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Insuring Sustainable Homeownership

David Reiss

Brooklyn Law School, david.reiss@brooklaw.edu

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Insuring Sustainable
Homeownership



By David Reiss

The Federal Housing Administration (FHA) has suffered from many of the same unrealistic underwriting assumptions that have done in so many lenders during the 2000s. It too was harmed by a housing market as bad as any seen since the Great Depression. As a result, the federal government announced in 2013 that the FHA would require the first bailout in its history. Margaret Chadbourn, *U.S. Federal Housing Administration to Tap \$1.7 Bln in Taxpayer Funds*, Reuters, Sept. 27, 2013, <http://reuters.com/article/usa-housingbailout-idUSW1N0G702P20130927>. At the same time that it faced these financial challenges, the FHA came under attack for poor execution of some of its policies attempting to expand homeownership opportunities.

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 clear failures, but they fail to address the FHA's long history of undertaking comparable initiatives. In fact, the FHA has a history of successfully conducting new homeownership programs. The FHA does have operational flaws, however, that should be addressed to prevent them from reoccurring if the FHA were to undertake similar homeownership initiatives in the future.

This article examines the criticism that has been leveled at FHA and the goals the agency should pursue. For

David Reiss is a professor of law at Brooklyn Law School in Brooklyn, New York.

a more thorough treatment of this topic by the author, see the author's law review article on the subject. David Reiss, *Underwriting Sustainable Homeownership: The Federal Housing Administration and the Low Down Payment Loan*, 50 Ga. L. Rev. 1019 (2016).

Introduction to the FHA

Mortgage insurance is a product that is paid for by the homeowner but protects the lender if the homeowner defaults on the mortgage. The insurer pays the lender for the losses that it suffers from any default by the homeowner. Mortgage insurance typically is required for borrowers with limited funds for down payments. Gen. Accounting Office, GAO/RCED-96-123, *Homeownership: FHA's Role in Helping People Obtain Home Mortgages* 16 (1996), <http://www.gao.gov/archive/1996/rc96123.pdf>. The FHA provides mortgage insurance for mortgage loans on single family and multifamily homes and is the world's largest government mortgage insurer. Other significant providers are the Department of Veterans Affairs (VA) and private companies, known as private mortgage insurers (PMIs). Mortgage insurance makes homeownership possible for many households that would otherwise not be able to meet the underwriting requirements of lenders.

As with much of the federal housing infrastructure, the FHA has its roots in the Great Depression. National Housing Act, Pub. L. No. 73-479, 48 Stat. 1246 (1934). The private mortgage insurance industry, like many others, was devastated in the early 1930s. Its companies began to fail as almost half of all mortgages

in the nation defaulted. The FHA was created to replace the PMI industry, which remained dormant for decades.

Housing markets faced problems in the Great Depression that were similar in kind to those encountered in the late 2000s. These problems included rapidly falling housing prices, widespread unemployment and underemployment, rapid tightening of credit, and, as a result of these trends, much higher rates of default and foreclosure. 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 . . ." U.S. Fed. Hous. Admin., *Second Ann. Rep. Fed. Housing Admin.* 28 (1936). Needless to say, the same could be said of our most recent housing bust.

Over its lifetime, the FHA has insured more than 40 million mortgages, helping to make homeownership available to a broad swath of American households. Dep't of Hous. & Urban Dev., *Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance Fund Fiscal Year 2014* (2014), at 60. And indeed, the FHA mortgage has been essential to America's transformation from a nation of renters to a nation of homeowners. Kenneth T. Jackson, *Crabgrass Frontier: The Suburbanization of the United States* 205 (1985). The early FHA created the modern American housing finance system, as well as the look and feel of post-war suburban communities

because of the construction standards it set for the new houses that it insured. *Id.* at 205, 215.

The FHA also had many other missions over the course of its existence and a mixed legacy to match. The FHA's role changed, beginning in the 1950s, from serving the entire mortgage market to focusing on specific segments of it. This changed mission had a major effect on everything the FHA did, including how it underwrote mortgage insurance and for whom it did so.

The Failures of the FHA

The FHA is an understudied topic, despite having a massive effect on the built environment of the United States. The neglect is particularly unfortunate because the FHA has had some severe failures that mar its long history of success as a provider of liquidity for, stability in, and access

to the residential mortgage market. Because of these shortcomings, the leading commentators on the FHA have judged its initiatives to encourage homeownership to be failures. The absence of a vibrant and balanced scholarly exchange regarding the FHA stands in the way of responsibly charting its future course.

In recent years, the FHA has come under attack for its poor execution of some of its attempts to expand homeownership opportunities, and leading commentators have called for the federal government to stop assigning such mandates to the FHA. See, e.g., Joseph Gyourko, *Rethinking the FHA* 1 (Am. Enter. Inst. 2013). They argue that the FHA should focus on providing liquidity for the portion of the mortgage market that serves low- and moderate-income households. Edward J. Pinto, *How the FHA Hurts Working-Class Families and Communities* 41 (Am. Enter. Inst. 2012). These critics rely heavily on a couple of examples of failed programs, such as the Section 235 program enacted as part of the Housing and Urban Development Act of 1968 and the American Dream Downpayment Assistance Act of 2003.

These programs required tiny or even nominal down payments. The Section 235 program was enacted in response to the riots that burned through American cities in the 1960s. It was intended to expand homeownership opportunities for low-income households, particularly

African-American ones. The American Dream program also was geared to increase homeownership among lower-income and minority households. The crux of the critique of these programs is that they failed to ensure that borrowers had the capacity to repay their mortgages, leading to bad results for the FHA and borrowers alike.

Notwithstanding these harmful initiatives, the FHA has a parallel history of successfully undertaking new homeownership programs. These successes include programs for veterans returning home from World War II, a mission that was later handed off to the VA. At the same time, the FHA has clearly suffered from operational failures over the course of its existence that should be addressed in the design of any future initiatives. Unfortunately, the FHA has not really grappled with its past failures as it moves beyond the financial crisis.

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.” Robert Van Order & Anthony Yezer, *FHA Assessment Report: The Role of the Federal Housing Administration in a Recovering U.S. Housing Market* 9 (George Washington University Center for Real Estate and Urban Analysis June 2011), <https://creua.business.gwu.edu/files/2016/12/2obama-tkomqq.pdf>. They argue that this is nonetheless unavoidable because “there are powerful political forces willing to push FHA to allow very unsound lending practices.” *Id.* Given that Yezer is the co-author of one of the handful of comprehensive studies of the FHA, this is a damning assessment indeed.

The few policy analysts who have made 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*,

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writes: "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." Edward J. Pinto, *Truth in Government Lending Is Long Overdue* (Am. Enter. Inst. Mar. 20, 2012), <http://www.aei.org/publication/truth-in-government-lending-is-long-overdue/>. Housing economist Joseph Gyourko is more succinct, but equally pessimistic: the FHA "has failed by any reasonable metric." Joseph Gyourko, *Rethinking the FHA* (Am. Enter. Inst. June 2013), http://images.politico.com/global/2013/06/19/gyourko_rethinking_the_fha-report_online.pdf.

There is much to support these characterizations of the FHA, but they cherry-pick from the historical record to make their cases, focusing on disastrous policies in the early 1970s and the 2000s. By failing to address the FHA's other initiatives over its 80-plus years of operation, these commentators fail to make a convincing case that the FHA's history is a one of failed government action.

Van Order and 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." Van Order & Yezer, *supra*, at 2. Van Order and Yezer, like 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*. The historical record, however, is much more complicated, both at the FHA's origin and over the course of its long history.

Underwriting Sustainable Homeownership

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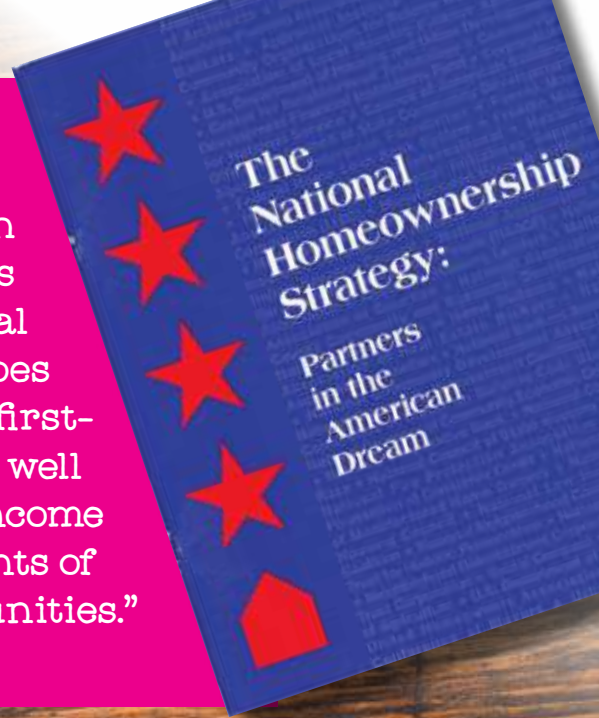
mission is to serve borrowers that the conventional mortgage market does not serve effectively: first-time homebuyers as well as "minorities, low-income families and residents of underserved communities." U.S. Fed. Hous. Admin., *Ann. Mgmt. Rep. Fiscal Year 2015*, at 4. More concretely, right after the financial crisis, it set concrete performance goals such as increasing homeownership by insuring over 1.4 million single-family mortgages.

Sadly, it did not seem that the FHA learned much from 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 commentators agree on—is for appropriate underwriting to drive the FHA. This is not to say that promoting homeownership for various groups is not a legitimate goal. It is to say that if it is not done in a way that avoids frequent defaults and foreclosures, it can do more harm than good to the FHA itself and the homeowners it claims to serve.

An essential element of appropriate underwriting is the down payment requirement, as expressed in the loan-to-value (LTV) ratio. Indeed, there is a strong correlation between low LTV and low default rates over the FHA's 80-plus year history. From an underwriting perspective, a 20%

down payment is great. It keeps defaults very low. But it is very tough for low- and moderate-income families to save enough money in a reasonable amount of time to put together a 20% down payment. The median household income in 2014 was a bit more than \$50,000. The median existing home sales price in 2014 was around \$200,000. It would take quite some time for that median household (let alone a low-income household) to save the \$40,000 necessary to have a 20% down payment on that median house. Moreover, high down payment requirements would have a disproportionate effect on communities of color, which tend to have lower income and less wealth than white households. There have been periodic pushes to decrease down payment requirements to increase homeownership rates, but those pushes have not included an evaluation of the sustainability of that increase.

To rationalize the FHA's mission, we must ensure that its underwriting practices make sense. There are three generally agreed on goals for FHA underwriting: (1) FHA insurance should not require support from the public fisc; (2) the FHA should use lower-risk eligible borrowers to cross-subsidize higher-risk eligible borrowers; and (3) the class of





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eligible borrowers should be limited to those with a reasonable likelihood of not defaulting on their loans. 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," wealth redistribution, and consumer protection regulation.

The first goal, that FHA insurance should not require support from the public fisc, has been part of the FHA's mission since its creation. The capital has not received FHA's recent financial difficulties with sympathy. It is hard, in this environment, to imagine a politically feasible alternative to a self-supporting FHA.

The second goal, that the FHA should use lower-risk eligible borrowers to cross-subsidize higher-risk eligible borrowers, has also been integral to the FHA since its founding. Indeed, the FHA's main program, the Mutual Mortgage Insurance Fund, was designed to be a form of mutual insurance in which policyholders spread the risk of default among themselves. This second goal also has been a relatively noncontroversial one.

Surprisingly, the third goal—ensuring that borrowers do not default in high numbers—has been given just lip service at various times in the FHA's history. The policy of the FHA was sure to err on the side of

low defaults from the 1930s through the 1950s. Starting in the 1960s, however, this approach was loosened up and at times it was implicitly rejected or ignored. This was seen with the Section 235 fiasco of the 1970s, as well as the American Dream Down-payment Act debacle in the 2000s. It appears that households and communities of color are most harmed by such thoughtlessly loose underwriting criteria because they are disproportionately represented among homeowners affected by the defaults and foreclosures from those failed programs.

History teaches us that the goal of sustainable homeownership should not be ignored. It should be hewed to closely to ensure the FHA's viability. It also should be hewed to closely 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.

The FHA must work to identify a down-payment requirement that balances access (therefore, no 20% down payments) with sustainability (thus, no 0% down payments). Academic research is beginning to tease out how low the FHA's down payment requirement can responsibly go: it seems that programs can work in the 3%–5% range. But we should have

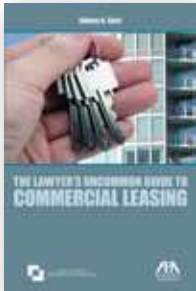
learned enough from history to know we cannot will sustainable homeownership into existence—underwriting matters and people must have the capacity to maintain their mortgages as they deal with the slings and arrows of fate, including unemployment, divorce, and poor health. If the FHA does not take these into account, too many homeowners will suffer from the stresses of default, foreclosure, and eviction.

Conclusion

The FHA has been a versatile tool of government since its creation during the Great Depression. It was created in large part to inject liquidity into a moribund mortgage market. It has since been repositioned to achieve a variety of additional social goals, some of which have not been realized. The FHA's failed programs, coupled with the recent financial woes of the FHA that resulted in a government bailout, have fueled criticism of the institution. The FHA has been more successful, however, in achieving its broader goals than is generally recognized. Nonetheless, its mission still needs clarification and its operations likewise need rationalization, if it is to assist the low- and moderate-income borrowers it claims to serve, not just to get a mortgage but also to sustain it over the long term. ■

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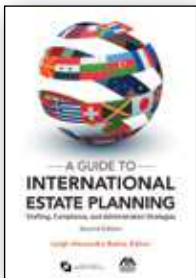


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