ACCOUNTING OFFICE, *supra* note 66, at 17 ("If a borrower does not repay an insured mortgage loan as agreed, the lender may acquire the property through foreclosure and file a claim with the mortgage insurer for all or a portion of its total losses.").

[96] *Id.*

[97] *Id.* at 35.

[98] *Id.*

[99] *Id.* at 36.

that can be financed as part of the mortgage in addition to an annual premium.[100] These premiums allow the FHA to be self-funded; that is, it requires no funds from the federal government to maintain its operations.[101]

Mortgage insurance products from the various insurers differ from each other as to the

1. maximum mortgage amounts and LTV ratios allowed;
2. underwriting standards for borrowers, such as the income-to-expense qualifying ratio requirement;
3. funds required at loan closing for such items as down payment and closing costs; and
4. dollar amount or percent of loss that each organization will pay lenders to cover the losses associated with foreclosed loans.[102]

The FHA generally insures a lower maximum principal amount than other insurers.[103] FHA insurance stands out from other forms of mortgage insurance for protecting the lender from nearly all of the losses from a loan that has gone through foreclosure; other insurers, both government and private, only insure a portion of the potential losses.[104]

The amount insured by the VA has been changed by Congress over time but has never been as high as that of the FHA.[105] PMIs usually insure a much smaller proportion of the losses, from 20%

---

[100] *Id.* at 35.

[101] *Id.* at 18. The recent bailout discussed below in Part III.B.*9* broke this long string of self-sufficiency.

[102] *Id.* at 26.

[103] *See id.* at 5.

[104] *Id.* at 36. FHA mortgage insurance has differed from the other types because "it allows closing costs to be financed in the mortgage" and "provides nearly full insurance coverage to lenders." *Id.* at 4.

[105] *See id.* at 36–37 (illustrating the VA guaranty schedule); *id.* at 5 (noting the "VA covers only 25 to 50 percent of the mortgage balance, even if a loss exceeds that amount").

to 35%.[106] While the FHA and the VA insure or guarantee "loans with effective loan-to-value ratios that exceed 100 percent (due to the financing of closing costs or other fees)," PMIs typically require at least a 3% down payment,[107] although that requirement has relaxed during the Subprime Boom of the early 2000s.[108]

Homeowners choose FHA over PMI mortgages for one or more of the following reasons:

1. they cannot or prefer not to make the minimum down payment required by private mortgage insurers;
2. their credit scores are weak;
3. their employment histories are short or spotty or they are self-employed; or
4. their total debt-to-income ratios are higher than what a private mortgage insurer would accept.[109]

Thus, the FHA effectively extends credit to borrowers whom other lenders reject, at least on the terms desired by the borrowers. The existence of PMI is explained in large part because of the FHA's cross-subsidization model by which low-risk borrowers pay the same premium as high-risk borrowers.[110] A PMI company can typically offer a better deal to the low-risk borrower and often has additional competitive advantages, such as easier paperwork and faster approval times.[111]

The FHA does most of its work through the operation of five insurance funds: Mutual Mortgage Insurance (MMI); General Insurance (GI); Special Risk Insurance (SRI); Hope for

---

[106] *Id.* at 36.

[107] *Id.* at 5.

[108] *See infra* Part III.B.8.

[109] *See* FOOTE & HAIRSTON, *supra* note 63, at 23 (outlining the reasons why homebuyers may choose FHA loans).

[110] *See* PRESIDENT'S COMM'N ON HOUS., *supra* note 6, at 162 (noting that PMIs can charge lower premium rates since they do not cross-subsidize).

[111] *Id.*

Homeowners (H4H); and the Cooperative Management Housing Insurance Fund (CMHI).[112] The MMI Fund is the FHA's largest by far. It is used for most of the FHA single-family programs.[113] The MMI Fund covers $1.173 trillion of insured mortgages.[114] Indeed, in 2010 alone, the massive MMI Fund amounted to 43% of all types of loans and guarantees made by the federal

---

[112] FED. HOUS. ADMIN., FISCAL YEARS 2013 AND 2012 FINANCIAL STATEMENTS AUDIT 27 (2013). Section 203(b) of the National Housing Act (12 U.S.C. § 1709(b)(2)(A)(i)), authorized the creation of the single-family mortgage insurance program. Program regulations are in 24 C.F.R. Part 203. The MMI Fund supports the 203(b) program. The fund is called a "mutual insurance" fund because it was designed to act like other types of mutual insurance with policyholders sharing in the risk of default as well as a share of any excess monies that the fund generated. *See* L.E. Cooper, *Prepare To Insure Home Mortgages*, N.Y. TIMES, Oct. 14, 1934, at RE1 ("When the amount accumulated in the fund equals the unpaid balances of the outstanding insured mortgages the excess will be applied for the benefit of the home owner by paying off the mortgage balances before maturity."); *see also* FED. HOUS. ADMIN., REVISED CIRCULAR NO. 1, MUTUAL MORTGAGE INSURANCE: AMENDED ADMINISTRATIVE RULES AND REGULATIONS UNDER TITLE II OF THE NATIONAL HOUSING ACT 5 (1935) ("The mortgage insurance system will operate on the mutual principle, which may be described as follows: The premium for insurance, ultimately payable by the mortgagor, represents a charge adequately in excess of any amount which might be necessary to cover any possible losses. Out of the fund built up from such premiums actual losses and costs of administration will first be paid, and then the remainder of the fund will be redistributed to the mortgages to apply toward extinguishing the mortgage debt for the benefit of the mortgagors."). The "mutual" aspect of FHA insurance has diminished over time. *See* INTEGRATED FIN. ENG'G, INC., ACTUARIAL REVIEW OF THE FEDERAL HOUSING ADMINISTRATION MUTUAL MORTGAGE INSURANCE FUND FORWARD LOANS FOR FISCAL YEAR 2013, at 2 (2013) ("To further strengthen the capital position of the Fund, the NAHA [National Affordable Housing Act] legislation linked FHA's ability to pay distributive shares to the actuarial soundness of the entire MMI Fund (as defined in the legislation), rather than solely considering the performance of the loans endorsed during a particular year, as had been done in years prior to 1990. This amendment allowed distributive share payments only if the Fund achieved the capital standard established by the legislation, and then at the discretion of the Secretary of HUD. No distributive shares have been paid since the passage of NAHA.").

[113] CONG. BUDGET OFFICE, ASSESSING THE GOVERNMENT'S COSTS FOR MORTGAGE INSURANCE PROVIDED BY THE FEDERAL HOUSING ADMINISTRATION 1 (2006), http://www.cbo.gov/ftpdocs/74xx/doc7412/07-17-FHA.pdf.

[114] INTEGRATED FIN. ENG'G, INC., *supra* note 112, at 68. In 2006, the MMI Fund was "the federal government's largest mortgage insurance program." CONG. BUDGET OFFICE, *supra* note 113, at 1.

government.[115] The MMI's programs are "unique among federal direct loan and guarantee programs as they are required to be self-supporting."[116] In contrast, the VA mortgage guaranty program is subsidized by the federal government.[117]

At the outset, the MMI Fund was operated very conservatively.[118] But the FHA changed in many ways over its eighty-year history, as will be seen in the following section. It faced competitive pressures from a resurgent private mortgage insurance industry. It responded to great social and economic upheavals and shed some of those responses as times changed. And most importantly for this Article, it loosened its underwriting to achieve various social goals to good and ill effect.

B. A HISTORY OF THE FHA'S CHANGING MISSIONS

Congress added and discontinued various missions of the FHA since its creation during the Great Depression. Depending on the political winds, it targeted different types of buyers and different types of residences at different times. Some programs were very successful, and some were abject failures. These initiatives, and other important FHA developments, are reviewed below.

1. The 1930s: Creation and Execution. Compared to contemporary housing finance reforms, the FHA was set up fast, efficiently, and with a broad base of support throughout the country, the very model of a New Deal program.

The FHA was meant to replace the private mortgage insurance industry that predated it. The first mortgage insurance company was incorporated in 1887, with a few more incorporating through

---

[115] DEP'T OF HOUS. & URBAN DEV., ANNUAL REPORT TO CONGRESS REGARDING THE FINANCIAL STATUS OF THE FHA MUTUAL MORTGAGE INSURANCE FUND FISCAL YEAR 2010, at 1 (2010), http://www.hud.gov/offices/hsg/rmra/oe/rpts/actr/2010actr_subltr.pdf.

[116] *Id.* As noted above, the federal government had to provide a cash infusion to the FHA for the first time in its history in 2013. *See* FED. HOUS. ADMIN., *supra* note 24, at ii (describing how the FHA required a $1.68 billion appropriation from the Treasury in 2013).

[117] GEN. ACCOUNTING OFFICE, *supra* note 66, at 18.

[118] The FHA's second annual report states that the "sound operation of the mutual mortgage insurance system requires that only sound mortgages be accepted for insurance." SECOND ANNUAL REPORT, *supra* note 16, at 25.

the early 1900s.[119] The industry first took off after New York legalized it in 1904[120] and then boomed during World War I.[121] There were twelve companies in New York in 1921 and at least fifty by 1930.[122] For many years, the industry had "practically no losses"[123] until it was wiped out in the early 1930s.[124] Its

---

[119] GEORGE W. ALGER, REPORT TO HIS EXCELLENCY HERBERT H. LEHMAN, GOVERNOR OF THE STATE OF NEW YORK, BY GEORGE W. ALGER, APPOINTED UNDER THE EXECUTIVE LAW TO EXAMINE AND INVESTIGATE THE MANAGEMENT AND AFFAIRS OF THE INSURANCE DEPARTMENT WITH RESPECT TO THE OPERATION, CONDUCT, AND MANAGEMENT OF TITLE AND MORTGAGE GUARANTEE CORPORATIONS UNDER ITS SUPERVISION 8 (1934). According to one source, "a poorly worded stretch of the New York State 1885 Statutes in regard to title insurance was misinterpreted to permit the guaranty of mortgages against loss for reasons other than title defect." James Graaskamp, *Development and Structure of Mortgage Loan Guaranty Insurance in the United States*, 34 J. RISK & INS. 47, 49 (1967).

[120] *See In re* Ryan's Will, 52 N.E.2d 909, 921 (N.Y. 1943) ("[T]he legislature by laws of 1904, chapter 543, amending Insurance Law, § 170, had authorized title guaranty insurance companies to 'guarantee or insure the payment of bonds and mortgages.' "). The early PMI industry shared characteristics with modern title insurers, mortgage bankers and bond insurers. *See* ALGER, *supra* note 119, at 93. Thirteen other states had statutes governing mortgage insurance in 1933. *Id.* at 141.

[121] ALGER, *supra* note 119, at 8.

[122] FISHBACK ET AL., *supra* note 9, at 16. Those fifty companies had written insurance on an amount "equal to one-tenth of all outstanding residential mortgage debt. . . ." *Id.* The New York Banking Department also licensed mortgage insurers, and those companies are not included in the fifty companies mentioned above. PROMONTORY FIN. GRP., LLC, THE ROLE OF PRIVATE MORTGAGE INSURANCE IN THE U.S. HOUSING FINANCE SYSTEM 32 n.53 (2011), http://usmi.org/wp-content/uploads/2014/03/622-Genworth-Study-I-Role-of-PMI.pdf. This report was prepared at request of Genworth Financial, a private mortgage insurer.

[123] ALGER, *supra* note 119, at 12.

[124] Eugene N. White, *Lessons from the Great American Real Estate Boom and Bust of the 1920s*, 30, 32 (Nat'l Bureau of Econ. Research, Working Paper No. 15573, 2009), http://www.nber.org/papers/w15573.pdf. In the 1920s,

> the real estate aspects of the mortgage guaranty conformed to the general practice of inept appraisal, high leverage, and, in at least one case, over-certification of a mortgage portfolio. However, integrity of management did not actually break down until 1932 and 1933, when desperate executives found hope of continued liquidity in reselling at par, for cash, their own securities to the uninformed small investor, securities purchased in the money markets at great discount.

Graaskamp, *supra* note 119, at 51. In New York, the home to the most private mortgage insurers, eighteen companies were taken over by the New York Insurance Department. ALGER, *supra* note 119, at 2. The companies taken over had well over two thirds of the mortgage guarantee market in New York. *See* MORELAND COMM'N, MEMORANDUM RESPECTING THE PLAN FOR THE RELIEF AND PROTECTION OF HOLDERS OF GUARANTEED MORTGAGE CERTIFICATES 1 (undated) (appended to ALGER, *supra* note 119).

companies began to fail as almost half of all of the mortgages in the nation defaulted.[125] New York State banned PMI in 1938 in response to this track record,[126] and the PMI industry did not return until the 1950s.[127]

The FHA's Mutual Mortgage Insurance (MMI) Fund was the federal government's main alternative to PMI. It was initially "designed to make generally available, to owners of homes, mortgage loans that embrace the following features":

> 1. Long term credit, not exceeding 20 years;
> 2. Complete amortization which provides for (a) steady reduction of principal, (b) no renewals, and consequently no renewal charges, and (c) ultimate debt-free home ownership;
> 3. A single first mortgage for a higher percentage of the value than has been customary, but not exceeding 80 percent of the appraised value;
> 4. Low interest rate.[128]

The FHA Administrator noted after its first full year of operation that in "most districts of the country, mortgage money frozen almost solid a year ago, is now generally available to home owners on the most attractive terms in the history of the Nation."[129]

---

[125] Pennington-Cross & Yezer, *supra* note 21, at 358.

[126] PROMONTORY FIN. GRP., LLC, *supra* note 122, at 31.

[127] DENNIS & PINKOWISH, *supra* note 7, at 154.

[128] SECOND ANNUAL REPORT, *supra* note 16, at 17. For a limited time, Congress authorized the FHA to insure certain mortgages with twenty-five year terms with loan-to-value ratios as high as 90%. National Housing Act Amendments of 1938, Pub. L. No. 75-424, 52 Stat. 8, 10–11 (1938) (amending section 203(b) of the National Housing Act of 1938). Only mortgages secured by newly constructed, owner-occupied homes with (i) a principal amount of less than $5,400 where the owner had paid a 10% down payment or (ii) a principal amount of less than $8,600 where the owner had paid a down payment of between 10% and 20% were eligible for this particular type of mortgage insurance. *Id.* The FHA clearly laid out the elements of the original program in a consumer guide, HOW TO HAVE THE HOME YOU WANT (1936).

[129] SECOND ANNUAL REPORT, *supra* note 16, at vii.

The next year, the FHA Administrator ascribed the following developments in the residential mortgage market to the introduction of the MMI Fund:

> The firm establishment of the long-term monthly amortized mortgage in the home mortgage lending practice of the Nation.
>
> The free flow of mortgage money from centers of supply into communities where funds are normally scarce.
>
> The reduction in mortgage financing charges for large sections of the country, due to the uniform interest rate established by the [FHA].
>
> Improvement in construction practices, influenced by standardized appraisal methods, based on minimum property standards.
>
> Increased safety to both the home buyer and the mortgage lender throughout the life of the mortgage as a result of insurance protection and the safeguards attending it.[130]

In sum, the FHA helped American housing markets to rise from their bottom by providing more easily accessible credit on terms that were more attractive than those offered by the private sector. The FHA largely replaced the private mortgage insurance companies that had failed in the early 1930s, but it went far beyond their role in many, many ways.[131]

As told by Kenneth Jackson in his classic book *Crabgrass Frontier*, the FHA had a major negative impact on central cities and minority communities from its very beginning.[132] Its impact

---

[130] *Id.* at vi.

[131] Green & Wachter, *supra* note 21, at 95.

[132] JACKSON, *supra* note 26, at 203–18. *See* Robert C. Weaver, *Housing Discrimination: An Overview*, *in* A SHELTERED CRISIS: THE STATE OF FAIR HOUSING IN THE EIGHTIES 1, 3, Keynote Address at a consultation sponsored by the United States Commission on Civil Rights (Sept. 26–27, 1983) ("Exclusion of blacks from suburbia inflicted a high level of discrimination upon them."); ROBERT C. WEAVER, THE NEGRO GHETTO 70 (1948) ("Not only

on the former was unintentional. Because the FHA made financing available for so much new housing, white working-class families fled the cities to the newly built suburbs in massive numbers.[133]

But the impact on minority households was quite intentional: the FHA reflected the widely-held prejudices and discriminatory practices already endemic in the all-white housing and mortgage-lending industries.[134] One of the main such practices was the imposition of restrictive covenants that excluded blacks and other minorities.[135] The FHA also drew red lines on its underwriting maps to cordon off blocks in which even a single non-white family

---

were the vast majority of Negroes financially unable to participate in the FHA program, but even those who could afford to build new homes were stymied by their relegation to the Black Belt."). The FHA was not the only or first federal agency to have such an impact. *See* Amy E. Hillier, *Redlining and the Homeowners' Loan Corporation*, 29 J. URB. HIST. 394, 412–15 (2003) (arguing that HOLC played a role in institutionalized redlining and industry practices); ERNEST FISHER & HOMER HOYT, FED. HOUS. ADMIN., THE STRUCTURE AND GROWTH OF RESIDENTIAL NEIGHBORHOODS IN AMERICAN CITIES 28 (1939) (noting, in this FHA report, that the federal government began tracking the "[p]ercentage of the total number of persons living in the block that are of a race other than white" in 1934 as part of the real property surveys conducted by the Works Progress Administration).

[133] JACKSON, *supra* note 26, at 211–17.

[134] *See* RICHARD R.W. BROOKS & CAROL M. ROSE, SAVING THE NEIGHBORHOOD: RACIALLY RESTRICTIVE COVENANTS, LAW, AND SOCIAL NORMS 109 (2013) (stating that the FHA's "Underwriting Manual reflected private developers' and brokers' views of the kinds of features that made housing values stable and secure. Those features clearly included racial segregation."). *See generally* Amanda Tillotson, *Race, Risk and Real Estate: The Federal Housing Administration and Black Homeownership in the Post World War II Home Ownership State*, 8 DEPAUL J. SOC. JUST. 25 (2014) (arguing that the FHA was not the first to implement discriminatory practices like restrictive covenants).

[135] *See* FED. HOUS. ADMIN., UNDERWRITING MANUAL para. 980(3)g (1938) (stating that restrictive covenants should prohibit "the occupancy of properties except by the race for which they are intended"); Charles M. Lamb & Adam W. Nye, *Do Presidents Control Bureaucracy? The Federal Housing Administration during the Truman-Eisenhower Era*, 127 POL. SCI. Q. 445 (2012) (documenting similar history); *see also* FED. HOUS. ADMIN., *supra* note 79, para. 233 (stating that areas surrounding the home should be investigated "to determine whether or not incompatible racial and social groups are present, to the end that an intelligent prediction may be made regarding the possibility or probability of the location being invaded by such groups. If a neighborhood is to retain stability it is necessary that properties shall continue to be occupied by the same social and racial classes. A change in social or racial occupancy generally leads to instability and a reduction in values.").

lived.[136] Such "redlined" blocks were not eligible for FHA-insured mortgages.[137] The end result of such redlining was a massive disinvestment in cities with large black populations.[138] Older cities of the Northeast, like Camden, N.J., were particularly hard hit.[139] The link between bureaucratic redlining and the decline of cities was not fully made until the 1960s at which point many of the affected cities had become shadows of their former selves.[140]

One contemporaneous estimate found that FHA insured 16% of all new single-family non-farm residences in 1935 and 23% in 1936.[141] By 1937, the FHA "participated in 45% of all housing starts in the United States. From 1935 to 1939, FHA-insured loans accounted for 23% of all single-family mortgage lending, including refinance loans."[142] Conservative underwriting meant that in 1940, lenders had foreclosed on less than four-tenths of 1% of those FHA-insured mortgages originated in the 1930s.[143] The FHA's first few years seemed to be an unvarnished success as a government response to the liquidity crisis in the mortgage market brought about by the Great Depression. By 1939, the FHA was

---

136 JACKSON, *supra* note 26, at 208–09. An official 1939 FHA report states that in "wholly white areas, the gradual filtration of other than white races tends slowly to change the character of neighborhoods. The presence of even one nonwhite person in a block otherwise populated by whites may initiate a period of transition." FISHER & HOYT, *supra* note 132, at 54.

137 JACKSON, *supra* note 26, at 209, 213.

138 *Id.* at 210–14.

139 *Id.* at 213.

140 *Id.* at 214–15. John Kimble, and others, have argued that African Americans were intentionally contained in older urban areas by the FHA. John Kimble, *Insuring Inequality: The Role of the Federal Housing Administration in the Urban Ghettoization of African Americans*, 32 L. & SOC. INQ. 399, 407–13 (2007). Whether it was intentional or not, the FHA's policies certainly had that effect.

141 Weimer, *supra* note 13, at 477.

142 Dan Immergluck, *From Minor to Major Player: The Geography of FHA Lending During the U.S. Mortgage Crisis*, 33 J. URB. AFF. 1, 4 (2011).

143 FED. HOUS. ADMIN., SEVENTH ANNUAL REPORT OF THE FEDERAL HOUSING ADMINISTRATION, LETTER OF TRANSMITTAL (1941), http://babel.hathitrust.org/cgi/pt?id=mdp.39015005860161.

financially self-sustaining, with its insurance premiums and other fees covering its operating expenses.[144]

2. *The 1940s: War Housing.* The FHA, as with the rest of the nation, transitioned from responding to the Great Depression to responding to the exigencies imposed by World War II. For the FHA, this meant helping to house defense industry workers and their families.[145] At the same time, the FHA sought to "encourage production of new homes for families in income classifications which were not considered as feasible markets for new homes under the previous systems of home financing."[146] FHA market share increased to 45% by 1944.[147] As World War II ended, the FHA turned its attention from war mobilization to the needs of returning veterans and their families.[148] One effect of this shift in attention was that FHA borrowers skewed younger as a result.[149]

---

[144] MILES L. COLEAN, AMERICAN HOUSING: PROBLEMS AND PROSPECTS 267 (1944). Previously, the FHA's operating expenses had been paid by the Reconstruction Finance Corporation. *Losses Are Small on FHA Mortgages*, N.Y. TIMES, Sept. 25, 1938, at 1. The FHA was initially capitalized with an initial fund of $10 million to cover its losses. COLEAN, *supra*.

[145] FED. HOUS. ADMIN., EIGHTH ANNUAL REPORT OF THE FEDERAL HOUSING ADMINISTRATION 3 (1942), http://babel.hathitrust.org/cgi/pt?id=mdp.39015005860161; *see also Gain in Home Building Attributed Largely to Defense Area Growth*, WALL ST. J., Jan. 5, 1942, at 63 ("In the past 17 months, a major portion of the American residential construction industry has been devoted to the production of new housing to meet the acute need for additional living accommodations in defense production centers where employment has been increasing rapidly."). This housing was referred to as Section 603 housing, built pursuant to the War Housing Program. *See* ERNEST M. FISHER, URBAN REAL ESTATE MARKETS: CHARACTERISTICS AND FINANCING 80 tbl.23 (1951) (listing the distribution of FHA-insured mortgages on new and existing single-family homes from 1935 to 1948). In 1945, for instance, the bulk of new homes were financed by Section 603. *Id.*

[146] FED. HOUS. ADMIN., SEVENTH ANNUAL REPORT OF THE FEDERAL HOUSING ADMINISTRATION 17 (1941), http://babel.hathitrust.org/cgi/pt?id=mdp.39015005860161.

[147] Immergluck, *supra* note 142, at 6.

[148] FED. HOUS. ADMIN., THIRTEENTH ANNUAL REPORT OF THE FEDERAL HOUSING ADMINISTRATION 6 (1946), http://babel.hathitrust.org/cgi/pt?seq=87&id=mdp.39015082064752&page=root&view=image&size=100&orient=0; *see FHA Plans Drive for Construction of Several Hundred Thousand Homes on $6,000 Insured Mortgages*, WALL ST. J., Nov. 3, 1948, at 4 (discussing the FHA's plan to build lower-cost housing to meet demand).

[149] FED. HOUS. ADMIN., FOURTEENTH ANNUAL REPORT OF THE FEDERAL HOUSING ADMINISTRATION 77 (1947), http://babel.hathitrust.org/cgi/pt?seq=349;id=mdp.39015082064752;page=root;view=1up;size=100;orient=0;17;num=117.

The VA mortgage-guarantee program was created in 1944 as part of the "GI Bill."[150] The VA did not require down payments "on the theory that soldiers weren't paid enough to accumulate savings."[151] The VA market share peaked in 1947 at almost 28%,[152] and this peak was matched by a decline in the FHA market share.[153]

In 1948, the FHA made an important change that is now integral to our notion of the American mortgage: it increased the maximum term for an FHA mortgage to thirty years.[154] Extraordinarily, nearly one-third of "new nonfarm residential construction (including rental housing as well as small homes)" received financing through the FHA's war housing insurance program by 1948.[155] Continuing with one of its original mandates to protect the housing consumer, the FHA sought to improve the quality of construction: "The revised FHA regulations contemplate the construction of a basic house, sound and livable, stripped of nonessential features but embodying complete living facilities and conforming to local standards for comparable dwellings."[156]

Prior to 1948, explicit restrictions based on race, ethnicity, and religion were common among private property owners. Even more, the federal government actively encouraged such restrictions through a variety of methods, including underwriting decisions of the FHA.[157] The Supreme Court rejected this form of

---

[150] The GI Bill is formally known as the Servicemen's Readjustment Act of 1944, Pub. L. No. 78-346, 58 Stat. 284m. The mortgage guarantee program is found in Title III of the Act.

[151] Carliner, *supra* note 64, at 308. The VA's no-down-payment requirement changed at times. *See* HOME MORTGAGE DELINQUENCY AND FORECLOSURE 7–11 (John P. Herzog & James S. Earley eds., 1970) (describing such changes for new and existing homes between 1946 and 1967).

[152] Jaffee & Quigley, *supra* note 57, at 106.

[153] Immergluck, *supra* note 142, at 6.

[154] Green & Wachter, *supra* note 21, at 96.

[155] FED. HOUS. ADMIN., *supra* note 149, at 11.

[156] *Id.* at 14. *See also* COLEAN, *supra* note 28, at 22–23 ("Through the construction requirements and housing standards of the Federal Housing Administration, the government has imposed a sort of super-code in so far as the operations of that agency are concerned.").

[157] *See, e.g.*, FED. HOUS. ADMIN., UNDERWRITING MANUAL para. 980(3)g (1938) ("Recommended restrictions should include provision for the following: . . . Probation of the occupancy of properties except by the race for which they are intended.").

discrimination in the landmark case of *Shelley v. Kraemer.*[158] Soon after *Shelley*, the FHA amended its rules to bar insurance for homes for which covenants "restricting the use or occupancy of the property on the basis of race, creed, or color" were to be recorded prior to the recordation of the FHA-insured mortgage.[159] But notwithstanding this clear statement of the law, the FHA continued to informally support the use of racially restrictive covenants for years after *Shelley* was decided.[160] This support was true even though the Truman Administration revised the FHA's Underwriting Manual in 1949 to include equal opportunity standards as very little actually changed in practice.[161]

---

[158] 334 U.S. 1, 20–21 (1948).

[159] FED. HOUS. ADMIN., SIXTEENTH ANNUAL REPORT OF THE FEDERAL HOUSING ADMINISTRATION 3 (1949), http://babel.hathitrust.org/cgi/pt?seq=647;id=mdp.39015082064752;page=root;view=1up;size=100;orient=0;num=11 (stating that the ban applied to covenants recorded after February 15, 1950).

[160] Lamb & Nye, *supra* note 135, at 449. *See also* David M.P. Freund, *Marketing the Free Market: State Intervention and the Politics of Prosperity in Metropolitan America*, *in* THE NEW SUBURBAN HISTORY 11, 31 (Kevin M. Kruse & Thomas J. Sugrue eds., 2006) (noting that Eisenhower's nominee to run the Housing and Home Finance Agency, which included the FHA, "announced during his 1953 confirmation hearing that he would not stop local authorities from maintaining racial segregation in federally funded programs"); COMM'N ON CIVIL RIGHTS, UNDERSTANDING FAIR HOUSING 5 (1973) (noting that eighteen months after *Shelley* was decided, the "new FHA policy of refusing to insure mortgages on properties carrying a racial covenant applied only to covenants filed after February 1950. This left the accumulation of the first 15 years of FHA-insured mortgages protected by the covenants on thousands of homes untouched.").

[161] *See* FED. HOUS. ADMIN., UNDERWRITING MANUAL para. 242 (1955) (including 1949 revisions which states "[U]nderwriting considerations shall recognize the right to equality of opportunity to receive the benefits of the mortgage insurance system in obtaining adequate housing accommodations irrespective of race, color, creed or national origin."). Despite these revisions, most FHA staff turned a blind eye to these equality of opportunity provisions. *See* WENDELL E. PRITCHETT, ROBERT CLIFTON WEAVER AND THE AMERICAN CITY: THE LIFE AND TIMES OF AN URBAN REFORMER 155 (2008) ("The *Shelley* decision in particular created intense concern for many builders, realtors, and their supporters in the government. In response, federal housing administrator Raymond Foley asked for a review of agency policies to see if they would have to be changed in light of the decision. The conclusion of his staff was that the agency could continue business as usual. They would no longer recommend restrictive covenants (a change Truman had ordered a year before), but they would do nothing to prevent them or other forms of discrimination. According to FHA commissioner Franklin Richards, it was not the place of the government 'to require private individuals to give up their right to dispose of their property as they see fit.'" (citing

The FHA continued in its role as a mainstay in the single-family housing market. The FHA had more than a third of the mortgage market at the beginning of the 1950s, and the VA had an additional 13%.[162] Its underwriting remained conservative: foreclosures in process for FHA's primary one-to-four family program (the Section 203 program) in 1950 were 0.04% of mortgages in force.[163]

3. The 1950s: The Maturation of the American Mortgage. Like an episode of *Mad Men*,[164] the FHA offered a glittery, new world to whites and a gritty and impoverished one to blacks. The quality of housing for white households improved dramatically in the 1950s.[165] Black households, however, continued to suffer from a variety of discriminatory policies, including redlining by the FHA.[166]

FHA mortgages in the 1950s began to look very much like FHA mortgages that would later be offered in the 2000s. For instance, in 1950, Congress allowed some loans to have lower down

---

Memorandum from Franklin Richards, Comm'r, Fed. Hous. Admin., to Raymond Foley, Adm'r, Hous. Home Fin. Admin. (May 21, 1948))).

[162] Immergluck, *supra* note 142, at 6 (noting that FHA had 35% market share in 1950). *See* J.E. MORTON, URBAN MORTGAGE LENDING: COMPARATIVE MARKETS AND EXPERIENCE 25, tbl.6 (1956) (providing total FHA/VA market share from 1935–1953).

[163] DEP'T OF HOUS. & URBAN DEV., 1968 HUD STATISTICAL YEARBOOK 117 (1968), https://babel.hathitrust.org/cgi/pt?id=uc1.32106016148535;view=1up;seq=7.

[164] *Mad Men* (AMC Television Broadcast, July 19, 2007 to May 17, 2015).

[165] PRESIDENT'S COMM'N ON HOUS., *supra* note 6, at xix.

[166] *Id.* Even the positive steps taken by the FHA appeared to be a drop in the bucket. Kimble, *supra* note 140, at 428–29 ("In 1947, following the creation of the Minority Group Housing Program, the agency did increase its acceptance of minority housing projects, insuring 205 new developments for minority occupancy between 1947 and 1954 with an additional 146 small projects in the process of being completed. Yet in aggregate this amounted to a total of only 29,386 dwelling units, 15 percent of which were open to white occupants as well. To provide some perspective on the proportion of this effort relative to the FHA's broader operations, by 1953 the FHA had provided $33 billion of insurance on nearly 3,500,000 homes and 650,000 rental and cooperative units, the vast majority of which were new dwellings outside of central cities."). Between 1934 and 1960, just 2% of FHA mortgages were made to African Americans. Weaver, *supra* note 132, at 3.

payments than previously authorized, as little as 5%.[167] In 1957, the minimum down payment was lowered to 3% in some cases.[168]

The 1950s also brought another significant change to the housing sector. States, with the memory of the failures of the Great Depression growing dim, began passing laws to allow private mortgage insurance companies to form.[169] In 1957, the private mortgage insurer, Mortgage Guaranty Insurance Corporation, became the first to operate since the Great Depression.[170] Such private mortgage insurance allowed borrowers to make just 5% or 10% down payments, and the insurer covered a lender's first 20% to 25% of any potential loss on an insured loan.[171] However, this private alternative remained a small competitor to the FHA until the 1980s.

The FHA began to loosen underwriting requirements in the middle of the 1950s, and defaults increased as well.[172] This loosening was reflected in part by the amendment to the Housing Act of 1954 which replaced "economic soundness" as the guideline for the Mutual Mortgage Insurance Fund to "acceptable risk."[173]

---

[167] Housing Act of 1950, Pub. L. No. 81-475, § 104(a), 64 Stat. 48, 51–52 (amended 1950). This amendment also allowed for larger loans for three and four family homes. *Id.*

[168] Housing Act of 1957, Pub. L. No. 85-104, § 101, 71 Stat. 294, 295 (amending section 203(b) of the National Housing Act of 1934) (also setting higher maximum loan amounts for three and four family homes).

[169] Dwight Jaffee, *Monoline Restrictions, with Applications to Mortgage Insurance and Title Insurance*, 28 REV. INDUS. ORG. 83, 85 (2006). Wisconsin passed the first such law in 1956, and California followed suit in 1961. *Id.* By 1973, every state passed legislation authorizing PMI. FED. HOUS. FIN. AGENCY, MORT. MKT. NOTE 09-4, STATE OF THE PRIVATE MORTGAGE INSURANCE INDUSTRY: IMPLICATIONS FOR U.S. MORTGAGE MARKETS AND THE ENTERPRISES 2 (2009).

[170] FOOTE & HAIRSTON, *supra* note 63, at 3.

[171] *Id.*

[172] M. MCFARLAND CARTER, FHA EXPERIENCE WITH MORTGAGE FORECLOSURES AND PROPERTY ACQUISITIONS 4 (1963). M. McFarland Carter was Assistant Commissioner of FHA at the time of this report.

[173] *See* FED. HOUS. ADMIN., UNDERWRITING MANUAL para. 101 (1936) (noting that the National Housing Act provided "that no mortgage shall be accepted for insurance unless it is economically sound"). The Housing Act of 1954 introduced the concept of "acceptable risk." Pub. L. No. 83–560, 68 Stat. 590 § 110 (amending section 203 of the National Housing Act such that if the FHA Commissioner "finds that the project with respect to which the mortgage is executed is an acceptable risk, giving consideration to the need for providing adequate housing for families of low and moderate income particularly in

This amendment was a harbinger of even looser underwriting standards to come.[174] These looser standards would have an outsized impact on the housing stock in older cities.[175]

The FHA's performance reflected the changes in its underwriting policies. Default rates for the primary single-family insurance program, Section 203, were 0.83% of the mortgages in force in 1960. Foreclosure rates for the Section 203 program by 1960 were 0.23% of mortgages in force, roughly triple the previous decade.[176] Change was afoot.

4. The 1960s: Housing in the Urban Core. Over its first thirty years of operation, the FHA helped to finance about a fifth of all newly constructed housing, most of it in the suburbs.[177] However, as of 1967, only 3% of all new homes were sold to African Americans.[178] But as with the rest of the nation, the ferment over segregation, civil rights, and economic inequality were the major historical themes of the 1960s for the FHA. Each of these themes were clearly reflected in the FHA and its role in the housing markets, for both good and ill.[179]

Beginning in the 1950s and continuing through the 1960s, Congress added a number of innovative insurance programs to the FHA's stable.[180] They included insurance programs for urban

---

suburban and outlying areas or small communities," the Commissioner may insure mortgages that otherwise comply with the FHA requirements). The "economic soundness" standard had already been weakened somewhat by the provisions of the Housing Act of 1948. COLEAN, *supra* note 28, at 123–26.

[174] *See* Pennington-Cross & Yezer, *supra* note 21, at 360.

[175] *Id.* at 359 (describing the change to the "acceptable risk" standard).

[176] DEP'T OF HOUS. & URBAN DEV., 1977 HUD STATISTICAL YEARBOOK 95 tbl.19 (1977), http://babel.hathitrust.org/cgi/pt?id=uc1.32106016648039;num=121;seq=121;view=1up.

[177] RAPKIN ET AL., *supra* note 91, at 28.

[178] PRITCHETT, *supra* note 161, at 312.

[179] *See* COMM'N ON CIV. RIGHTS, HOUSING 79 (1961) (FHA and VA did not have "effective policy to insure that the fruits of these benefits (an increased housing supply) reach home buyers on an equal opportunity basis").

[180] And as early as 1961, the federal government began to loosen underwriting standards. Milton P. Semer et al., *Evolution of Federal Legislative Policy in Housing: Housing Credits*, *in* FEDERAL HOUSING POLICY AND PROGRAMS: PAST AND PRESENT 69, 96 (J. Paul Mitchell ed., 1985) ("[I]mportant relaxation in FHA mortgage terms was made by the Housing Act of 1961 as one of the efforts of the Kennedy Administration to fight the recession beginning in 1960.").

renewal; new forms of homeownership like condominiums and cooperatives; and housing for seniors and the disabled.[181] In 1962, President Kennedy reversed the FHA's redlining policy that had been in effect since its inception, and the FHA began to embark on a change of focus to supporting low- and moderate-income homeownership as well as minority homeownership.[182] In 1965, the FHA became a part of the HUD Office of Housing.

Notwithstanding the addition of these new programs, FHA market share declined in the 1960s.[183] By 1964, PMI provider Mortgage Guaranty Insurance Corporation had eleven competitors.[184] As PMI was growing, the FHA was also acknowledging significant operating difficulties, such as delays in processing applications.[185]

In response to the civil unrest of the mid-1960s, President Johnson appointed the National Advisory Commission on Civil Disorders, popularly known as the Kerner Commission. The Kerner Commission found that residential segregation and unequal housing opportunities were a major cause of civil unrest in cities.[186] In particular, it found that

> Federal programs have been able to do comparatively little to provide housing for the disadvantaged. In the 31-year history of subsidized Federal housing, only

---

[181] *See* Pennington-Cross & Yezer, *supra* note 21, at 359 (discussing the FHA's targeted programs designed to combat urban blight).

[182] Carliner, *supra* note 64, at 307. This reversal also applied to the VA. *Id.* "Part of the interest in proposals to subsidize low-income homeownership was stimulated by the wave of urban riots that began in 1963." *Id.* at 311. *See also FHA Will Not Do Business with Anyone Violating Pennsylvania Anti-Bias Law*, WALL ST. J., Mar. 2, 1962, at 6 (describing Pennsylvania's anti-discrimination housing law and the FHA's response to it). The order "applied only to FHA and VA housing insured or guaranteed after the date of the order's issuance (November 20, 1962). It left hundreds of thousands of existing housing units receiving FHA and VA assistance immune from the requirement of the nondiscrimination mandate." COMM'N ON CIVIL RIGHTS, UNDERSTANDING FAIR HOUSING 6 (1973).

[183] Immergluck, *supra* note 142, at 6.

[184] PROMONTORY FIN. GRP., LLC, *supra* note 122, at 35.

[185] CARTER, *supra* note 172, at 2.

[186] *See generally* REPORT OF THE NATIONAL ADVISORY COMMISSION ON CIVIL DISORDERS (1968).

> about 800,000 units have been constructed, with recent production averaging about 50,000 units a year. By comparison, over a period only 3 years longer, FHA insurance guarantees have made possible the construction of over 10 million middle and upper income units.[187]

In response to this historical inequity, Congress ensured that many of the FHA's new programs had a very different underwriting model than the traditional one.[188] These newer programs typically targeted "underserved borrowers" such as households of color and were subsidized by the federal government.[189] The FHA's core single-family Section 203(b) program, in contrast, had low-risk homeowners cross-subsidize high-risk homeowners.[190]

One such initiative that Congress enacted in 1968, the Section 235 homeownership program, was seen as giving the FHA "an opportunity to overcome its image as an anti-poor, anti-minority Government agency."[191] The program was also seen as having great potential by a wide variety of groups, including those "representing business as well as social welfare concerns."[192] This move away from conservative underwriting led to rapidly

---

[187] *Id.* at 13.

[188] In addition to new underwriting models, the FHA also attempted to promote innovative housing design, for instance by promoting mini-houses on mini-lots. ELSIE EAVES, NAT'L COMM'N ON URBAN PROBLEMS, RESEARCH REPORT NO. 16, HOW THE MANY COSTS OF HOUSING FIT TOGETHER 36 (1969).

[189] *See* PRESIDENT'S COMM'N ON HOUS., *supra* note 6, at 163–64 (describing the new FHA initiatives).

[190] Cross-subsidies allow the FHA to use premiums from low-risk borrowers to subsidize the cost of default associated with higher risk borrowers. *Id.* at 162.

[191] COMM'N ON CIVIL RIGHTS, HOME OWNERSHIP FOR LOWER INCOME FAMILIES A REPORT ON THE RACIAL AND ETHNIC IMPACT OF THE SECTION 235 PROGRAM 77 (1971). The Section 235 program was enacted as part of the Housing and Urban Development Act of 1968 § 101. Another initiative was the Section 223(e) program, which "increased the availability of mortgages for minority and low-income buyers in urban areas." BERYL SATTER, FAMILY PROPERTIES: RACE, REAL ESTATE, AND THE EXPLOITATION OF BLACK URBAN AMERICA 332 (2009).

[192] COMM'N ON CIVIL RIGHTS, *supra* note 191, at 7.

increasing foreclosure rates and ultimately wreaked much havoc in the early 1970s.[193] This havoc is embodied in the poorly executed Section 235 program, described below.[194]

Defaults and foreclosures rose again during the 1960s. Total defaults for Section 203 in 1970 were 1.69% of mortgages in force.[195] Foreclosures in process for Section 203 in 1970 were 0.52% of mortgages in force, more than doubling the rate of the previous decade.[196] These were significant increases from 1950.[197]

5. *The 1970s: Spectacular Failure.* By the early 1970s, the dreams of the 60's were replaced with the hangovers induced by war, inflation, recession, and continuous civil-rights struggles. By this time, the FHA "acquired a deserved reputation for confining its service mostly to white, middle class, suburban home buyers."[198] Notwithstanding this failing, the American homeownership rate increased from roughly 44% in 1940 to about 63% in 1970, and the FHA was partially responsible for this

---

[193] HOME MORTGAGE DELINQUENCY AND FORECLOSURE, *supra* note 151, at 25 tbl.9. VA mortgages also saw a significant increase in foreclosures, but it was not nearly as large as that for FHA mortgages. *Id.* Contemporaneous studies such as MCFARLAND, *supra* note 172, proposed various hypotheses for this increase, but none were considered particularly strong. The latter report does, however, acknowledge a move away from conservative underwriting and towards policies unconnected from sustainable mortgage lending. MCFARLAND, *supra* note 172, at 1. These policies included the goals of Congress, homebuyers, and the home construction industry. *Id.* *See also FHA Finds Easier Terms Have Increased Defaults on Home Mortgages It Insures*, WALL ST. J., June 1, 1961, at 3 ("The F.H.A. Chief emphasized, however, that in his view the rise in defaults 'is not at all alarming.' He added: 'The terms under our programs have been liberalized and this is being reflected in the rise in insurance claims. But this liberalization, as it helps our economy and the American people to be better housed, is a wholesome development for the country and for the F.H.A. program.' ").

[194] *See infra* Part III.B.5. *See also* VAN ORDER & YEZER, *supra* note 36, at 7 (discussing the creation of Section 285); Housing and Urban Development Act of 1968, Pub. L. No. 90-448, § 101, 82 Stat. 476, 477 (1968) (creating Section 235 program). *See generally* John McClaughry, *The Troubled Dream: The Life and Times of Section 235 of the National Housing Act*, 6 LOY. L.J. 1 (1975) (discussing the history of the 1968 HUD Act and the problems HUD and FHA experienced).

[195] DEP'T OF HOUS. & URBAN DEV., 1979 HUD STATISTICAL YEARBOOK 113 tbl.21 (1979), http://babel.hathitrust.org/yr/pt?.id=uc1.32106006213851;seq=133;view=1up;num=113.

[196] DEP'T OF HOUS. & URBAN DEV., *supra* note 176, at 95 tbl.19.

[197] *Id.*

[198] COMM'N ON CIVIL RIGHTS, *supra* note 191, at 77.

increase.[199] The FHA's mortgage origination share (by dollar volume) reached a new high in 1970, at about a quarter of the market.[200] This share accounted for nearly 30% of all single-family loans.[201] This large share was due to a variety of factors including the acceleration of the new Section 235 program with its subsidized interest rates, at the same time that unsubsidized interest rates were reaching new highs.[202] In its first four years, the Section 235 program helped to finance homes for about 400,000 low- and moderate-income families.[203] Section 235 home buyers had to make only tiny down payments.[204]

In 1973, the Section 235 program was suspended because so many of its mortgages ended up in default and foreclosure. The program was terminated a few years later.[205] Moreover, many of the homes sold through the program were sold by predators who covered up structural problems with sheetrock and paint and sold them to unsophisticated low- and moderate-income buyers. Once the structural problems surfaced, many of these households could not afford to repair them, and the homes went into default.[206] Entire blocks in some cities were lined with boarded-up homes that had been financed pursuant to Section 235.[207]

Section 235 represented a low point for the FHA with more than 200 people convicted for abuses arising from the program.[208]

---

[199] *See* LAWRENCE L. THOMPSON, A HISTORY OF HUD 3 (2006).

[200] *See* Jaffee & Quigley, *supra* note 57, at 106 (noting that the share peaked in 1970).

[201] Immergluck, *supra* note 142, at 6.

[202] FOOTE & HAIRSTON, *supra* note 63, at 4. Section 235 "reduced the effective interest rate for homebuyers, depending on their income, to as low as one percent with HUD paying the remaining interest directly to the bank." THOMPSON, *supra* note 199, at 3.

[203] Carliner, *supra* note 64, at 313.

[204] *Id.* Down payments could be as low as $200, which was about two weeks' pay for the median Section 235 purchaser. LOUIS HYMAN, DEBTOR NATION: THE HISTORY OF AMERICA IN RED INK 226 (2011).

[205] BRENT D. RYAN, DESIGN AFTER DECLINE: HOW AMERICA REBUILDS SHRINKING CITIES 92 (2012).

[206] *See* VAN ORDER & YEZER, *supra* note 36, at 8 ("There were many documented cases of abuse in which substantial units were given cosmetic rehabilitation and sold to households who simply could not maintain the units when their flaws became evident.").

[207] THOMPSON, *supra* note 199, at 3.

[208] RYAN, *supra* note 205, at 93.

The federal government lost over $2 billion on mortgages that ended up in foreclosure during this period.[209] The Section 235 fiasco "was one of the major reasons for the moratorium on subsidized housing programs declared in 1973."[210]

If the broader dreams of equality of the 1960s were dashed in the 1970s, so were the dreams of an effective FHA.[211] At the same time the Section 235 fiasco was unfolding, the FHA was rocked by a series of scandals.[212] Indeed, HUD Secretary George Romney called for the FHA to be privatized in 1972, in part because of problems in the agency and in part because of the growth of the PMI industry.[213]

During the early 1970s, the mortgage insurance sector was subject to big swings in market share between the FHA and private mortgage insurers.[214] Fannie Mae and Freddie Mac set the stage for a revival of the PMI industry in the early 1970s as they

---

[209] *Id. See generally* NAT'L CTR. FOR HOUS. MGMT., *supra* note 34 (report prepared for HUD arguing that despite declines the FHA is still integral in the provision of single-family mortgage insurance).

[210] VAN ORDER & YEZER, *supra* note 36, at 8.

[211] *See, e.g.*, *Civil Rights Unit Says Housing Bias Study Shows HUD Has Failed to Change Pattern*, WALL ST. J., June 11, 1971, at 10 ("'Traditionally attuned to serving the housing needs of white, middle-class families', the [U.S. Civil Rights Commission] report said, the FHA 'has been poorly prepared to serve a different racial and ethnic group of home seekers and has done little to develop affirmative procedures and mechanisms to assure that lower-income buyers are treated fairly.'").

[212] *See, e.g.*, John Herbers, *U.S. Report Finds Fraud in Housing*, N.Y. TIMES, Jan. 6, 1971, at 1, http://www.nytimes.com/1971/01/06/archives/us-report-finds-fraud-in-housing-cites-wide-abuse-in-federal-home.html?_r=0 (reporting on a study by the House Banking and Currency Committee that found the FHA "allowed speculators to make huge profits at the expense of the poor in what amounted to 'sheer fraud'"); *Former FHA Chief in Philadelphia Named in 2 U.S. Indictments*, WALL ST. J., May 12, 1972, at 2 (reporting that the former director of the Philadelphia FHA had been indicted on multiple counts of taking bribes and tax evasions); Monroe W. Karmen, *Restoring Cities After the Scandals*, WALL ST. J., July 5, 1972, at 8 (describing the failure of programs in urban areas).

[213] *See, e.g.*, Karmen, *supra* note 212, at 8 (stating that Romney advocated for private investment to save cities).

[214] *See* John Hebers, *Romney Recommends Abolition of Federally Subsidized Housing*, N.Y. TIMES, Oct. 24, 1972, at 22, http://query.nytimes.com/mem/archive-free/pdf?res=9E06EFD8143EE63ABC4C51DFB6678389669EDE.

sought to purchase high-LTV mortgages.[215] Because their charters required that the high-LTV mortgages have mortgage insurance,[216] private mortgage insurers had a steady stream of business.[217]

Underwriting stabilized toward the end of the 1970s. In 1978, default rates for the Section 203 program had lowered to 0.89% of mortgages in force, from 1.69% of mortgages in force in 1970.[218] Foreclosures in process by 1978 for the Section 203 program were 0.30% of mortgages in force, a slight decline from the rate at the end of the previous decade.[219]

6. The 1980s: PMI Is Back! Before Gordon Gekko pronounced that greed is good,[220] skepticism for that government instrumentality, the FHA, blossomed during the Reagan years. At the beginning of the decade, the FHA and VA had about 20% of the

---

[215] PRESIDENT'S COMM'N ON HOUS., *supra* note 6, at 162–63. *See also* STEPHEN ROSS & JOHN YINGER, THE COLOR OF CREDIT: MORTGAGE DISCRIMINATION, RESEARCH METHODOLOGY, AND FAIR-LENDING ENFORCEMENT 17 (2002) ("In the early 1970s, Fannie Mae's charter was changed to allow it to buy conventional mortgages, and two new secondary mortgage market institutions appeared. The Government National Mortgage Association (GNMA, or Ginnie Mae) was established to purchase FHA and VA mortgages from any source, and the Federal Home Loan Mortgage Corporation (Freddie Mac) was established to purchase conventional mortgages from savings and loans. These institutional developments, along with tremendous growth in the popularity of MBSs as an investment, have made it possible for mortgage bankers to move into the conventional market, as well.").

[216] 12 U.S.C. § 1717(b)(5)(C) (Fannie Mae); 12 U.S.C. § 1454(a)(2) (Freddie Mac).

[217] *See* PROMONTORY FIN. GRP., LLC, *supra* note 122, at 3 (noting that, unlike the FHA, Fannie, and Freddie, private mortgage insurers are regulated by state insurance regulators); PRESIDENT'S COMM'N ON HOUS., *supra* note 6, at 162–63 (explaining the attractive financial terms that drew home buyers away from the FHA). Section 201 of the Emergency Home Finance Act of 1970, Pub. L. No. 91-351, 84 Stat. 450–51, required that mortgages purchased by Fannie and Freddie with less than a 20% down payment have mortgage insurance. For a technical overview of modern private mortgage insurance, see PROMONTORY FIN. GRP., LLC, *supra* note 122.

[218] DEP'T OF HOUS. & URBAN DEV., 1979 HUD STATISTICAL YEARBOOK 113 tbl.21, http://babel.hathitrust.org/cgi/pt?id=uc1.32106006213851;seq=133;view=1up;num=113.

[219] *Id.*

[220] WALL STREET (20th Century Fox 1987) ("The point is, ladies and gentleman, that greed, for lack of a better word, is good. Greed is right, greed works. Greed clarifies, cuts through, and captures the essence of the evolutionary spirit. Greed, in all of its forms; greed for life, for money, for love, knowledge, has marked the upward surge of mankind. And greed, you mark my words, will not only save Teldar Paper, but that other malfunctioning corporation called the USA.").

market (by dollar amount) for new mortgages, and the PMI industry had about the same market share.[221] The FHA's express mission also changed from its original one of serving a broad swath of homeowners to one of particularly serving lower-income households.[222] This transition was not untroubled, as FHA loans continued to be at the root of big problems in urban communities.[223]

Although the FHA had turned away from its history of racial discrimination, its record of success in communities of color was decidedly mixed. In many ways, this disconnect was a problem of underwriting. FHA underwriting went from being prejudicially restrictive for households of color in its early years to being irrationally loose in its later years. The FHA had still not come up with any sort of approach to its underwriting that balanced access to credit and sustainability of credit. This failure continued to haunt the FHA and the communities it served decades after it rejected its early discriminatory practices.

The FHA faced something of an identity crisis in the early 1980s. President Reagan created a Commission on Housing to study the FHA and other aspects of the housing sector.[224] The Commission believed that the FHA should cede much of its market to the PMI industry, which had recovered by then.[225] By 1980, the PMI industry had grown to fourteen firms[226] which had insured 31% of the entire mortgage market.[227] The industry was arguing

---

[221] PRESIDENT'S COMM'N ON HOUS., *supra* note 6, at 163.

[222] *See* Jaffee & Quigley, *supra* note 57, at 108 (describing the shift towards lower-income borrowers).

[223] *See, e.g.*, Martin Gottlieb, *F.H.A. Case Recalls Bushwick in 70s*, N.Y. TIMES, Feb. 2, 1986 (describing an FHA mortgage scandal in Brooklyn).

[224] Exec. Order No. 12,310, 46 Fed. Reg. 31,869 (June 16, 1981).

[225] PRESIDENT'S COMM'N ON HOUS., *supra* note 6, at xxiv ("Like so much else that is 50 years old, FHA has become a prisoner of its own habits, and the Commission recommends that more agile private mortgage insurance institutions take over many FHA functions relating to single-family homes. But there are still pioneering tasks ahead for FHA in the Commission's scenario, in the testing of new mortgage instruments and in assistance to homeowners for whom private insurers are unwilling or unable to supply insurance.").

[226] PROMONTORY FIN. GRP., LLC, *supra* note 122, at 4.

[227] FOOTE & HAIRSTON, *supra* note 63, at 7.

that FHA had become unnecessary.[228] Indeed, the Reagan Administration even bandied around a proposal to privatize it.[229] At the same time, the FHA's market share began falling to very low levels, as low as 5% by the mid-1980s.[230]

The late 1980s told a completely different story, as the PMI industry faced heavy losses from riskier products such as adjustable-rate mortgages (ARMs) and from depressed housing prices in the Farm Belt and the Southwest.[231] Some PMI companies merged with better-capitalized ones.[232] One of the fourteen was not able to fully repay its policyholders.[233] By the late 1980s, the FHA (as well as the VA) came roaring back, with a roughly 60% market share of insured loans, leaving the PMI industry with 40%.[234] But the private mortgage insurance industry, like the Reagan-era Arnold Schwarzenegger, was already prepared to say, "I'll be back!"[235]

During the late 1980s, the FHA's delinquency and foreclosure rates were about twice those for conventional loans.[236] Reflecting its changed mission, the FHA began keeping statistics on the number of mortgages going to first-time homebuyers. By 1991, 58% of FHA single-family insured mortgages went to first-time homebuyers.[237]

7. *The 1990s: The FHA Goes Out with a Whimper.* As the Soviet Union collapsed in the face of triumphant capitalism, the

---

228 *Id.* at 3.

229 *See, e.g.*, Robert Pear, *Reagan Proposes Selling off F.H.A. to Private Bidder*, N.Y. TIMES, Dec. 14, 1985, http://www.nytimes.com/1985/12/14/us/reagan-proposes-selling-off-fha-to-private-bidder.html (noting that the President's fiscal budget proposed selling the FHA by 1989); Joann S. Lublin, *Opposition Shelves Budget Office's Plan to Sell FHA*, WALL ST. J., at 1 (Dec. 20, 1985) (reporting that housing officials and others opposed Reagan's plan).

230 Immergluck, *supra* note 142, at 6.

231 Eric N. Berg, *Upheaval at Mortgage Insurers*, N.Y. TIMES, Mar. 3, 1988, http://www.nytimes.com/1988/03/03/business/upheaval-at-mortgage-insurers.html.

232 DENNIS & PINKOWISH, *supra* note 7, at 176.

233 PROMONTORY FIN. GRP., LLC, *supra* note 122, at 4.

234 Berg, *supra* note 231.

235 THE TERMINATOR (Orion Pictures 1984).

236 DENNIS & PINKOWISH, *supra* note 7, at 156 tbl.8-1.

237 DEP'T OF HOUS. & URBAN DEV., FHA ANNUAL MANAGEMENT REPORT FISCAL YEAR 1992, at 39 (1992) (detailing the previous year's statistic for first-time homebuyers).

FHA looked as if it would collapse in the face of a resurgent PMI industry. The FHA arrived in the 1990s with the legacy of high default rates and a variety of other problems.[238] The Cranston-Gonzalez National Affordable Housing Act of 1990 implemented more conservative underwriting standards for mortgages and the FHA's insurance funds.[239] The FHA's share of the mortgage market continued to face serious competition from the PMI industry. Over much of the decade, the FHA and the PMI industry each had a share of the total mortgage market that was measured in the teens.[240]

By the late 1990s, the nine remaining private mortgage insurers[241] insured about the same number of mortgages as the FHA and the VA combined and more than twice the dollar amount of mortgage debt than the FHA and the other government insurance programs combined.[242] And it looked like the PMI industry had nowhere to go but up: the U.S. Government Accountability Office (GAO) found that a third of the FHA's 1995 portfolio would have been eligible for PMI.[243]

During the late 1990s, the FHA's delinquency and foreclosure rates were often more, and sometimes much more, than three times as high as those for conventional loans.[244] In 2000, FHA mortgages were about three-fourths the size of PMI mortgages.[245] This reflected the market segmentation of the two, with the FHA having a bigger share of low- and moderate-income households.

---

[238] Defaults and other operational problems led to a decrease in the MMI Fund's net worth from $7.8 billion in 1980 to $2.6 billion in 1989 (in constant 1989 dollars). U.S. GEN. ACCOUNTING OFFICE, HUD REFORMS: PROGRESS MADE SINCE THE HUD SCANDALS BUT MUCH WORK REMAINS 30–31 (1992).

[239] Pub. L. No. 101-625, § 332, 104 Stat. 4079 (1990) (amending Section 205 to ensure MMIF meets new capital ratio requirements).

[240] Immergluck, *supra* note 142, at 4 (noting the FHA market share was between 15%–20%); FOOTE & HAIRSTON, *supra* note 63, at 7 (noting PMI market share averaged 13% during this decade).

[241] PROMONTORY FIN. GRP., LLC, *supra* note 122, at 38.

[242] DENNIS & PINKOWISH, *supra* note 7, at 174, tbl.9-1.

[243] GEN. ACCOUNTING OFFICE, *supra* note 66, at 4.

[244] DENNIS & PINKOWISH, *supra* note 7, at 156 tbl.8-1.

[245] *Id.* at 177, tbl.9-2 (noting that the FHA average loan amount was $100,344, PMI was $131,964 and VA was $118,953).

8. The 2000s: The FHA Goes Boom! Good times in the booming financial markets of the early 2000s meant lean times for the FHA.[246] While the mortgage market was heating up overall, the FHA's share of mortgage originations by dollar volume fell from its 1970 peak of roughly 25% to its 2006 trough of less than 2%.[247] This long-term decline had begun in earnest in 1996 and was most pronounced among minority borrowers who were moving over to the private-label subprime market which was dramatically loosening its underwriting standards and offering extremely attractive teaser rates as well.[248] Before this subprime boom, the FHA's low-down-payment mortgages and less stringent credit score requirements had meant that the FHA had a larger market share in those communities that had been underrepresented among homeowners.[249] During this same period, the FHA decided to originate loans with down payments funded by sellers which were channeled through various not-for-profit organizations.[250]

---

[246] SARAH ROSEN WARTELL, MILLENNIAL HOUS. COMM'N, SINGLE-FAMILY RISKSHARING: AN EVALUATION OF ITS POTENTIAL AS A TOOL FOR FHA 16–41 (2002) (detailing the FHA's operational weaknesses and riskier loan practices in the 2000s).

[247] Jaffee & Quigley, *supra* note 57, at 106. Not as dramatically, but still shockingly, the VA's market share (by dollar volume) in 2006 fell to less than 1%. *Id.*

[248] GOV'T ACCOUNTABILITY OFFICE, GAO-07-645 FEDERAL HOUSING ADMINISTRATION, DECLINE IN THE AGENCY'S MARKET SHARE WAS ASSOCIATED WITH PRODUCT AND PROCESS DEVELOPMENTS OF OTHER MORTGAGE MARKET PARTICIPANTS 4 (2007), http://www.gao.gov/new.items/d07645.pdf.

[249] *See* Jaffee & Quigley, *supra* note 57, at 108 ("[T]he overwhelming fraction of FHA borrowers have obtained mortgages with LTV ratios of 95 to 98 percent or more, including a large number of borrowers with 'nontraditional' credit histories or with imperfect credit records. The academic literature has documented these specific attributes of the FHA clientele. For example, Ambrose and Pennington-Cross (2000) found that FHA market shares are higher in cities with higher economic risk characteristics, while Ambrose, Pennington-Cross, and Yezer (2002) found that as local economic conditions deteriorate, conventional lenders tend to withdraw mortgage finance, in effect making the government programs the only source of credit.").

[250] DEP'T OF HOUS. & URBAN DEV., ANNUAL REPORT TO CONGRESS REGARDING THE FINANCIAL STATUS OF THE FHA MUTUAL MORTGAGE INSURANCE FUND 11 (2009), http://www.hud.gov/offices/hsg/rmra/oe/rpts/actr/2009actr_subltr.pdf. With a typical seller-funded down payment transaction, the seller gives a third party an amount equal to the buyer's down payment. The third party then gives the funds to the buyer who uses it for a down payment. This structure allowed the parties to avoid legal limitations on seller-paid down payments. *See generally* GOV'T ACCOUNTABILITY OFFICE, GAO-06-24, MORTGAGE FINANCING: ADDITIONAL

Such loans were no-down-payment loans by another name, as the third party paid the down payment, leaving the borrower with no skin in the game. These loans, unsurprisingly, defaulted at very high rates.[251]

The national homeownership rate peaked in the mid-2000s at about 69%.[252] The FHA was part of that dramatic expansion. For instance, 79.8% of FHA-insured purchases were first-time homebuyers in 2001.[253] But the FHA's success with communities of color, since the rejection of its explicitly discriminatory practices, remained decidedly mixed. Although African American homeownership had increased significantly since the FHA's creation, it was about twenty percentage points behind the national rate in 2006, as was the rate for Hispanic households.[254]

The FHA's competitors were themselves lowering down payment requirements to as little as zero; the FHA responded by in some cases offering insurance for financing of nearly 100% of the sales price.[255] PMI had 62% of the mortgage insurance market

---

ACTION NEEDED TO MANAGE RISKS OF FHA-INSURED LOANS WITH DOWN PAYMENT ASSISTANCE 3–6 (2005) (noting that HUD does not monitor the use of seller-funded down payment loans and recommending more routine monitoring). Unsurprisingly, the purchase price typically accounted for the seller-funded down payment by selling for 2% to 3% more than similar homes sold without seller-funded down payments. GOV'T ACCOUNTABILITY OFFICE, GAO-07-1033T, MORTGAGE FINANCING: SELLER-FUNDED DOWN-PAYMENT ASSISTANCE CHANGES THE STRUCTURE OF THE PURCHASE TRANSACTION AND NEGATIVELY AFFECTS LOAN PERFORMANCE 3 (2007).

251 DEP'T OF HOUS. & URBAN DEV., *supra* note 250, at 11. They were also very popular: "The proportion of FHA-insured purchase loans that were financed in part by down-payment assistance from various sources increased from 35 percent to nearly 50 percent from 2000 through 2004." GOV'T ACCOUNTABILITY OFFICE, GAO-07-1033T, *supra* note 250, at 2.

252 THOMPSON, *supra* note 199, at 14 fig.1.6.

253 DEP'T OF HOUS. & URBAN DEV., FHA ANNUAL MANAGEMENT REPORT FISCAL YEAR 2001, at 7 (2001). A typical first-time homebuyer "is at the beginning of his or her income-earning years, does not have substantial accumulated wealth and retirement funds, and has other consumer debt." DENNIS & PINKOWISH, *supra* note 7, at 175.

254 U.S. CENSUS BUREAU, HOUSING VACANCIES & HOMEOWNERSHIP (CPS/HVS): HISTORICAL TABLES tbl.16, http://www.census.gov/housing/hvs/data/histtabs.html (last visited Aug. 31, 2016) (noting that in the "3rd Quarter of 2006, the African American rate was 48.6%, the Hispanic rate was 49.7%, and the national average was 69%").

255 *See* GOV'T ACCOUNTABILITY OFFICE, GAO-07-708, FEDERAL HOUSING ADMINISTRATION: MODERNIZATION PROPOSALS WOULD HAVE PROGRAM AND BUDGET IMPLICATIONS AND REQUIRE CONTINUED IMPROVEMENTS IN RISK MANAGEMENT 9, 20–21, 27 (2007), http://

by the mid-2000s.[256] Subprime lenders pushed the envelope, offering mortgages with flexible payment and variable interest options that were particularly attractive to purchasers in areas with rapidly rising prices.[257] Some mortgage insurers were going so far as to underwrite loans with LTVs of 100% and even 103%.[258]

In response to changes in the industry, and to further expand homeownership, Congress enacted the American Dream Downpayment Act of 2003.[259] This new program gave first-time homeowners up to $10,000 as a down payment.[260] This program, like the 1970s' Section 235 program, was an unmitigated failure for homeowners and a financial catastrophe for the FHA. Once again, a no-down-payment loan program failed.[261] That being said, "with the exception of the years during the subprime boom," the 203(b) program, the FHA's primary mortgage insurance program for single family homes, "served as the major source of mortgage financing for first-time, low-income and minority homebuyers."[262]

HUD continued to scramble to respond to the changes in the market, proposing to Congress a variety of long-due reforms in

---

www.gao.gov/new.items/d07708.pdf. Some mortgage industry officials also pointed to other product restrictions as a reason why FHA loans have been less competitive than conventional loans. Many borrowers either cannot or do not want to make a down payment, and "in recent years, members of the conventional mortgage market [such as private mortgage insurers, the housing GSEs (government-sponsored enterprises), and large private lenders] increasingly have been active in supporting low- and no-down-payment mortgages." *Id.* at 9. For example, the GSEs introduced no-down-payment mortgage products in 2000. In contrast, FHA did not offer a zero-down-payment product, which some lenders and industry observers have cited as a major factor underlying the decline in FHA's market share. *Id.* at 31. However, as previously noted, FHA allows borrowers to finance their up-front insurance premium and some closing costs; as a result, an FHA-insured loan could equal nearly 100% of the property's value or sales price. *Id.* at 27.

256 DENNIS & PINKOWISH, *supra* note 7, at 178.

257 GOV'T ACCOUNTABILITY OFFICE, *supra* note 255, at 9.

258 DENNIS & PINKOWISH, *supra* note 7, at 178.

259 American Dream Downpayment Act, Pub. L. No. 108-186, 117 Stat. 2685 (2003).

260 VAN ORDER & YEZER, *supra* note 36, at 8.

261 *See id.* ("Subsequently it proved approximately as long-lived as the Section 235 program, i.e., it was terminated in 2007.").

262 ROBERTO G. QUERCIA ET AL., UNC CTR. FOR CMTY. CAPITAL AND CTR. FOR RESPONSIBLE LENDING RESEARCH 2012, BALANCING RISK AND ACCESS: UNDERWRITING STANDARDS FOR QUALIFIED RESIDENTIAL MORTGAGES 6.

2006.[263] Echoing the FHA's consumer protection goals from the Great Depression, Congress passed the Expanding Homeownership Act of 2007 to help FHA modernize, "to make government-insured loan products competitive with the private sector and make available affordable housing to more Americans . . . ."[264] In particular, this modernized FHA was intended to "provide a safe, fair, and affordable FHA alternative to the subprime market."[265] Not incidentally, the legislation also allowed the FHA to reduce the minimum 3% down payment requirement.[266] These efforts to compete with the private sector on its terms turned out to be a big mistake.

Events soon overtook Congress as the FHA's dramatic loss of market share was soon to be matched by an equally dramatic rise. Once the subprime crisis hit, government-insured mortgages absorbed an extraordinary level of demand for mortgages as the private-label (non-conforming subprime and jumbo) sector shriveled to next to nothing.[267]

By 2008, the FHA and the VA had a market share of all mortgage originations of more than 20%.[268] Congress significantly raised the loan limits that the FHA could insure to provide

---

[263] *See* GOV'T ACCOUNTABILITY OFFICE, *supra* note 248, at 1 (noting that HUD proposed to "raise FHA's loan limits, give the agency flexibility to set insurance premiums based on the credit risk of borrowers, and reduce down-payment requirements from the current 3 percent to potentially zero").

[264] GINNIE MAE, *supra* note 71, at 11.

[265] *Id.*

[266] *Id.* *See also* FED. HOUS. ADMIN., *supra* note 53, at 5 (the FHA's Annual Management Report for fiscal year 2007 states that its key policy objectives include increasing FHA loan limits and enhancing "downpayment flexibility requirements").

[267] *See* VIRAL V. ACHARYA ET AL., GUARANTEED TO FAIL: FANNIE MAE, FREDDIE MAC, AND THE DEBACLE OF MORTGAGE FINANCE 9–10 (2011) ("As of the first half of 2010, Fannie and Freddie plus the FHA were buying or guaranteeing more than 90% of all residential mortgages that were originated."). By 2013, that number has shrunk a bit to 80%, with the FHA and VA accounting for twenty percentage points between them. JOINT CTR. FOR HOUS. STUDIES, HARV. UNIV., THE STATE OF THE NATION'S HOUSING 2013, at 11 (2013). "Non-conforming loans" are those that do not conform to Fannie and Freddie purchase guidelines; "jumbo" mortgages are non-conforming loans that do not comply with the limitations on the size of the mortgages that Fannie and Freddie can purchase. Reiss, *supra* 9, at 1032, 1033 n.61.

[268] Jaffee & Quigley, *supra* note 57, at 106.

liquidity to a wider swath of the mortgage market.[269] The FHA's market share continued to explode as capital from other sources in the residential mortgage market dried up.[270] By 2010 it was 30% overall[271] and nearly 40% for home purchases.[272] The FHA's role in home purchases for minorities during this period was even greater: Home Mortgage Disclosure Act (HMDA) data indicates that 60% of all African American and Latino purchasers had FHA-insured mortgages.[273] This homeownership rate was nearly an exponential increase from 2005 and 2006 where 10% of African American and just 6% of Hispanic purchasers had FHA loans.[274] More broadly, the FHA had "become the primary lender to borrowers with down payments of less than 20 percent, lifting its share of mortgage originations to nearly 20 percent" in 2010.[275]

This dramatic increase in market share was soon followed by an equally dramatic increase in defaults and foreclosures on FHA mortgages.[276] This poor performance resulted from bad programs,

---

[269] *See* INTEGRATED FIN. ENG'G, INC., *supra* note 112, at 5–6 (discussing the Economic Stimulus Act of 2008's increased loan limits). In 2006, the MMI Fund accounted for about 90% of the FHA's entire portfolio. CONG. BUDGET OFFICE, *supra* note 113, at 1.

[270] Private-label MBS issuance was $930 billion in fiscal year 2007, the year the credit crisis began, and had fallen to $58 billion in fiscal year 2010. GINNIE MAE, REPORT TO CONGRESS FISCAL YEAR 2010, at 12 (2010); GINNIE MAE, REPORT TO CONGRESS FISCAL YEAR 2008, at 10 (2008), http://www.ginniemae.gov/about/ann_rep/ReportToCongress08.pdf ("The evaporation of the private-label securitization market has resulted in virtually no capital for nonconforming loans."). During the same time, the government-supported MBS insurers (Ginnie, Fannie, and Freddie) saw their issuance grow to $1.3 trillion in fiscal year 2010 from $1.1 trillion in fiscal year 2007. GINNIE MAE, 2010, *supra*, at 12.

[271] *HAMP Changes, Revamped GSE Plan Expected as Housing Woes Continue*, BNA BANKING REP., at 5 (Jan. 25, 2010). *See also* DEP'T OF HOUS. & URBAN DEV., *supra* note 250, at 1 ("FHA was largely shut-out of the mortgage market during the boom years of 2003–2007, but has now emerged as a primary source of credit guarantees both for home buyers and for homeowners seeking to refinance into lower-cost and safer mortgage products.").

[272] DEP'T OF HOUS. & URBAN DEV., ANNUAL REPORT TO CONGRESS REGARDING THE FINANCIAL STATUS OF THE FHA MUTUAL MORTGAGE INSURANCE FUND FISCAL YEAR 2010, at ii (Nov. 15, 2010), http://www.hud.gov/offices/hsg/rmra/oe/rpts/actr/2010actr_subltr.pdf.

[273] *Id.* at 6. HMDA requires certain lenders to report information about home loan applicants and the loans for which they apply. *See generally* Home Mortgage Disclosure (Regulation C), 12 C.F.R. § 203 (2014).

[274] DEP'T OF HOUS. & URBAN DEV., *supra* note 272, at 6.

[275] JOINT CTR. FOR HOUS. STUDIES, *supra* note 267, at 10.

[276] *HAMP Changes*, *supra* note 271, at 1–2.

such as the American Dream Downpayment initiative, as well as from the general meltdown of the housing markets in the late 2000s.[277] As a result, it was expected that the FHA's massive MMI fund was "unlikely to meet its statutory capital requirements by the end of" the 2009 fiscal year.[278] It soon appeared that the MMI Fund was in great distress, "[a]ll of the annual books-of-business from 2000 through 2008 are expected to result in net losses over the life of the loan guarantees, but the largest losses will be from the 2004–2008 books."[279] The Gyourko and Aragon studies discussed above offer detailed, depressing prognoses for the MMI Fund.[280]

While the FHA was riding this rollercoaster, the PMI industry was on one of its own. The industry peaked in 2003, and then shrank dramatically as a result of the subprime crisis.[281] Some firms went into bankruptcy because of mounting claims on defaulting mortgages, and some were barred by their regulators from selling new policies.[282] Indeed, the industry was considered to be "crippled" by the crisis, being hit by the financial equivalent

---

[277] *Id.*

[278] Michael Goldberg & Ann Schnare, *An Update on the Capital Adequacy of the FHA Single Family Insurance Program* 1 (2009), http://ssrn.com/abstract=1510387; *see* Michael Goldberg & Ann B. Schnare, *An Alternative Look at the Financial Strength of the FHA Single Family Insurance Program* (Nov. 18, 2008) (source may be requested at http://www.researchgate.net/publication/256604066_An_Alternative_look_at_the_Financial_Strength_of_the_FHA_Single_Family_Insurance_Program).

[279] DEP'T OF HOUS. & URBAN DEV., *supra* note 272, at 23. *See also* Peter M. Zorn & Marsha J. Courchane, Mortgage Market Players and Products 16, Address at U.C. Irvine Housing After the Fall: Re-Assessing the Future of the American Dream (rev. Aug. 13, 2009) (presented at Housing After the Fall: Re-Assessing the Future of the American Dream University of California – Irvine, rev. Aug. 13, 2009), http://merage.uci.edu/ResearchAndCenters/CRE/Resources/Documents/Zorn-Courchane.pdf (arguing that because the FHA did not significantly tighten its underwriting standards, it "likely will experience significant credit costs issues from its most recent books of originations").

[280] *See supra* text accompanying notes 43–48.

[281] Kathleen Pender, *National MI to Get Fannie, Freddie Loans*, S.F. CHRON., Jan. 19, 2013.

[282] Clea Benson & Zachary Tracer, *FHA Pullback Boosts Mortgage Insurers Once Seen Failing*, BLOOMBERG, Mar. 7, 2013, http://www.bloomberg.com/news/2013-03-07/fha-pullback-boosts-mortgage-insurers-once-seen-failing.html; Pender, *supra* note 281.

of a hurricane.[283] As the housing markets recovered, so did the PMI industry,[284] but it was not able to support the housing market during the crisis in the way that the government-backed FHA was able to.

The Housing and Economic Recovery Act of 2008 barred the FHA from insuring mortgages in transactions involving seller-financed down payment assistance which was at the root of so much of the FHA's massive losses in the 2000s.[285] It also increased the minimum down payment to 3.5%.[286] And it began tightening its underwriting.[287] Finally, Congress authorized the FHA in 2010 to raise its premiums, which also helped to stabilize its financial health.[288]

For the years 2006–2012, the FHA's losses as a percent of its total debt outstanding was 17.3%, much higher than Fannie and Freddie's 3.9% but a bit lower than the private-label MBS sector's 20.3%.[289] The FHA continued to serve first-time and lower-income homebuyers, consistent with its change in focus in its later years. In fiscal year 2011, "75 percent of FHA purchase-loan endorsements were first-time homebuyers, which [was] a 5 percent decline from fiscal year 2010."[290] And in 2011, 59.2% of its insured borrowers were classified as low/moderate income, again reflecting the mission of the modern FHA.[291]

---

[283] Pender, *supra* note 281. For a more nuanced discussion of the effect of the financial crisis on the private mortgage insurance industry, see PROMONTORY FIN. GRP., LLC, *supra* note 122, at 41–42.

[284] Benson & Tracer, *supra* note 282.

[285] Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 2113, 122 Stat. 2654 (2008) (amending section 203(b)(9) of the National Housing Act). *See generally* GOV'T ACCOUNTABILITY OFFICE, GAO-07-1033T, *supra* note 250 (describing impacts of seller-financed down-payments).

[286] Housing and Economic Recovery Act § 2113.

[287] INTEGRATED FIN. ENG'G, INC., *supra* note 112, at 3.

[288] Act of Aug. 11, 2010, Pub. L. No. 111-229, 2010 U.S.C.C.A.N. (124 Stat. 2483).

[289] Jonathan R. Laing, *Fannie, Freddie: On Borrowed Time*, BARRON'S, July 29, 2013.

[290] DEP'T OF HOUS. & URBAN DEV., FHA ANNUAL MANAGEMENT REPORT FISCAL YEAR 2011, at 8 (2011), http://portal.hud.gov/hudportal/documents/huddoc?id=fhafy11annualmgmntrpt.pdf.

[291] *Id.* at 9.

9. The 2010s: The Reckoning. As the financial crisis recedes from memory, the FHA is hailed in heroic terms for expanding so rapidly in the face of the retreat of private capital from the mortgage market. It is also pilloried so mightily for the massive losses it suffered because of its loose underwriting in the early 2000s. These losses resulted in the FHA's first bailout in its eighty year history.

The FHA began to tighten its underwriting standards after its defaults began to rise.[292] Because of its poor financial position, the FHA also raised its premiums.[293] The MMI Fund's financial condition had been poor since 2009, when it failed to meet its required 2% minimum capital ratio.[294]

PMI began to make a comeback in 2010 when it insured 4.3% of all new mortgages.[295] By 2013, its market share grew to 11.3%.[296] The FHA continued to focus on first-time homebuyers. In 2012, about 78% of its loans went to that population and about 32% were households of color.[297]

* * *

This history of the FHA accomplishes a number of goals. First, it demonstrates, contrary to conventional wisdom, that the FHA's mission was actually many missions from its very start. Second, it demonstrates, again contrary to conventional wisdom, that the FHA added and shed missions over the years, some of which were big successes while others were big failures. Third, it demonstrates the FHA's ability to respond rapidly to systemic failure in the housing finance market, particularly when compared with the PMI industry. Fourth, it documents the FHA's very

---

[292] Bob Tedeschi, *F.H.A. Lending Standards Tightened*, N.Y. TIMES, Jan. 29, 2010, http://www.nytimes.com/2010/01/31/realestate/31mort.html.

[293] Lynnley Browning, *F.H.A. Rule Changes for Mortgage Borrowers*, N.Y. TIMES, Nov. 24, 2010, http://www.nytimes.com/2010/11/28/realestate/mortgages/28Mort.html.

[294] GOV'T ACCOUNTABILITY OFFICE, *supra* note 69, at 7 fig.2.

[295] Bob Tedeschi, *Private Mortgage Insurance Easier to Obtain*, N.Y. TIMES, May 28, 2010, http://www.nytimes.com/2010/05/30/realestate/30mort.html; Mike Ferullo, *Private Mortgage Insurers Seek More Clout With Launch of New Trade Association*, BNA BANKING REP., Mar. 18, 2014, at 451 (reporting market share for 2010).

[296] Ferullo, *supra* note 295.

[297] GOV'T ACCOUNTABILITY OFFICE, *supra* note 69, at 4.

troubled history of discrimination as well as misguided attempts to remedy past discrimination. Finally, and most importantly to this Article, it demonstrates the importance of responsible underwriting to the FHA's success, however one chooses to measure it.

The FHA has an important part to play in the mortgage market, but that part is not so clear, given its history. It is clear, at least, that the PMI industry is not capable of assuming all of the roles played by the FHA. The next section addresses a central component of the FHA's mission: making homeownership available to a broader swath of households. It identifies the flaws that have developed in the FHA's underwriting of single-family mortgages and how those flaws can be addressed, with the goal of charting a course forward for the FHA as it leaves the Great Recession behind.

IV. UNDERWRITING SUSTAINABLE HOMEOWNERSHIP

The modern FHA states that its mission is to serve borrowers that the conventional mortgage market does not serve effectively: "[f]irst-time homebuyers, minorities, low-income families and residents of underserved communities."[298] More concretely, in the midst of the Great Recession, it set performance goals of increasing homeownership opportunities and strengthening communities.[299] For instance, to achieve these goals, the FHA set and exceeded a goal of insuring over 1.4 million single-family mortgages in the fiscal year (FY) of 2009; set and exceeded a goal of having 73% of its single-family mortgages go to first-time homebuyers; set and almost achieved its goal of having 33% of its single-family mortgages go to minority households; set and

---

[298] FED. HOUS. ADMIN., *supra* note 8, at 3. *See also* CONG. BUDGET OFFICE, POLICY OPTIONS FOR THE HOUSING AND FINANCIAL MARKETS 23 (2008), http://www.cbo.gov/ftpdocs/90xx/doc9078/04-11-Housing_with_Letter.pdf (noting that the FHA "has a long tradition of assisting borrowers who would generally be considered candidates for today's troubled subprime and alt-A loans").

[299] FED. HOUS. ADMIN., ANNUAL MANAGEMENT REPORT FISCAL YEAR 2009, at 18–20 (2009), http://www.hud.gov/offices/hsg/fhafy09annualmanagementreport.pdf.

achieved a goal of having 35% of its single-family mortgages be in underserved communities.[300]

Sadly, it does not seem that the FHA got it, even in the aftermath of the financial crisis. By having homeownership goals drive its underwriting, it is bound to repeat the fiscal calamities of the past. What is needed—what all of the commentators agree upon—is for appropriate underwriting to drive the FHA. This position is not to say that promoting homeownership for various groups is not a legitimate goal. But rather it can do more harm than good to the FHA itself and the homeowners it serves if it is not done in a way that avoids frequent default and foreclosure.

A key element of appropriate underwriting is the downpayment requirement, as expressed in the LTV ratio. Indeed, as seen above, there is a strong correlation between low LTV and low default rates over the FHA's eighty year history. From an underwriting perspective, a 20% down payment is great.[301] It keeps defaults very low. But it is very hard for low- and moderate-income families to save enough money in a reasonable amount of time to put together a 20% downpayment. The median household income in 2013 was $51,939.[302] The median house price in 2013 for existing homes was about $198,000 at the end of 2013.[303] It would take quite some time for that median household to save the roughly $40,000 necessary to have a 20% downpayment on that median house. High downpayment requirements would also have a disproportionate effect on communities of color, which tend to

---

[300] *Id.*

[301] Downpayments have a signaling effect in addition to providing an equity cushion. *See* DENNIS & PINKOWISH, *supra* note 7, at 132 (stating that a downpayment "from accumulated savings, investments, retirement funds, or equity in another home sold is generally earned over time," and it "provides a good indication of the applicants' ability to handle debt and manage their income").

[302] CARMEN DENAVAS-WALT & BERNADETTE D. PROCTOR, U.S. CENSUS BUREAU, CURRENT POPULATION REPORTS, P60-249, INCOME AND POVERTY IN THE UNITED STATES: 2013, at 5 (2014).

[303] NAT'L ASS'N OF REALTORS, *December Existing-Home Sales Rise, 2013 Strongest in Seven Years* (Jan. 23, 2014), http://www.realtor.org/news-releases/2014/01/December-existing-home-sales-rise-2013-strongest-in-seven-years ("The median existing-home price for all housing types in December was $198,000, up 9.9 percent from December 2012.").

have lower income and less wealth than white households.[304] As seen above, there have been periodic pushes to decrease downpayment requirements in order to increase homeownership rates, but those pushes have not been accompanied by an evaluation of the sustainability of that increase.[305]

Advocates for low-income communities, lenders, and advocates of an "ownership society" have all pushed for much lower downpayment requirements, particularly for first-time homeowners. This has occurred, most notably, in the late 1960s and late 1990s, but also as veterans returned from World War II. Some of these pushes are accompanied by little thought as to the impact that low downpayments have on the likelihood that a household will keep its home over the long term. Others are more thoughtful, and are based on empirical research. Let us dismiss the first set out of hand, for there have been a number of low- or no-downpayment initiatives that have been unmitigated failures.[306]

Let us begin by addressing the criticisms of low-downpayment initiatives. The flaws with the FHA that commentators such as Van Order & Yezer and Pinto have identified are almost completely flaws of ultra-low or no-downpayment initiatives. Throwing the baby out with the bathwater, their prescription is to end innovative homeownership programs. Instead, the focus should be on the predictors of default, and in particular, the scholarly literature regarding the relationship between low downpayments and default. It is clear that the FHA (and the VA) have had success with relatively small downpayments at times, as have other entities such as the Self-Help Credit Union.[307]

---

304 CTR. FOR RESPONSIBLE LENDING, GOVERNMENT-MANDATED DOWN PAYMENT STANDARDS WOULD HARM THE ECONOMY, DENY HOMEOWNERSHIP TO CREDIT-WORTHY FAMILIES (2013), http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/CRL-Down-Payment-Mandates-Would-Harm-the-Economy-Credit-Worthy-Families-August-13-2013.pdf.

305 *See supra* text accompanying notes 246–67.

306 *See, e.g.*, *supra* Part III.B (discussing several FHA initiatives and their varying degrees of success).

307 *See, e.g.*, *supra* text accompanying note 168 (noting that Congress lowered down payment to 3% in some cases in the 1950s); UNC CTR. FOR CMTY. CAPITAL, SETTING THE

Much of the downpayment literature is focused on how lowering downpayment requirements increases homeownership rates.[308] But there is also a substantial body of literature that indicates that no-downpayment and low-downpayment mortgages are much more likely to default than mortgages with larger downpayments.[309] One article by Austin Kelly stands out for studying mortgage default rates where the borrower has made no downpayment. It confirms what seems intuitive: "[b]orrowers who provide even modest downpayments from their own resources have substantially lower default propensities than do borrowers whose downpayments come from relatives, government agencies, or nonprofits."[310] This finding—that "skin in the game" reduces defaults—implies that borrowers will assess the risk of purchasing a home more carefully if their own capital is at risk and will fight harder to keep their homes in order to protect that capital.[311] Otherwise a home purchase looks more like a long-term lease with an option to purchase should prices rise.

RECORD STRAIGHT ON HOMEOWNERSHIP 1–4 (Policy Brief, undated), http://ccc.sites.unc.edu/files/2013/02/Setting-Record-StraightHO.pdf (studying Self Help Credit Union Community Advantage Program portfolio of 46,000 home-purchase mortgages over a ten year period); ROBERTO G. QUERCIA ET AL., REGAINING THE DREAM: HOW TO RENEW THE PROMISE OF HOMEOWNERSHIP FOR AMERICA'S WORKING FAMILIES 26–33 (2011) (discussing the success of the Self-Help Community Advantage Program).

[308] *See, e.g.*, O. Emre Ergungor, *Homeownership for the Long Run: An Analysis of Homeowner Subsidies* 1, 25 (Fed. Res. Bank of Cleveland, Working Paper No. 10-21R, 2010), http://ssrn.com/abstract=1723445 (examining the impact of interest-rate and down-payment subsidies on default rates and losses given default); Christopher E. Herbert & Winnie Tsen, *The Potential of Downpayment Assistance for Increasing Homeownership Among Minority and Low-Income Households*, 9 CITYSCAPE 153 (2007), http://ssrn.com/abstract=1084122; Mark S. Doms & John Krainer, *Innovations in Mortgage Markets and Increased Spending on Housing* (Fed. Res. Bank of San Francisco, Working Paper No. 2007-05, 2007), http://ssrn.com/abstract=1007830.

[309] For a somewhat dated survey of the literature, see GOV'T ACCOUNTABILITY OFFICE, GAO-05-194, MORTGAGE FINANCING: ACTIONS NEEDED TO HELP FHA MANAGE RISKS FROM NEW MORTGAGE LOAN PRODUCTS 4 (2005). The GAO found that FHA mortgages with LTVs of 97% to 100% had default rates that were "about 1.75 times the average FHA default rate." *Id.* at 29.

[310] Austin Kelly, *"Skin in the Game": Zero Downpayment Mortgage Default*, 17 J. HOUS. RES. 75, 75 (2008).

[311] *See id.* at 86 (finding that when a buyer funded the downpayment, the 90-day delinquency rate was significantly lower than loans with gift downpayments).

The question, of course, is what is the socially optimal level for down payments?[312] No one has answered this question in the context of the FHA, but a body of research about down payments has recently sprung up as various parties have attempted to influence the rulemakings that define "Qualified Mortgages" (QM) and "Qualified Residential Mortgages" (QRM) pursuant to Dodd-Frank.[313]

The Center for Responsible Lending, an advocate for low- and moderate-income borrowers that also engages in serious research on lending issues, has looked at the question of whether very low downpayments are unacceptably risky. It starts out by noting that "it would take the typical family 22 years to save for a 10% down payment, and 14 years for a 5% down payment."[314] In a study of its affiliate-lender's record of borrower defaults, researchers found that "72% of borrowers made a down payment of less than 5 percent," but they were delinquent less than a quarter of the rate of subprime ARM borrowers.[315]

Some evidence exists that there is a downpayment sweet spot of around 5% at which default rates are within an acceptable range.[316] The Coalition for a Sensible Housing Policy, a coalition of lenders and consumer advocates, argues that:

---

312 The socially optimal level of downpayments may vary, of course, based upon different conditions. For instance, it might be lower during a recession. That is an issue better suited for an economist, and not this lawyer, to address.

313 Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (summarizing the purpose of the Dodd-Frank Act). *See also* Reiss, *supra* note 78, at 721 (discussing Qualified Mortgage and Qualified Residential Mortgage rulemakings).

314 CTR. FOR RESPONSIBLE LENDING, *supra* note 304, at 1 (emphasis omitted). *See* DENNIS & PINKOWISH, *supra* note 7, at 132 ("As a general rule, the secondary mortgage market is interested in establishing that an applicant either saved or obtained through housing price appreciation at least 5 percent of the down payment for the mortgage loan.").

315 UNC CTR. FOR CMTY. CAPITAL, *supra* note 307, at 1. *See also* QUERCIA ET AL., *supra* note 307, at 7–12 (reviewing experience of the Self-Help Credit Union in providing sustainable mortgages for low-income households).

316 *See* COAL. FOR SENSIBLE HOUS. POLICY, PROPOSED QUALIFIED RESIDENTIAL MORTGAGE DEFINITION HARMS CREDITWORTHY BORROWERS WHILE FRUSTRATING HOUSING RECOVERY 6 (2011), http://www.responsiblelending.org/mortgage-lending/policy-legislation/regulators/Coalition-QRM-White-Paper-1.pdf (noting that from 5% down to 10% down does not greatly reduce the risk of loss).

> once you apply the strong underwriting standards in the sample QRM definition, moving from a 5 percent to a 10 percent down payment requirement reduces the overall default experience by an average of only two- to three-tenths of one percent for each cohort year. However, the increase in the minimum down payment from 5 percent to 10 percent would eliminate from 4 to 7 percent of borrowers from qualifying for a lower rate QRM loan.[317]

The higher requirements would also have a strongly disproportionate effect on communities of color.[318]

Quercia et al. have looked at the trade-offs between safe underwriting and access to credit in the context of the QRM rules.[319] They have also developed a useful metric, which they refer to as a "benefit ratio." The benefit ratio compares "the percent reduction in the number of defaults to the percent reduction in the number of borrowers who would have access to QRM mortgages."[320] A metric of this sort would go a long way to ensuring that there is transparency for both homeowners and policymakers as to the likelihood that homeowners can pay their mortgages and keep their homes.

Quercia et al. would push the optimal downpayment size even lower, arguing that "LTVs of 97 percent result in a better benefit ratio, suggesting that a small downpayment requirement may have an important protective effect against default risk while still

---

317 *Id. See also* QUERCIA ET AL., *supra* note 262, at 27–28.

318 QUERCIA ET AL., *supra* note 262, at 27–28 ("[W]e find that imposing a 10 percent downpayment requirement would eliminate 38 percent of performing loans from the QRM market, and that at the 20 percent downpayment threshold, 61 percent would be excluded. . . . [I]mposing a 20 percent downpayment requirement on QM loans would prevent three-quarters of African Americans and 70 percent of Latinos from qualifying for a QRM mortgage, compared with 60 percent of non-Hispanic whites and 51 percent of Asians. Our analysis shows that these borrowers would be excluded from the QRM market even though they could be successful homeowners.").

319 *Id.* at 20.

320 *Id.* (emphasis omitted).

providing broad access to mortgage credit."[321] They conclude that "restricting the origination of risky loan features and underwriting a loan with a consideration of a borrower's ability to repay has the largest benefit in terms of reducing default risk without limiting access to credit."[322]

We need to ask some questions before applying this research to the FHA mortgage. The first question is—what are we trying to achieve with FHA underwriting? The second is—what is the best technical way to achieve that goal? And the final question is—what political realities can interfere with that approach? Let us take the three questions in turn.

A. GOALS OF FHA UNDERWRITING

There are three generally agreed-upon goals for FHA underwriting: (a) FHA insurance should not require support from the public fisc; (b) the FHA should use lower-risk eligible borrowers to cross-subsidize higher-risk eligible borrowers; and (c) the class of eligible borrowers should be limited to those with a

---

[321] *Id.* at 33. They reached this result after examining "the impacts of various proposed QRM underwriting standards on access to credit." *Id.* at 4. The authors acknowledge the limits of their study:

> this analysis does not model the dynamic nature of mortgage and housing markets, so it is necessarily an incomplete accounting of what may happen under various QRM guidelines. As the recent period taught us, changes in the cost and terms of credit can have a significant impact on mortgage demand and consumer behavior. For some borrowers, the difference in cost between a QRM and non-QRM loan may not limit access to homeownership; instead, it may change their housing cost calculus and either lead them to take out the more expensive, non-QRM mortgage or buy a less expensive house, or it may simply delay their decision to buy a house. For other borrowers, the inability to obtain a QRM-loan may exclude them from the homeownership market entirely. We also don't model the impact of QRM on housing demand; restrictive thresholds could reduce housing demand, which in turn could reduce house prices further (thereby limiting the ability of current owners to sell their house) and prompt additional foreclosures.

Id. at 5.

[322] *Id.* at 4.

reasonable likelihood of not defaulting on their loan.[323] These three goals, taken together, reflect a view that the FHA's long-term health depends on it navigating longstanding political debates over the "ownership society,"[324] wealth redistribution, and consumer protection regulation. The debate over the appropriate role of the FHA is often driven by broader ideological agendas,[325] so it would be helpful for those scholars commenting on it to make clear whether they agree or disagree with these three goals. To be clear: I think all three goals are appropriate and politically feasible for the FHA.

The first goal, that FHA insurance should not require support from the public fisc, has been part of the FHA's mission since it was created.[326] The FHA's financial difficulties have not been sympathetically received in the Capitol. Moreover, the current political environment is one in which there are frequent calls to end Fannie and Freddie resounding in the Capitol after the two companies needed extraordinary support from taxpayers during the Subprime Crisis.[327] It is hard, in this environment, to imagine a politically feasible alternative to a self-supporting FHA.[328]

The second goal, that the FHA should use lower-risk eligible borrowers to cross-subsidize higher-risk eligible borrowers, has

---

[323] DEP'T OF HOUS. & URBAN DEV., *supra* note 250, at 1 (noting that the FHA's MMIF is self-supporting); PRESIDENT'S COMM'N ON HOUS., *supra* note 6, at 162 (discussing FHA cross-subsidization); DEP'T OF HOUS. & URBAN DEV., *supra* note 163, at 117 (noting that Section 203 foreclosures in 1950 were 0.04% of mortgages in force).

[324] *See generally* David J. Reiss, *First Principles for an Effective Federal Housing Policy*, 35 BROOK. J. INT'L L. 795 (2010) (arguing that the principles of federal housing policy promote and incentivize homeownership).

[325] *See id.* at 800–04 (discussing justifications for housing policy).

[326] *See supra* Part III.B.*1* (discussing the FHA's conservative underwriting in the 1930s).

[327] *See, e.g.*, Laing, *supra* note 289, at 21.

[328] Indeed, the FHA's recent financial troubles, *supra* notes 49–50, make it even less likely that Congress would want to provide for a permanent subsidy for the FHA in the current political environment. *See generally* STANDARD & POOR'S, *U.S. Mortgage Finance Reform Efforts and the Potential Credit Implications* (2013) (discussing three proposals to reform the mortgage market).

also been integral to the FHA since its founding.[329] Indeed, the Mutual Mortgage Insurance Fund was designed, per its name, to be a form of mutual insurance where policyholders spread the risk of default among themselves.[330] This second goal has also been a relatively non-controversial one, although one could imagine alternatives to it.[331]

Surprisingly, the third goal—ensuring that borrowers do not default in high numbers—is less of a constant than one might suppose.[332] The policy of the FHA was surely to err on the side of low defaults from the 1930s through the 1950s.[333] But starting in the 1960s, this approach was relaxed, and at times it was implicitly rejected or ignored.[334] This relaxation of standards was seen with the Section 235 fiasco of the 1970s as well as the American Dream Downpayment Act debacle of the 2000s.[335] It appears that households and communities of color are most

---

329 *See supra* Part III.B.*1* (discussing the FHA's creation and its main goals in the 1930s); *see also* PRESIDENT'S COMM'N ON HOUS., *supra* note 6, at 162 (noting that cross-subsidization is "inherent in FHA's single-premium structure").

330 *See* Cooper, *supra* note 112, at RE1 (describing how the MMIF operates).

331 For instance, the FHA could stop insuring borrowers who are high credit risks and thereby lower the cost of credit for remaining borrowers even further by lowering the FHA insurance premium that they pay. *See* Edward J. Pinto, *The FHA is a Predatory Lender*, AM. ENTER. INST. (2013), http://www.aei.org/article/economics/financial-services/housing-finance/the-fha-is-a-predatory-lender/ ("When Congress established the FHA in 1934, cross-subsidization between low-and high-risk borrowers was explicitly prohibited.").

332 A couple of commentators have focused on this topic recently. Joseph Tracy presented a work-in-progress, *Is the FHA Producing Sustainable Homeownership?*, at the 2013 Cleveland Fed Policy Summit on September 9, 2013, http://www.clevelandfed.org/community_development/events/ps2013/pres_a1_tracy_a.pdf. Joseph Tracy forecast a default rate for the 2007 vintage in excess of 50%. Joseph Tracy, Fed. Reserve Bank of NY, Address at the 2013 Cleveland Fed. Policy Summit: Is the FHA Producing Sustainable Homeownership? (Sept. 9, 2013). Edward Pinto, who presented on the same panel, found a foreclosure rate of 15% for FHA loans in many low-income communities. Edward Pinto, Am. Enterprise Inst., Address at the 2013 Cleveland Fed. Policy Summit: How the FHA Hurts Working Class Families and Communities (Sept. 19, 2013).

333 *See supra* Part III.B.*1–3* (detailing the conservative underwriting practices during this time period).

334 *See supra* Part III.B.*4–9* (explaining the riskier lending practices that led to the current financial crisis).

335 *See* RYAN, *supra* note 205, at 92 (explaining that Section 235 was suspended and then terminated because of the high default and foreclosure rate); *HAMP Changes*, *supra* note 271, at 1–2 (discussing the high foreclosure rate of the 2010s).

harmed by such thoughtlessly loose underwriting criteria as they were disproportionately represented among homeowners impacted by the defaults and foreclosures from those failed programs.[336]

History teaches us that the goal of sustainable homeownership should not have been ignored.[337] It should be closely followed for the sake of the FHA's viability. It should also be closely adhered to for the sake of FHA-insured borrowers who should be able to rely on FHA underwriting as a signal that they will likely be able to afford their housing payments and keep their homes.

There will always be some percentage of FHA mortgagors who will default on their loans. The key policy question is what the acceptable range of default is over the long term. If the rate is too low, it would imply that some were not given the opportunity to benefit from homeownership. If the rate is too high, it would likely imply that an FHA mortgage was reducing household net worth and having too many negative social impacts on households as families deal with the effects of default, foreclosure, and eviction.

There is no objective way to identify the most ideal default rate for FHA mortgages. One might, however, look at the alternatives available to households. Because FHA-eligible households have the option of renting, the benefits and drawbacks of an FHA mortgage to a household should be compared to renting as well as to other mortgage products that might be available to them. Researchers at the UNC Center for Community Capital argue that homeownership beats renting in a number of ways, although their study is drawn from a very limited number of homeowners with mortgages from a particular loan program, the Community Advantage Program (CAP).[338]

---

[336] *See* Gottlieb, *supra* note 223 (detailing a real estate scam in the 1980s targeting minorities).

[337] *See generally supra* Part III.B (providing a historical overview of the FHA's risky underwriting process and its effects).

[338] UNC CTR. FOR CMTY. CAPITAL, *supra* note 307, at 1–4 (studying Community Advantage Program portfolio of 46,000 home-purchase mortgages over a ten year period). Having earlier reviewed the relevant literature about the social benefits of homeownership, Reiss, *supra* note 324, at 805–18 (discussing the alleged benefits of homeownership), I am skeptical of such one-sided claims about the value of homeownership, although some studies

The UNC researchers found that ownership provides a greater financial cushion than renting for low-income families. Most important for my purposes, they found that the loans in their study "[were] notable for their high loan-to-value ratios: 97 percent is the typical maximum loan-to-value ratio, though some programs issue loans all the way up to 103 percent of house value."[339]

They concluded that "having received assistance toward one's down payment and closing costs has no significant effect whatsoever on CAP homeowners' mortgage performance."[340] The authors of the study noted some "important caveats" in their findings that severely limit their generalizability.[341]

---

support a finding that homeownership does have positive financial impacts on households. *See, e.g.*, Christopher E. Herbert et al., *Is Homeownership Still an Effective Means of Building Wealth for Low-Income and Minority Households?*, *in* HOMEOWNERSHIP BUILT TO LAST: BALANCING ACCESS, AFFORDABLY, AND RISK AFTER THE HOUSING CRISES 52 (Eric S. Belsky et al. eds., 2014) ("[T]here continues to be strong support for the association between owning a home and accumulating wealth."); QUERCIA ET AL., *supra* note 262, at 7 ("[S]tudies have shown that, over time, homeowners do accumulate more wealth than their renter counterparts.").

[339] UNC CTR. FOR CMTY. CAPITAL, *supra* note 307, at 3. Even more striking,

> a substantial portion of CAP's borrowers had help meeting their modest down payment requirements and closing costs: some 38 percent of CAP owners relied on some form of assistance beyond their own savings and assets to buy their homes. Sellers and real estate agents were the source of assistance most frequently cited, followed by family and friends, then grants from community groups, government agencies or other organizations. Two percent of owners used a second mortgage, while another 2 percent used help from a different source altogether. Community grants and loans were particularly important for African American borrowers.

Id.

[340] *Id.* at 4. *See generally* Allison Freeman, *The Continuing Importance of Homeownership: Evidence from the Community Advantage Program*, 26 CMTY. INVESTMENTS 7, 7–9 (2014) ("CAP is an affordable-loan secondary market program that was created in 1998 in a partnership between Self-Help, Fannie Mae, and the Ford Foundation. The loans in the CAP portfolio are purchase money, 30-year, fixed-rate mortgages. These loans were originated not by brokers, but by banks earning Community Reinvestment Act credit for such investments. The vast majority of loans in the CAP portfolio were made to lower-income and minority borrowers.").

[341] UNC CTR. FOR CMTY. CAPITAL, *supra* note 307, at 4 ("First, not all owners fared equally well. Some owners who bought late in the cycle in more volatile markets have lost wealth. Second, the experience of the CAP homeowners cannot be generalized to all lower-income borrowers over this same period because the type of financing used is a key determinant of

I am cautious of assuming that the FHA's results with low downpayments would be the same as CAP's given the significant differences between the two programs. But CAP's results do, at least, suggest that we do not yet know how low downpayments can go while still maintaining an acceptable level of mortgage defaults.

Combining the UNC study with Quercia et al.'s (also affiliated with UNC) benefit ratio discussed above, we can reasonably identify a range of 3% to 5% downpayments as a starting point for FHA underwriting, and assume that future performance data could push that range lower over time. We can also imagine that a more sophisticated underwriting process could allow for trade-offs among LTV, credit score, and debt-to-income (DTI) that could push that range even lower for select borrowers.[342]

B. THE TECHNICAL APPROACH

There are two approaches that the FHA could take to achieve its three goals. It could propose a simple, conservative underwriting model that will reduce the likelihood that the FHA would ever need a bailout. Such a model would likely have hard cut offs for downpayment size, LTV ratio, and credit scores. The problem with this approach is that it is likely to exclude some borrowers who have a reasonable likelihood of not defaulting on their loan. This approach would be consistent with the FHA's behavior during its early years, but it would require a firmer commitment to conservative underwriting criteria than the FHA has shown over the last fifty years.[343]

---

the financial trajectory of investing in a home. All of the owners in the CAP portfolio received fixed-rate, fixed-payment, standardized, competitively priced, long-term mortgages. It is largely due to the durability of their affordable mortgages that CAP's owners have enjoyed the benefits traditionally associated with homeownership, even against a backdrop of economic upheaval. Borrowers who used costlier, riskier products were not as fortunate and many have lost their homes as a result.").

[342] High DTI ratios, for instance, may be justified by a variety of mitigating factors, such as a high net worth. *See* DENNIS & PINKOWISH, *supra* note 7, at 136 (listing mitigating factors).

[343] *See supra* Part III.B (discussing the conservative underwriting of the 1930s and the riskier standards that arose in the 1960s).

Alternatively, it could attempt to construct a dynamic default model like those used in the rest of the modern lending industry that attempts to expand access to credit to its reasonable limits. Fannie Mae and Freddie Mac, for instance, both use automated underwriting software to pre-screen loans for eligibility for purchase by the companies.[344] Such an approach risks exposing the FHA to insolvency—and the federal government to liability for another bailout—if the model is pushed too far or if market conditions make the model outdated. It has certainly been a double-edged sword for other lenders that have relied upon it.[345]

This choice between clear and simple rules on the one hand and a flexible set of guidelines on the other is, of course, just a particular example of the classic choice between rules and standards at the heart of many policy decisions.[346] Nonetheless, it poses a hard choice in this specific case. The clear and simple rules may be easy to understand and comply with but may be under- and over-inclusive in their application.[347] The dynamic model could, like a vague standard, be more costly to create and to get buy-in from the regulated parties (the originating lenders).[348] A technocrat would favor the latter as it would appear to maximize the social utility of the FHA. A cynical observer of the political scene might not be so sure that such a textured approach could survive for long amid the jockeying of special interests.

C. POLITICAL INTERFERENCE

The commentators who have lost faith in the FHA's ability to stay the course of responsible underwriting have had good

---

[344] Reiss, *supra* note 1, at 939 (discussing innovations which allow the companies to expand into other markets).

[345] *See id.* at 939 n.157 (noting the risks of innovation in the private sector).

[346] *See generally* Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257 (1974).

[347] *See* Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65, 68 (1983) (identifying "transparency, accessibility, and congruence" as aspects of "precise" rules).

[348] *See id.* at 73–74 (identifying costs and benefits to changing the rules).

reason.[349] Congress has shown itself to put politics ahead of responsible underwriting to disastrous effect.[350] But given the long history of the FHA, it seems the commentators are, perhaps, too pessimistic. Indeed, their aversion to policy experimentation by the FHA is consistent with a broader aversion to government social policy expenditures, an aversion that reverberates in just about every federal election throughout the country in recent years. All social policy can be done irresponsibly. All of it can lose or waste money or have unintended consequences. In my eyes, there is nothing about the FHA that is particularly flawed as an instrument of government action.[351] However, the FHA can be abused and is, in fact, occasionally abused—sometimes by Congressional mandate.

This is not to say that we have nothing to learn from the FHA's critics. The FHA should be constrained from repeating the errors of its past. Odysseus tied himself to the mast of his ship when passing the isle of the Sirens to both hear their beautiful song and to keep himself from jumping into the wine-dark sea.[352] At the same time, he made his sailors plug up their ears with beeswax so that they would not feel the pull of the Sirens' song and throw themselves into that same wine-dark sea.[353] And so Congress could tie itself to a strong underwriting standard by returning to the "economic soundness" standard of the pre-1950s FHA.[354]

Congress could also mandate that the FHA implement an appropriate benefit ratio through a rulemaking process. The rulemaking would protect the FHA from loose underwriting just as the beeswax protected Odysseus' men. There is, of course, always

---

[349] *See supra* Part II (describing the ebb and flow of the FHA's underwriting standards from the 1930s to the present).

[350] *See supra* Part III.B.5 (discussing the FHA's disastrous 1970s).

[351] I would contrast my position here with the one I take on the fatally flawed public/private hybrids, Fannie and Freddie. *See generally* Reiss, *supra* note 1 (arguing that Fannie and Freddie should be terminated in their current form).

[352] Homer, *The Odyssey*, *in* GREAT BOOKS OF THE WESTERN WORLD 251–52 (Robert Maynard Hutchins ed., 1952).

[353] *Id.*

[354] *See* FED. HOUS. ADMIN., *supra* note 173, para. 101 (noting that the National Housing Act stipulated that "no mortgage shall be accepted for insurance unless it is economically sound").

the risk that Congress would reverse itself, but—hey—that's democracy. If Odysseus refuses to bind himself to the mast, there is no one to save him from himself.

And if Congress finds that there are categories of households which are still not adequately accessing the mortgage markets, it would need to increase the cross-subsidy elements of the FHA insurance premium or allocate funds to subsidize them directly. Although increasing direct subsidies through Congressional action may be infeasible in the current political environment, increasing cross-subsidies may be done administratively.

The more sophisticated approach to underwriting which looks at the layering of risks like credit score, loan-to-value ratio, debt-to-income ratio, and other factors may, in theory, result in a more socially optimal level of lending.[355] Our worries do not disappear, however, merely because we undertake a rulemaking initiative that implements a dynamic underwriting standard.

Notwithstanding all of the benefits of a dynamic approach, a measured political analysis might suggest that there is good reason to stick with an easy-to-understand heuristic like a mandatory 3%–5% downpayment requirement. Such a requirement would be harder for homeowners, lenders, and politicians seeking to be "pro-homeowner" to manipulate, in contrast to the dynamic rule. That dynamic rule is always going to be subject to pressures from lenders looking to increase market share and politicians who put pressure on regulated financial institutions to expand access to credit for a variety of politically expedient reasons.

---

[355] Default risk "rises *exponentially* with each additional high-risk factor in" a loan. DENNIS & PINKOWISH, *supra* note 7, at 127 (emphasis in the original). This practice is referred to as "risk stacking." *Id.* Risk-based pricing can also account for compensating factors that reduce risk, such as a demonstrated "ability to accumulate savings." GOV'T ACCOUNTABILITY OFFICE, *supra* note 69, at 10–11.

V. CONCLUSION

The FHA has been a versatile tool of government since it was created in the 1930s, achieving a variety of social purposes through its mortgage insurance programs. However, it can fail when the goals to which it is put are muddled. There is no doubt that today's FHA is suffering from many of the same unrealistic underwriting assumptions that have derailed so many subprime lenders, as well as Fannie and Freddie. It had also been harmed, like other lenders, by a housing market as bad as any seen since the Great Depression.

Commentators on the FHA have rightly brought attention to the risks of FHA programs that fail to underwrite its products appropriately. They are right that the FHA needs to be bailed out because of this failed underwriting practice. These commentators have therefore concluded that the FHA is not particularly good at achieving its social policy objectives. They call for a more limited role for the FHA, one that focuses on liquidity and stability and leaves innovative approaches to expanding homeownership behind.

These commentators do not, however, fully appreciate the extent to which modest downpayment requirements and responsible underwriting can drive the success of new FHA initiatives. Central to any analysis of the FHA's role is an understanding of its policies relating to downpayment size. Much of the FHA's performance is driven by its downpayment requirements, which have trended ever downward so that homeowners were able to get loans for 100% of the value of the house in recent years. But as is obvious to all, the larger the downpayment, the safer the loan, if everything else is equal.

What has been less obvious to policy makers is that tiny or nonexistent downpayments are unacceptably risky. Given that the FHA insures 100% of the losses on its mortgages, the downpayment requirement is a key driver of its performance. Empirical researchers should continue to study how low downpayment requirements can go while still maintaining an acceptable benefit ratio for FHA mortgages. At this point, a downpayment in the range of 3% to 5% seems appropriate, but one could contemplate that number being responsibly pushed lower over time, within a rulemaking context. One could also contemplate a sophisticated approach that might allow for lower downpayments for those with stronger credit histories or other strengths in their underwriting profiles. This approach would require an underwriting system that was relatively insulated from politics.

It seems too simple to conclude by saying that although it is important to make residential credit broadly available, the FHA will not be doing borrowers any favors if their loans are not sustainable and they end up in default or foreclosure. But simply put, in the past the FHA has not always balanced the goal of access to credit with the goal of sustainable credit. It should, however, plan on always keeping that balance in mind going forward. In that way, it can make homeownership available to households who could reasonably expect to maintain it over the long term.