2017

The Federal Housing Administration and African-American Homeownership

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

Recommended Citation
26 J. Affordable Hous. & Cmty. Dev. L. 123 (2017-2018)

The Federal Housing Administration and African-American Homeownership

David Reiss

The United States Federal Housing Administration (FHA) has been a versatile tool of government since it was created during the Great Depression. It achieved success with some of its goals and had a terrible record with others. Its impact on African-American households falls, in many ways, into the latter category. The FHA began redlining African-American communities at its very beginning. Its later days have been marred by high default and foreclosure rates in those same communities.

At the same time, the FHA's overall impact on the housing market has been immense. Over its lifetime, it has insured more than 40 million mortgages, helping to make home ownership available to a broad swath of American households. And indeed, the FHA mortgage was central to America's transformation from a nation of renters to homeowners. The early FHA really created the modern American housing finance system, as well as the look and feel of post-World War II suburban communities.

Recently, the FHA has come under attack for the poor execution of some of its policies to expand homeownership, particularly minority 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. 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 to expand homeownership opportunities in the future, particularly for African-American households.

Part I of this Article provides a basic introduction to the FHA and mortgage insurance more generally. Part II provides a more textured history of the FHA, with a particular emphasis on its impact on African-American communities. Part III describes the divide between two camps of academics,

---

David Reiss (david.reiss@brooklaw.edu) is Professor of Law and Academic Program Director, Center for Urban Business Entrepreneurship (CUBE) at Brooklyn Law School. *This article is based in part on David Reiss,* Underwriting Sustainable Homeownership: The Federal Housing Administration and the Low Down Payment Loan, *50 GA. L. REV. 1019 (2016). Thanks to Subrina Chowdhury, Luci Smith, and Dominika Wilk for excellent research assistance.*

whom I divvy up into "Policy Scholars" and "Historians." More particularly, this Article is the first to synthesize the economics literature regarding the role that down payments play in the appropriate underwriting of mortgages, on the one hand, and the scholarly literature regarding the history of race and housing policy, on the other, in order to give a more detailed picture of the federal government's role in housing finance for African-American households. The article concludes that the FHA can responsibly promote homeownership in low- and moderate-income communities, notwithstanding past failures in African-American communities. 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 borrowers can afford their mortgages over the long term.

I. The Functions of 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 and foreclosure by the homeowner. The FHA provides insurance guaranteed by the federal government for mortgage loans for single-family homes and multifamily buildings. Like much of the federal housing infrastructure, the FHA has its roots in the Great Depression. It was meant to replace the private mortgage insurance (PMI) industry, which was obliterated in the early 1930s. The PMI industry did not begin to revive until the 1950s.

The FHA's first full year of operation was 1935. The FHA's primary goals for insuring residential mortgages were to make "a sounder investment for the lender" and to extend "the practicable range of borrowers and of home-mortgage loans."[1] The FHA had many other missions during the Great Depression as well, ranging from providing liquidity to the mortgage market, to supporting industries relating to housing, to consumer protection.

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. Beginning in the 1950s, the FHA's role changed from serving the entire mortgage market to focusing on certain segments of it. This changed mission had a major impact on everything the FHA did, including how it underwrote mortgage insurance and for whom it did so. The FHA's patchwork legacy matches its motley history. The next section demonstrates just how mottled the FHA's mandate has been.

1. FED. HOUS. ADMIN., SECOND ANNUAL REPORT OF THE FEDERAL HOUSING ADMINISTRATION 3 (1936) [hereinafter SECOND ANNUAL REPORT].

II. The FHA's Changing Missions

Congress added and discontinued many missions to the FHA since it was created in the Great Depression. Depending on the political winds, it targeted different types of buyers and different types of residences. Some programs were very successful, and some were abject failures. These initiatives, and other important FHA developments from its eighty-plus year history, are reviewed below.

A. 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 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."[2] The next year, the FHA Administrator found that the freeze had lifted and replaced with the "free flow of mortgage money from centers of supply into communities where funds are normally scarce."[3]

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 replaced the private mortgage insurance companies that had failed in the early 1930s, but it went far beyond their role in many, many ways.

As told by Kenneth Jackson in his classic book *Crabgrass Frontier*, the FHA also had a major negative impact on central cities and minority communities from its very beginning.[4] Its impact on the former was unintentional. Because the FHA made financing available for so much new housing, massive numbers of white working-class families fled the cities to the newly built suburbs.

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. One of the main such practices was the imposition of restrictive covenants that excluded African-Americans and other minorities from white communities. The FHA also drew red lines on its underwriting maps to cordon off blocks in which even a single non-white family lived. Such "redlined" blocks were not eligible for FHA-insured mortgages. The end result of such redlining was massive disinvestment in cities with large black populations. Older cities of the Northeast, like Camden, New Jersey, were

2. *Id.* at vii.
3. *Id.* at vi.
4. Kenneth T. Jackson, Crabgrass Frontier: The Suburbanization of the United States 203–18 (1985).

particularly hard hit.[5] 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.[6]

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."[7] 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. 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, although its corrosive effects on cities and African-American communities were just getting started.

B. 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.[8] 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."[9] FHA market share increased to 45% by 1944. As World War II ended, the FHA turned its attention from war mobilization to the needs of returning veterans and their families.

The VA mortgage-guarantee program was created in 1944 as part of the "GI Bill." The VA did not require down payments "on the theory that soldiers weren't paid enough to accumulate savings."[10] The VA market share peaked in 1947 at almost 28%,[11] and this peak was matched by a decline in the FHA market share.[12]

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

---

5. *Id.* at 213.

6. *Id.* at 214–15.

7. 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).

8. FED. HOUS. ADMIN., EIGHTH ANNUAL REPORT OF THE FEDERAL HOUSING ADMINISTRATION 3 (1942), http://babel.hathitrust.org/cgi/pt?id=mdp.39015005860161.

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

10. Michael S. Carliner, *Development of Federal Homeownership "Policy,"* 9 HOUS. POL'Y DEBATE 299, 308 (1998).

11. Dwight M. Jaffee & John M. Quigley, *Housing Policy, Mortgage Policy, and the Federal Housing Administration*, MEASURING AND MANAGING FEDERAL FINANCIAL RISK 106 (Deborah Lucas ed., 2010).

12. Immergluck, *supra* note 7, at 1, 6.

FHA mortgage to thirty years.[13] 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.[14]

Prior to 1948, legally enforceable 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.[15] The Supreme Court rejected this form of discrimination in the landmark case of *Shelley v. Kraemer* in 1948.[16] 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.[17] 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. This support was true even though the Truman administration revised the FHA's Underwriting Manual in 1949 to include equal opportunity standards because very little actually changed in practice.[18]

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%.[19] Its underwriting remained conservative: 0.04% of mortgages in 1950 were in process of foreclosure in the FHA's primary one-to-four family program (the Section 203 program).[20]

13. Richard K. Green & Susan M. Wachter, *The American Mortgage in Historical and International Context*, 19 J. ECON. PERSP. 93, 96 (2005).

14. FED. HOUS. ADMIN., FOURTEENTH ANNUAL REPORT OF THE FEDERAL HOUSING ADMINISTRATION 11 (1947), http://babel.hathitrust.org/cgi/pt?seq=349;id=mdp.39015082064 752;page=root;view=1up;size=100;orient=0;17;num=117.

15. *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.").

16. 334 U.S. 1 (1948).

17. FED. HOUS. ADMIN., SIXTEENTH ANNUAL REPORT OF THE FEDERAL HOUSING ADMINISTRATION 3 (1949), http://babel.hathitrust.org/cgi/pt?seq=647;id=mdp.390150820647.52;page=root;view=1up;size=100;orient=0;num=11 (stating that the ban applied to covenants recorded after February 15, 1950).

18. FED. HOUS. ADMIN., UNDERWRITING MANUAL para. 242 (1955).

19. Immergluck, *supra* note 7, at 6.

20. 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.

C. The 1950s: The Maturation of the American Mortgage

Like an episode of *Mad Men*, 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. Black households, however, continued to suffer from a variety of discriminatory policies, including redlining by the FHA.

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 payments than previously authorized, as little as 5%.[21] In 1957, the minimum down payment was lowered to 3% in some cases.[22]

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. 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. This loosening was reflected in part by the amendment to the Housing Act of 1954, which replaced "economic soundness" as the guideline for the FHA's main insurance fund to "acceptable risk."[23] This amendment was a harbinger of even looser underwriting standards to come. These looser standards would have an outsized impact on the housing stock in older cities.

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

21. Housing Act of 1950, Pub. L. No. 81-475, § 104(a), 64 Stat. 48, 51–52 (amended 1950).

22. 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).

23. *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 suburban and outlying areas or small communities," the Commissioner may insure mortgages that otherwise comply with the FHA requirements).

for the Section 203 program by 1960 were 0.23% of mortgages in force, roughly triple the previous decade.[24] Change was afoot.

D. *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. However, as of 1967, only 3% of all new homes were sold to African-Americans.[25] But as with the rest of society, the ferment over segregation, civil rights, and economic inequality were the major historical themes of the 1960s for the FHA too. Each of these themes was clearly reflected in the FHA's operations and its role in the housing markets, for both good and ill.

Beginning in the 1950s and continuing into the 1960s, Congress added a number of innovative insurance programs to the FHA's stable. They included insurance programs for urban renewal, new forms of homeownership like condominiums and cooperatives, and housing for seniors and the disabled.[26] In 1962, President Kennedy reversed the FHA's redlining policy that had been in effect since its inception,[27] and the FHA began to embark on a change of focus to supporting low- and moderate-income homeownership as well as minority homeownership. In 1965, the FHA became a part of the Department of Housing and Urban Development (HUD) Office of Housing.

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

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. 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 about 800,000 units have been constructed, with recent production averaging about 50,000 units a year. By comparison, over a period

24. 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.

25. Wendell E. Pritchett, Robert Clifton Weaver and the American City: The Life and Times of an Urban Reformer 312 (2008).

26. Anthony Pennington-Cross & Anthony M. Yezer, *The Federal Housing Administration in the New Millennium*, 11 J. Hous. Res. 357, 359 (2000).

27. Carliner, *supra* note 10, at 299, 307.

only 3 years longer, FHA insurance guarantees have made possible the construction of over 10 million middle and upper income units.[28]

In response to this historical inequity, Congress determined that many of the FHA's new programs would have a very different underwriting model than the traditional one. These newer programs typically targeted "underserved borrowers," such as households of color.[29] They were also subsidized by the federal government. The FHA's core single-family Section 203(b) program, in contrast, had lower-risk homeowners cross-subsidize higher-risk homeowners.

One such initiative that Congress enacted in 1968, the Section 235 homeownership program, was seen at the time as giving the FHA "an opportunity to overcome its image as an anti-poor, anti-minority Government agency."[30] 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."[31] This move away from conservative underwriting led to rapidly increasing foreclosure rates and ultimately wreaked much havoc in the early 1970s. This havoc is embodied in the poorly executed Section 235 program, described in greater detail below.

Defaults and foreclosures rose again during the 1960s. Total defaults for Section 203 in 1970 were 1.69% of mortgages in force.[32] Foreclosures in process for Section 203 in 1970 were 0.52% of mortgages in force, more than doubling the rate of the previous decade.[33] These were significant increases from the 1950s.

E. The 1970s: Spectacular Failure

By the early 1970s, the dreams of the 60s were replaced with the hangovers induced by the Vietnam 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."[34] 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 increase.[35] The FHA's mortgage

---

28. Report of the National Advisory Commission on Civil Disorders 13 (1968).

29. President's Comm'n on Hous., The Report of the President's Commission on Housing 163–64 (1982), http://huduser.org/portal//Publications/pdf/HUD-2460.pdf.

30. 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).

31. *Id.* at 7.

32. 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.

33. Dep't of Hous. & Urban Dev., *supra* note 24, at 95 tbl.19.

34. Comm'n on Civil Rights, *supra* note 30, at 77.

35. Lawrence L. Thompson, A History of HUD 3 (2006).

origination share (by dollar volume) reached a new high in 1970, at about a quarter of the market. This share accounted for nearly 30% of all single-family loans.[36] 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. In its first four years, the Section 235 program helped to finance homes for about 400,000 low- and moderate-income families.[37] Section 235 homebuyers had to make only tiny down payments.

In 1973, the Section 235 program was suspended because so many of its mortgages were going into default and foreclosure. The program was terminated a few years later.[38] 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.[39] Once the structural problems surfaced, many of these households could not afford to repair them, and the homes went into default. Entire blocks in some cities were lined with boarded-up homes that had been financed pursuant to Section 235.[40]

Section 235 represented a low point for the FHA with more than 200 people convicted for abuses arising from the program.[41] The federal government lost over $2 billion on mortgages that ended up in foreclosure during this period.[42] The Section 235 fiasco "was one of the major reasons for the moratorium on subsidized housing programs declared in 1973."[43]

If the broader dreams of equality of the 1960s were dashed in the 1970s, so were the dreams of an effective FHA. At the same time the Section 235 fiasco was unfolding, the FHA was rocked by a series of scandals.[44]

---

36. Immergluck, *supra* note 7, at 6.

37. Carliner, *supra* note 10, at 313.

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

39. 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/files/fha-assessment-report-06-2011.pdf.

40. THOMPSON, *supra* note 35, at 3.

41. RYAN, *supra* note 38. *See also* KEVIN FOX, GOTHAM, RACE, REAL ESTATE, AND UNEVEN DEVELOPMENT: THE KANSAS CITY EXPERIENCE, 1990-2000 145 (2002) (noting that private real estate brokers, home builders, mortgage lenders, and FHA appraisers were convicted for abusing the FHA program).

42. RYAN, *supra* note 38, at 93.

43. VAN ORDER & YEZER, *supra* note 39.

44. *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.*

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 return of the PMI industry.

During the early 1970s, the mortgage insurance sector was subject to big swings in market share between the FHA and private mortgage insurers. Fannie Mae and Freddie Mac set the stage for a revival of the PMI industry in the early 1970s as they sought to purchase high-LTV (loan-to-value) mortgages. Because their charters required that the high-LTV mortgages have mortgage insurance, private mortgage insurers had a steady stream of business.

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.[45] Foreclosures in process by 1978 for the Section 203 program were 0.30% of mortgages in force, a meaningful decline from the rate at the end of the previous decade.[46]

F. The 1980s: PMI Is Back!

Even before Gordon Gekko pronounced that greed is good,[47] 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 market (by dollar amount) for new mortgages, and the PMI industry had about the same market share.[48] 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.[49] This transition was not untroubled, as FHA loans continued to be at the root of big problems in urban communities.

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

---

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).

45. 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.

46. *Id.*

47. Stanley Weiser & Oliver Stone, *Wall Street* (1987).

48. PRESIDENT'S COMM'N ON HOUS., *supra* note 29, at 163.

49. *See* Jaffee & Quigley, *supra* note 11, at 108 (describing the shift towards lower-income borrowers).

continued to plague 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. The Commission believed that the FHA should cede much of its market to the PMI industry, which had recovered by then. By 1980, the PMI industry had grown to fourteen firms, which had insured 31% of the entire mortgage market.[50] The industry was arguing that FHA had become unnecessary. Indeed, the Reagan Administration even batted around a proposal to privatize it.[51] At the same time, the FHA's market share began falling to very low levels, as low as 5% by the mid-1980s.[52]

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.[53] Some PMI companies merged with better-capitalized ones. One of the fourteen was not even able to fully repay its policyholders.[54] 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%.[55] Much like the Terminator, played by Arnold Schwarzenegger in the Reagan-era movie, the private mortgage insurance industry was already prepared to say, "I'll be back!"[56]

During the late 1980s, the FHA's delinquency and foreclosure rates were about twice those for conventional loans. Reflecting its changing 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.[57]

50. Bruce E. Foote & Pamela Hairston, Cong. Research Serv., 98-421, Raising the FHA Mortgage Limit: Issues and Options 7 (1998), http://www.cq.com/graphics/crsreports/98-421_1998-11-03.pdf.

51. 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.

52. Immergluck, *supra* note 7, at 6.

53. 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.

54. Promontory Fin. Grp., LLC., The Role of Private Mortgage Insurance in the U.S. Housing Finance System 4, http://usmi.org/wp-content/uploads/2014/03/622-Genworth-Study-I-Role-of-PMI.pdf.

55. Berg, *supra* note 53.

56. James Cameron, et al., *The Terminator* (1984).

57. Dep't of Hous. & Urban Dev., FHA Annual Management Report Fiscal Year 1992, at 39 (1992).

G. The 1990s: The FHA Goes Down with a Whimper

As the Soviet Union collapsed in the face of triumphant capitalism, the 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. The Cranston-Gonzalez National Affordable Housing Act of 1990[58] mandated more conservative underwriting standards for mortgages and the FHA's insurance funds. 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.

By the late 1990s, the nine remaining private mortgage insurers 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. And it looked as though 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.[59]

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.[60] In 2000, the principal amount of FHA mortgages was about three-fourths the size of that of PMI mortgages. These differences reflected the market segmentation of the two, with the FHA having a bigger share of low- and moderate-income households.

Starting in the late 1990s, subprime mortgage lenders offered terms that appeared better than those offered by FHA lenders. As a result, many households left the FHA market and entered into the subprime market. Subprime mortgages turned out to be much worse for homeowners than they seemed at the time. For instance, borrowers were given low interest rates that lasted for short periods of a couple of years or even a few months before shooting up so much that payments became unaffordable. This would have a big negative impact on homeowners, particularly those in African-American communities, in the 2000s.

H. The 2000s: The FHA Goes Boom!

Good times in the booming financial markets of the early 2000s meant lean times for the FHA. While the mortgage market was heating up overall, the FHA's share of mortgage originations by dollar volume fell from its

58. Pub. L. No. 101-625, § 332, 104 Stat. 4079 (1990).

59. GEN. ACCOUNTING OFFICE, GAO/RCED-96-123, HOMEOWNERSHIP: FHA'S ROLE IN HELPING PEOPLE OBTAIN HOME MORTGAGES 4 (1996), http://www.goa.gov/archive/1996/rc96123.pdf.

60. MARSHALL W. DENNIS & THOMAS J. PINKOWISH, RESIDENTIAL MORTGAGE LENDING: PRINCIPLES AND PRACTICES 156, tbl. 8-1 (5th ed. 2004).

1970 peak of roughly 25% to its 2006 trough of less than 2%.[61] 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 that was dramatically loosening its underwriting standards and offering extremely attractive teaser rates as well.[62] 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. During this same period, the FHA decided to originate loans with down payments funded by sellers that were channeled through various not-for-profit organizations.[63] 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.

The national homeownership rate peaked in the mid-2000s at about 69%.[64] The FHA was part of that dramatic expansion. For instance, about 80% of FHA-insured purchases were first-time homebuyers in 2001.[65] But

61. Jaffee & Quigley, *supra* note 11, at 106.

62. *See* David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 997 (2006) ("Communities of color have been disproportionately represented in the subprime market in contrast to their representation in the prime market. African-Americans and Hispanics combined made up less than 8% of the prime home purchase mortgage market in 1998, but such borrowers made up nearly 20% of subprime home purchase mortgage market in that same year. Similarly, African-American and Hispanic borrowers together make up about 6% of all prime conventional refinance mortgages and 17% of subprime refinance mortgages. And more than half of all loans in predominantly African-American communities are subprime, compared to only 9% of loans in predominantly white communities.").

63. 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 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).

64. THOMPSON, *supra* note 35, at 14 fig.1.6.

65. DEP'T OF HOUS. & URBAN DEV., FHA ANNUAL MANAGEMENT REPORT FISCAL YEAR 2001, at 7 (2001).

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 stuck about twenty percentage points behind the national rate in 2006, as was the rate for Hispanic households.

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.[66] PMI had 62% of the mortgage insurance market by the mid-2000s.[67] At the same time, 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. Some mortgage insurers were going so far as to underwrite loans with LTVs of 100% and even 103%, in order to cover closing costs too.[68]

In response to changes in the industry, and to further expand homeownership, Congress enacted the American Dream Downpayment Act of 2003.[69] This new program gave first-time homeowners up to $10,000 as a down payment. 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.[70] 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."[71]

HUD continued to scramble to respond to the changes in the market, proposing to Congress a variety of long-due reforms in 2006. 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. . . ."[72] In particular, this modernized FHA was intended to

66. 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://www.gao.gov/new.items/d07708.pdf.

67. Dennis & Pinkowish, *supra note* 60, at 178.

68. *Id.*

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

70. Van Order & Yezer, *supra* note 39, at 8.

71. 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.

72. Ginnie Mae, Report to Congress Fiscal Year 2007, at 11, http://www.ginniemae.gov/about/ann_rep/ReportToCongress07.pdf.

"provide a safe, fair, and affordable FHA alternative to the subprime market."[73] Not incidentally, the legislation also allowed the FHA to reduce the minimum 3% down payment requirement. 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.

By 2008, the FHA and the VA had a market share of all mortgage originations of more than 20%. Congress significantly raised the loan limits that the FHA could insure to provide liquidity to a wider swath of the mortgage market. The FHA's market share continued to explode as capital from other sources in the residential mortgage market dried up. By 2010, it was 30% overall and nearly 40% for home purchases. The FHA's role in home purchases for minorities during this period was even greater: 60% of all African-American and Latino purchasers had FHA-insured mortgages. 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. 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.[74] The FHA had filled the gap left by the implosion of the subprime industry.

This dramatic increase in market share was soon followed by an equally dramatic increase in defaults and foreclosures on FHA mortgages. This poor performance resulted from ill-conceived programs, such as the American Dream Downpayment initiative, as well as from the general meltdown of the housing markets in the late 2000s. As a result, it was expected that the FHA's massive fund that ensured Section 203 mortgages was "unlikely to meet its statutory capital requirements by the end of" the 2009 fiscal year.[75] It soon appeared that the fund was in great distress, with "[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."[76] The FHA ultimately

73. *Id.*

74. JOINT CTR. FOR HOUS. STUDIES, HARV. UNIV., THE STATE OF THE NATION'S HOUSING 2013, at 10 (2013).

75. Michael Goldberg & Ann Schnare, *An Update on the Capital Adequacy of the FHA Single Family Insurance Program* 1 (2009), http://ssrn.com/abstract=1510387.

76. 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 23 (2010), http://www.hud.gov/offices/hsg/rmra/oe/rpts/actr/2010actr_subltr.pdf.

recovered because of an improving housing market, higher premiums, and better underwriting, but the FHA was now at a new low.

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. As the housing markets recovered, so did the PMI industry, 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.[77] It also increased the minimum down payment to 3.5%.[78] And it began tightening its underwriting. Finally, Congress authorized the FHA in 2010 to raise its premiums, which also helped to stabilize its financial health.

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%.[79] 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."[80] And in 2011, 59.2% of its insured borrowers were classified as low/moderate income, again reflecting the mission of the modern FHA.

I. 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. Because of its poor financial position, the FHA also raised its premiums. The financial condition of the FHA's fund that insured Section 203 program mortgages had been poor since 2009, when it failed to meet its required 2% minimum capital ratio.

PMI began to make a comeback in 2010 when it insured 4.3% of all new mortgages. By 2013, its market share grew to 11.3%. The FHA continued

77. 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).

78. *Id.*

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

80. DEP'T OF HOUS. & URBAN DEV., FHA ANNUAL MANAGEMENT REPORT FISCAL YEAR 2011, at 8 (2011), http://portal.hud.gov/hudportal/documents/huddoc?id=fhafy1 1annualmg mntrpt.pdf.

to focus on first-time homebuyers. In 2012, about 78% of its loans went to that population and about 32% went to households of color.

* * *

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. Thus, critics' calls for a return to the FHA's "original" mission misread its history. 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 troubled history of discrimination as well as misguided attempts to remedy past discrimination. Finally, 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, though, that the PMI industry is not capable of assuming all of the roles played by the FHA. The next section addresses the scholarly debate over the future of the FHA and demonstrates that, in large part, the debate is over the FHA's mixed legacy in African-American communities and what we can learn from that legacy.

III. The Scholarly Debate Regarding the FHA's Legacy

The FHA is an understudied topic despite having a massive impact on the built environment of the United States. This lack of scholarship is particularly unfortunate because the FHA 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 contemporary commentators on the FHA have panned its initiatives to encourage homeownership. The absence of a vibrant scholarly exchange regarding the FHA stands in the way of responsibly charting its future course.

The scholarly literature that does exist can be roughly divided into two camps. I will refer to the first camp as the "Policy Scholars." The Policy Scholars, with backgrounds in economics, finance, and accounting, are mostly concerned with the future direction of the FHA. I will refer to the second camp as the "Historians." The Historians have backgrounds in history and sociology. They are generally concerned with the FHA's track record.

Both groups find a lot to criticize about the FHA. After reviewing their findings, I will take a middle way that accounts for both critiques but charts a way forward for the FHA that can produce good policy results.

A. The Policy Scholars

Mostly writing after the Great Recession, the Policy Scholars have highlighted the harms that the FHA has suffered as a result of loose underwriting standards. Indeed, these harms had to be measured in the billions of dollars as the FHA absorbed the biggest losses in its history. Following these losses, the Policy Scholars would impose some stark changes on the FHA, changes that would reduce the risk of big losses but also reduce the FHA's ability to expand the rate of homeownership going forward.

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."[81] However, they further note that this approach is nonetheless unavoidable because "there are powerful political forces willing to push FHA to allow very unsound lending practices."[82] Given that Yezer is the co-author of one of the handful of comprehensive studies of the FHA, this is a damning assessment indeed.[83] Housing economist Joseph Gyourko is more succinct, but equally pessimistic: the FHA "has failed by any reasonable metric."[84]

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*,[85] writes that "[g]overnment 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."[86]

Much data exists to support these characterizations of the FHA, but the Policy Scholars 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, they fail to make a convincing case that the FHA's history is a tale of failed government action.

The Policy Scholars all advocate a return to the more conservative underwriting that characterized the FHA's early years. They do not

81. Van Order & Yezer, *supra* note 39, at 9.

82. *Id.*

83. Pennington-Cross & Yezer, *supra* note 26, at 357358.

84. Joseph Gyourko, Am. Enter. Inst., Rethinking the FHA iii (2013).

85. Edward J. Pinto, FHA Watch, https://www.aei.org/tag/fha-watch/.

86. 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/.

explicitly address how this conservative underwriting will impact minority homeownership. It seems, however, that they believe that the negative impacts of excessively loose underwriting outweigh the gains that would be made in the homeownership rates for African-American and Hispanic households.

B. The Historians

The Historians have focused on the FHA's track record in African-American communities while it implemented systemically racist policies. They identify how the FHA's history of discrimination and neglect are part and parcel of that track record. Implicit in this critique is that the FHA could do better once those flaws are remedied.

The Historians' main focus on the FHA is from the 1940s through the 1960s when the gap between its service to white and black communities was most egregious. The Historians convincingly argue that these past discriminatory policies and practices continue to affect African-American communities today.[87] At the same time, the Historians also see the big positive effect that the FHA had for white households and they argue that the FHA can do the same for black households.

The Historians include the authors of three classics: *Crabgrass Frontier* by historian Kenneth Jackson,[88] *American Apartheid: Segregation and the Making of the Underclass* by sociologists Douglas Massey and Nancy Denton,[89] and *Black Wealth/White Wealth: A New Perspective on Racial Inequality* by sociologists Melvin Oliver and Thomas Shapiro.[90]

After reviewing the history of FHA policies in the mid-20th century, Jackson concluded that the "lasting damage done by the national government was that it put its seal of approval on ethnic and racial discrimination and developed policies which had the result of the practical abandonment of large sections of older, industrial cities."[91] He also concludes that the FHA's attempts to address its past practices had the opposite effect. The shift in the 1960s to increasing mortgage credit in the urban core had the main effect of making "it easier for white families to finance

87. Ta-Nehisi Coates makes the case that the federal government's mid-20th century housing policies is one of the justifications for reparations for African-Americans. *The Case for Reparations*, THE ATLANTIC (June 2014), *available at* http://www.theatlantic.com/magazine/archive/2014/06/the-case-for-reparations/361631/.

88. KENNETH JACKSON, CRABGRASS FRONTIER (2d ed. 2005).

89. DOUGLAS MASSEY & NANCY DENTON, AMERICAN APARTHEID: SEGREGATION AND THE MAKING OF THE UNDERCLASS (1993).

90. MELVIN OLIVER & THOMAS SHAPIRO, BLACK WEALTH / WHITE WEALTH: A NEW PERSPECTIVE ON RACIAL INEQUALITY (2d ed. 2006). Many others, of course, have contributed to this body of scholarship. For a recent example, see RICHARD ROTHSTEIN, THE COLOR OF LAW: A FORGOTTEN HISTORY OF HOW OUR GOVERNMENT SEGREGATED AMERICA (2017).

91. JACKSON, *supra* note 88, at 217.

their escape from areas experiencing racial change."[92] This looser credit for black applicants also meant that home improvement companies could buy properties at low cost, make cosmetic improvements, and sell the renovated home at inflated prices approved by the FHA. Many of the minority purchasers could not afford the cost of maintenance, and the FHA had to repossess thousands of homes. The final result was to increase the speed with which areas went through racial transformation and to victimize those it was designed to help.[93]

Massey and Denton also document the separate-but-equal housing finance system for whites and blacks. They conclude that for "at least fifty years, from 1940 through 1990, African-Americans were subject to a system of institutionalized housing discrimination."[94] And Oliver and Shapiro note that in addition to incentivizing de facto segregation, the FHA's actions have had a lasting impact on the wealth portfolios of black Americans. Locked out of the greatest mass-based opportunity for wealth accumulation in American history, African-Americans who desired and were able to afford home ownership found themselves consigned to central city communities where their investments were affected by the "self-fulfilling prophecies" of the FHA appraisers: cut off from sources of new investment, their homes and communities deteriorated and lost value in comparison to those homes and communities FHA appraisers deemed desirable.[95]

The Historians document just how deeply the FHA was involved in processes of white flight, de facto segregation, and wealth creation in white communities as well as the lack thereof in black communities. Their work addresses broad aspects of the FHA's operations that the Policy Scholars just touch on. But the Historians, not being policy wonks by the nature of their disciplines, fail to offer up much by way of solutions to the problems created by the FHA.

C. The Middle Way

During the Great Recession, the FHA stated that its mission was to serve borrowers that the conventional mortgage market did not serve effectively: "[f]irst-time homebuyers, minorities, low-income families and residents of underserved communities."[96] More concretely, it set performance goals of increasing homeownership opportunities and strengthening communities. For instance, to achieve these goals, the FHA set and exceeded a goal of insuring over 1.4 million single-family mortgages in fiscal year 2009, set and exceeded a goal of having 73% of its single-family

92. *Id.* at 215.
93. *Id.*
94. MASSEY & DENTON, *supra* note 89, at 212.
95. OLIVER & SHAPIRO, *supra* note 90, at 18.
96. FED. HOUS. ADMIN., ANNUAL MANAGEMENT REPORT FISCAL YEAR 2010, at 3 (2010), http:// www.hud.gov/offices/hsg/fhafy10annualmanagementreport.pdf.

mortgages go to first-time homebuyers, set and almost achieved its goal of having 33% of its single-family mortgages go to minority households, and set and achieved a goal of having 35% of its single-family mortgages be in underserved communities.[97]

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 down payment requirement, as expressed in the LTV ratio. Indeed, as seen above, there is a strong correlation between LTV and default rates over the FHA's eighty-year history. From an underwriting perspective, a 20% down payment is great. 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% down payment. The median household income in 2013 was $51,939. The median house price in 2013 for existing homes was about $198,000 at the end of 2013. It would take quite some time for that median household to save the roughly $40,000 necessary to have a 20% down payment on that median house. High down payment requirements would also have a disproportionate effect on communities of color, which tend to have lower income and less wealth than white households. As seen above, there have been periodic pushes to decrease down payment requirements in order to increase homeownership rates, but those pushes have not been accompanied by an evaluation of the sustainability of the increase based on such a strategy.

Advocates for low-income communities, lenders, and proponents of an "ownership society" have all pushed for much lower down payment 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 down payments 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-down payment initiatives that have been unmitigated failures.

Let us begin by addressing the criticisms of low down payment initiatives. The flaws with the FHA that commentators such as Van Order & Yezer and Pinto have identified are almost completely flaws of ultra-

97. Fed. Hous. Admin., Annual Management Report Fiscal Year 2009, at 18-20 (2009), http://www.hud.gov/offices/hsg/fhafy09 annualmanagementreport.pdf.

low or no-down payment initiatives. 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 down payments and default. It is clear that the FHA (and the VA) have had success with relatively small down payments at times, as have other entities such as the Self-Help Credit Union, a mission-driven financial institution.[98]

Much of the down payment literature is focused on how lowering down payment requirements increases homeownership rates. But there is also a substantial body of literature that indicates that no-down payment and low-down payment mortgages are much more likely to default than mortgages with larger down payments. One article by Austin Kelly stands out for studying mortgage default rates where the borrower has made no down payment. 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."[99] 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 investment.

The question, of course, is what is the socially optimal level for down payments? No one has answered this question in the context of the FHA, but a body of research about down payments has 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.

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 down payments 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

98. *See, e.g.*, *supra* text accompanying note 22 (noting that Congress lowered down payment to 3% in some cases in the 1950s); UNC Ctr. for Cmty. Capital, Setting the 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).

99. Austin Kelly, *"Skin in the Game": Zero Downpayment Mortgage Default*, 17 J. Hous. Res. 75, 75 (2008).

payment."[100] 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.[101]

Some evidence exists that there is a down payment sweet spot of around 5% at which default rates are within an acceptable range.[102] The Coalition for a Sensible Housing Policy, a coalition of lenders and consumer advocates, argues that:

> 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.[103]

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

Quercia et al. have looked at the trade-offs between safe underwriting and access to credit in the context of the QRM rules.[104] 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."[105] 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.

They would push the optimal down payment size even lower, arguing that "LTVs of 97 percent result in a better benefit ratio, suggesting that a small down payment requirement may have an important protective effect against default risk while still providing broad access to mortgage credit."[106] They conclude that "restricting the origination of risky loan

100. CTR. FOR RESPONSIBLE LENDING, GOVERNMENT-MANDATED DOWN PAYMENT STANDARDS WOULD HARM THE ECONOMY, DENY HOMEOWNERSHIP TO CREDIT-WORTHY FAMILIES 1 (2013), http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/CRL-Down-Payment-Mandates-Would-Harm-the-Economy-Credit-Worthy-Families-A ugust-13-2013.pdf (emphasis omitted).

101. QUERCIA ET AL., *supra* note 71, at 1.

102. *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/C oalition-QRM-White-Paper-1.pdf.

103. *Id.*

104. QUERCIA ET AL., *supra* note 71, at 20.

105. *Id.* (emphasis omitted).

106. *Id.* at 33.

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."[107]

The goal of ensuring that borrowers do not default in high numbers is less of a constant than one might suppose. The policy of the FHA was surely to err on the side of low defaults from the 1930s through the 1950s. But starting in the 1960s, this approach was relaxed, and at times it was implicitly rejected or ignored. 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. It appears that households and communities of color are most harmed by such thoughtlessly loose underwriting criteria because they were disproportionately represented among homeowners impacted by the defaults and foreclosures from those failed programs.

History teaches us that the goal of sustainable homeownership should not have been ignored. It should be pursued for the sake of the FHA's viability. It should also be pursued 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.[108]

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 should be 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).[109]

---

107. *Id.* at 4.

108. *See Andrew Caplin et al., Is the FHA Creating Sustainable Homeownership?*, 43 REAL EST. ECON. 957 (2015) (finding high delinquency rates for "the 2007-2009 vintages of FHA borrowers" with negative implications for the FHA and the borrowers alike).

109. UNC CTR. FOR CMTY. CAPITAL, *supra* note 95, at 1-4 (Policy Brief, undated), http://ccc.sites.unc.edu/ files/2013/02/Setting-Record-StraightHO.pdf (studying

The UNC researchers found that ownership provides a greater financial cushion than renting for low-income families. Most important for our 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."[110] They concluded that "having received assistance toward one's down payment and closing costs has no significant effect whatsoever on CAP homeowners' mortgage performance."[111] The authors of the study noted some "important caveats" in their findings that severely limit their generalizability.[112]

I am cautious of assuming that the FHA's results with low down payments 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 down payments can go while still maintaining an acceptable level of mortgage defaults.

Combining the UNC study with the benefit ratio of Quercia et al. (also affiliated with UNC) discussed above, we can reasonably identify a range of 3% to 5% down payments 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.

This all seems straightforward enough, but there has been a long history of politicizing mortgage underwriting in federal programs. Congress has shown itself to put politics ahead of responsible underwriting to disastrous effect. The commentators who have lost faith in the FHA's ability to stay the course of responsible underwriting thus have good reasons. But given the long history of the FHA, it seems they are, perhaps, too pessimistic. Indeed, their aversion to policy experimentation by the FHA is consistent with a broader aversion to government social policy

---

Self Help Credit Union Community Advantage Program portfolio of 46,000 home-purchase mortgages over a ten-year period).

110. *Id.* at 3.

111. *Id.* at 4.

112. *Id.* ("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 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.").

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, though, there is nothing about the FHA that is particularly flawed as an instrument of government action.

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. Congress could commit itself to a strong underwriting standard by returning to the "economic soundness" standard of the pre-1950s FHA.

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. There is, of course, always the risk that Congress would reverse itself, but—hey—that's democracy.

And if Congress finds that there are categories of households that 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 such as 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. 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% to 5% down payment requirement. Such a requirement, in contrast to the dynamic rule, would be harder for homeowners, lenders, and politicians seeking to be "pro-homeowner" to manipulate. 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.

IV. 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 stumble when the goals to which it is put are muddled. There is no doubt that today's FHA suffered 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.

The Policy Scholars have rightly brought attention to the risks of FHA programs that fail to underwrite its products appropriately. They are right

that the FHA needed to be bailed out because of this failed underwriting practice. They 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.

The Policy Scholars do not, however, fully appreciate the extent to which modest down payment 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 down payment size. Much of the FHA's performance is driven by its down payment requirements, which have trended ever downward so that homeowners were able at times to get loans for 100% of the value of the house in recent years. But as is obvious to all, the larger the down payment, the safer the loan, if everything else is equal.

What has been less obvious to policy makers is that tiny or nonexistent down payments are unacceptably risky. Given that the FHA insures 100% of the losses on its mortgages, the down payment requirement is a key driver of its performance. Empirical researchers should continue to study how low down payment requirements can go while still maintaining an acceptable benefit ratio for FHA mortgages. At this point, a down payment 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 down payments 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. This is true for all FHA borrowers, but particularly true for African-American households that have been disproportionately hurt by FHA underwriting practices over its eighty-year history.

The FHA can be used to make homeownership more accessible generally and for African-American homeowners in particular.