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The FHA Single-Family Insurance Program: Performing a Needed Role in the Housing Finance Market

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Executive Summary

Introduction

In laying out the Federal Housing Administration's (FHA's) mission in the single-family mortgage market and in presenting its historical role in meeting immediate and emerging challenges over its history, this paper serves as a useful foundation for considering FHA's future role in housing finance as both institutional and regulatory reforms are debated. The paper focuses on the historical and ongoing role of FHA mortgage insurance in sustaining access to mortgage credit, stabilizing housing markets, and expanding sustainable homeownership opportunities. In so doing, it provides useful facts, descriptions of policies undertaken, and information that can inform debates about FHA's appropriate role going forward. In performing its historical role, FHA has insured more than 41 million mortgages since its inception in 1934.

The paper is organized into four sections and an appendix. The first section provides a historical overview of FHA's role in stabilizing housing markets, setting market standards, providing information, and addressing market failures such as credit rationing. The second section shows how this role provides improved opportunities for low-wealth (often newly formed) households to access affordable, sustainable homeownership. The third section describes some significant challenges that FHA has faced over the years and the steps it has taken to meet these challenges. Throughout the current crisis, FHA has borrowed from lessons it learned in the past. The fourth section examines FHA's response to the current housing crisis: FHA has stabilized declining markets by maintaining access to federally guaranteed mortgage credit in the face of a severe curtailment of private capital in the market, and it has assisted distressed homeowners to keep their homes. Finally, the appendix reviews key questions and policies that will inform the future role of FHA, including questions related to the costs and benefits of FHA's countercyclical role, pending regulatory and institutional reforms that could affect underwriting standards in the conventional mortgage market.

Historical Overview of FHA's Role

Before the government's involvement in the 1930s, the recorded homeownership rate was never higher than 48 percent. Financial markets were highly volatile with financial panics every 10 to 20 years and frequent depressions. Mortgage loans were difficult to obtain. Substantial downpayments for first-lien mortgages were in the neighborhood of 50 percent, and second- and third-lien financing at high interest rates were commonplace. In 1934, with new mortgage credit frozen, residential construction stalled, and a serious nationwide decline in construction employment, Congress authorized FHA mortgage insurance with the aim of getting the building trades and private credit back to work.

Initially, FHA was intended to revitalize the housing industry and make home financing attainable for a much larger share of American families in the face of national recession. It has since extended this role to help soften the effects of local or regional downturns and increase homeownership opportunities for lower wealth, minority, and first-time buyers. Studies show that profit-maximizing conventional lenders do not raise prices just when lending becomes riskier in areas experiencing economic downturns; instead, they tighten underwriting to ration the number of mortgages made in such an area. FHA, on the other hand, maintains its presence in all markets, providing stability and liquidity in markets experiencing recession. By addressing the tendency of the private marketplace to ration credit, FHA has always brought a great deal more stability to mortgage markets and extended the opportunity for homeownership to a much broader segment of the population.

It should be noted that mortgage loan limits rather than borrower income limits have been the principal method of targeting FHA's insurance activities over its history. This has the effect of focusing FHA insurance activity on specific segments of the housing market, and it helps maintain stability in credit flow to these market segments. Temporary expansion of FHA's loan limits in the current housing crisis has extended FHA access to a broader segment of the housing market, thereby leveraging FHA's ability to provide stability to the distressed housing market.

In its early days, FHA also took on the task of developing and building the national infrastructure to operate an economically sound insurance program across the United States. FHA redefined mortgage underwriting standards to allow a much broader segment the population to qualify for mortgage finance, and it created new uniform construction and appraisal standards in the building and finance industries so that the FHA mortgage contract was readily tradable across the country. Another important role of FHA was to make information available to the market on the performance of relatively high loan-to-value ratio (LTV) mortgage lending (compared with the low LTV loans before the Great Depression). By the mid-1950s FHA had demonstrated the feasibility of such lending, given the sound underwriting and appraisal standards it pioneered. The upshot of this was a rebirth in the 1950s of the private mortgage insurance (PMI) industry, which originally operated for a time before the Great Depression wiped it out. By 1970, the system of thrifts, commercial banks, FHA-insured lending, PMI-insured conventional lending, and access to private capital via secondary market support from Ginnie Mae (a government agency) and Fannie Mae (a government-sponsored enterprise [GSE]) had helped to raise the national homeownership rate from its 1930 measure of 46 percent to 63 percent.

FHA Offers Opportunities for Low-Wealth Families

To a large extent, FHA does not compete with conventional lenders. FHA focuses on homebuyers who, in comparison with those typically served in the conventional market, have lower wealth and pose moderately higher risks, yet are deemed creditworthy. FHA addresses the credit market imperfections that prevent households from accessing the type and level of housing consumption best suiting their needs and budget. As a result, and as an ancillary benefit to addressing these market imperfections, FHA provides opportunities for newly formed lower wealth households that wish to buy a home that meets their family's needs at a time when their children are young and can still experience the full range of benefits from homeownership.

To illustrate the above, the Office of Policy Development and Research at the U.S. Department of Housing and Urban Development (HUD) has compared characteristics of FHA and GSE (Fannie Mae and Freddie Mac combined) first-time homebuyer loans (the latter restricted to those falling below FHA loan limits) for selected origination years to gain understanding of how FHA has been used by first-time homebuyers in relation to the (prime) conventional market. The vast majority of FHA home purchase loans over the past 15 years have been made to first-time homebuyers. Except for the peak housing boom years, first-time homebuyers tended to rely more heavily on FHA financing—by two to three times as much—than on GSE conventional financing, and that reliance has grown dramatically in the past 2 years. For younger homebuyers using FHA—those under age 35—FHA's first-time buyer percentage has been consistently 80 to 90 percent; for those over age 35, 60 to 80 percent; and, overall, nearly 80 percent. Among FHA's first-time buyers, nearly 70 percent have been below age 35—consistent with the notion that FHA provides greater opportunities than the conventional market to families starting out.

FHA has also long been known to serve a disproportionately larger number and share of minority homebuyers, particularly African-American and Hispanic buyers. For example, in 2001, FHA served more than twice as many minority first-time buyers (about 220,000) than Fannie Mae and Freddie Mac combined (about 100,000). During the peak boom years, when many minority homebuyers chose subprime or other nontraditional conventional loans, the FHA minority first-time buyer counts dipped below those of the GSEs; however, since the crisis began, FHA has returned to serving a disproportionate number of minority first-time buyers.

FHA Has Overcome Challenges in Its History

Over its history, FHA has faced challenges regarding its financial condition or its relegation to small niche status in the marketplace. Three such challenges and FHA's responses are discussed: (1) in 1989, FHA faced a severe financial crisis and a large portfolio of unsound legacy business insured over many prior years; (2) large market shifts between 2001 and 2006 during the runup of the housing bubble called into question the continuing relevance of FHA in the market; and (3) poor performance during the 2000s from home purchase mortgages with downpayment gifts provided by nonprofit organizations in which the gift funds were contributed by the homesellers involved in the specific transactions, and possibly financed by inflated house values.

1. It may not be widely known, but FHA faced a severe financial crisis once before in its history during the administration of George H.W. Bush. The accounting firm of Price Waterhouse was commissioned in 1989 to conduct an independent actuarial review (the first of many such annual reports) of FHA's Mutual Mortgage Insurance (MMI) Fund, the principal ac-counting fund used by FHA to insure its home mortgages. The Price Waterhouse analysis found that FHA was underpricing its mortgage insurance and had been doing so for a decade. Price Waterhouse attributed a sharp decline in the MMI Fund's net worth during the 1980s, primarily to the lower rates of inflation and house price appreciation in the 1980s compared with the 1970s. The 1980-to-1982 recession years and the economic problems in the energy-producing states generated particularly large losses; losses due to lax management also were a contributing factor, but the underlying trend in house price appreciation was cited as the fundamental problem.

   During 1990, Congress and the Bush administration considered various policy proposals to shore up the MMI Fund. The policy debate in 1990 centered on how best to balance the public purposes of FHA with policies designed to improve its financial soundness. The Cranston-Gonzales National Affordable Housing Act (NAHA) of 1990 was ultimately enacted to restore the MMI Fund to actuarial soundness (along with other legislation enacted in 1989 to improve management effectiveness). The NAHA established a new actuarial soundness standard for FHA—a target level of capital of at least 2.0 percent of insurance-in-force (aggregate balance on insured loans in FHA's portfolio). But it was understood at the time that this target was designed only to enable FHA to withstand a moderate recession—not a severe downturn as has occurred since 2007. The law requires FHA to operate in an actuarially sound manner, but it does not require FHA to hold reserves that would make it able to withstand a severe economic event.

   Two years after the initial Price Waterhouse study and after the implementation of NAHA and other reforms, the fiscal year (FY) 1991 actuarial review of the MMI Fund found that the capital ratio of the fund had continued to fall. Price Waterhouse estimated the FY 1991 capital ratio to have declined to negative 0.2 percent (-0.2 percent) of insurance-in-force. NAHA and other reform measures adopted to reduce MMI Fund risks and to raise premiums were too new to offset the factors causing losses from the legacy business. That finding, however, did not mean that FHA needed a bailout. Rather, the 1991 actuarial review itself predicted future capital ratios would rebound, because the reforms would improve the performance of newly insured loans and the economy would recover. Price Waterhouse predicted the MMI Fund would meet its long-run capital ratio target of 2.0 percent by year 2000, and history shows that the fund actually achieved the 2.0 percent goal in FY 1995.

2. Large market share fluctuations during the decade of the 2000s also posed a challenge for FHA. Unlike a profit-motivated private insurer or lender, FHA does not actively seek to maximize market share. The extreme fluctuations observed in FHA's market share since 2000, however, have given rise to questions regarding FHA's appropriate role in the market. In particular, FHA had gone for more than a decade from capturing about 10 to 15 percent of the home purchase market—the approximate share it had for many years leading up to the new millennium—to less than 5 percent of the market during the boom years immediately preceding 2007 and rebounding to around 30 percent from mid-2008 forward. Although many believe the current 30 percent home purchase share represents too large a footprint for the FHA in the long term, there is less clarity about whether the very low (below 5 percent) precrisis share is the appropriate level for FHA going forward. The low FHA shares during the boom years occurred at a time when predatory and subprime lenders offering high-risk or high-cost alternative mortgage products attracted large numbers of homebuyers who might otherwise have chosen more sustainable FHA financing.

   Subprime underwriting criteria were "liberal to nonexistent" back then, and the high cost of these loans was often masked by short-run mortgage payments (before teaser rates adjusted) that were lower, giving borrowers the perception that the loan was affordable. A disproportionate share taking these products were minority homebuyers; thus, the declines in FHA market share were greatest for African American and Hispanic homebuyers. After the crisis hit, minority homebuyers were disproportionately affected by the dramatic tightening of conventional mortgage credit, and FHA's share of minority homebuyers has increased above the levels observed at the start of the decade.

   FHA did not follow the market's lead into teaser rate adjustable-rate mortgages (ARMs), low-documentation loans, or "piggyback" second liens. If FHA were to have extended itself into these products, it would likely have incurred large losses once home prices began to fall that could have undermined FHA's ability use its institutional capacity to assume a countercyclical role during the crisis. Although FHA is likely to sustain large losses on the loans it did insure during the precrisis boom years of 2005 to 2007—in part, because it may have been adversely selected during those years when the GSEs, in response to HUD affordable housing goals, were also extending credit to borrowers not typically served by the prime conventional market—FHA did avert even greater losses by staying principally with its traditional line of business.

3. Although FHA did not follow the market's lead into the nontraditional loan products, it did insure a group of loans that proved to be high risk: loans with downpayment gifts from nonprofit or charitable organizations in which the gift funds were ultimately replenished from a donation to the organization by the seller of the home. Often the borrowers who received the seller-funded downpayment gifts had weak credit histories as well. The combination of low or zero equity in a property often sold at an inflated sale price (sellers would recoup their donations through raising asking prices) to a buyer with weak credit history resulted in a group of loans that, on average, had a frequency of mortgage insurance claims that was two to three times the average for other comparable FHA loans.

   In 1996, FHA published guidance for mortgagees on the acceptable sources of the homebuyer's required investment (downpayment) beyond the homebuyer's own cash savings. Nowhere did FHA extend permission to obtain downpayment funds from the seller of the property—a practice expressly prohibited by conventional lenders. In the 1990s, however, some charitable organizations, which are permissible sources of downpayment gifts, began to circumvent the FHA restriction on gifts from sellers in various ways, including the establishment of a fund that provides the "gift" to the homebuyer that is replenished by the homeseller through a "charitable donation" to the organization after the sale is completed.

   As early as 1999, FHA took steps to prohibit the funding of downpayment gifts in which the source of the funds directly or indirectly comes from the seller of the property. Ultimately, the elimination of the seller-funded downpayment gifts would be accomplished through statutory prohibition of the practice. The passage of the Housing and Economic Recovery Act (HERA) on July 30, 2008, finally terminated seller-funded downpayment assistance effective for loans underwritten on or after October 1, 2008. The practice, however, did result in large losses for FHA, as documented in FHA's MMI Fund actuarial reviews.

FHA Response to the Crisis

Beginning in 2007, FHA began to focus on its countercyclical role as conventional credit dramatically tightened in response to the rise in delinquencies and foreclosures among subprime mortgages and the drop in home prices. Home prices continued falling for 33 consecutive months through early 2009, and the FHA played a major part in the government's efforts to slow this trend and stabilize prices. Mark Zandi, chief economist at Moody's Analytics, offered this assessment of FHA's role during the crisis:

> The FHA had been virtually dormant during the housing bubble, but it made about one-third of all U.S. mortgage loans in the period after the bust. Without such credit, the housing market would have completely shut down, taking the economy with it. The effort took a toll on the agency's finances, but so far the FHA has avoided turning to taxpayers for help, making it one of the few housing-related enterprises—public or private—that have not.

As home prices peaked and began to decline, and as delinquencies and foreclosures increased, lenders withdrew credit from the conventional mortgage market. The sheer volume of delinquent mortgages and foreclosure filings, along with numerous failures of mortgage lenders beginning in 2007, created a situation in which markets were in a self-perpetuating spiral with declining home prices and rising mortgage defaults; that is, defaults and foreclosures in the subprime sector led to falling home prices and tighter underwriting by conventional lenders, which, in turn, affected the prime sector and caused further home price declines. Arguably, FHA's response to the crisis was one of many actions taken by the federal government to help break the home price downward spiral. FHA's response consisted of (1) enabling home purchases, (2) enabling mortgage refinances, and (3) helping homeowners keep their homes.

The increase in FHA's home purchase market share starting in 2008 is due to three principal factors: (1) the tightening of private credit, (2) FHA keeping its underwriting standards fairly constant, and (3) the temporary increases in FHA's loan limits enacted by Congress. In 2006, FHA was authorized to insure loans of up to $200,160 in all markets and up to $363,790 in high-cost markets. In 2008, the Emergency Economic Stabilization Act (EESA) and, later, HERA granted FHA temporary authorization to insure mortgage loans of up to $271,050 in all markets and up to $729,750 in high-cost areas. The result was that, during FY 2006, as the crisis was about to begin, FHA insured 314,000 home purchase loans, but, by FY 2009, it had increased it volume of home purchase loans to 996,000 during a year in which the overall home purchase market was considerably smaller.

Not widely known is the fact that FHA also provided support for the refinance segment of the housing market during the crisis. Beginning in 2007, FHA stepped in to enable growing numbers of homeowners facing interest rate resets from expiring teaser rates on conventional ARMs to avoid large payment shocks. These conventional-to-FHA "product refinances" helped hundreds of thousands of borrowers who met FHA's standard underwriting criteria to convert conventional mortgages facing (or that already had received) monthly payment increases into far more sustainable FHA loans. In addition to providing help to homeowners with unsustainable conventional loans, FHA also enabled borrowers with existing FHA loans to refinance through its streamlined FHA-to-FHA refinance programs. Because FHA already holds the default risk on the loan, it is not taking on new risk with a streamlined rate or term refinance of the loan (with no cash out other than to cover closing costs), even if the loan were to be under water, or if the borrower's credit history had deteriorated.

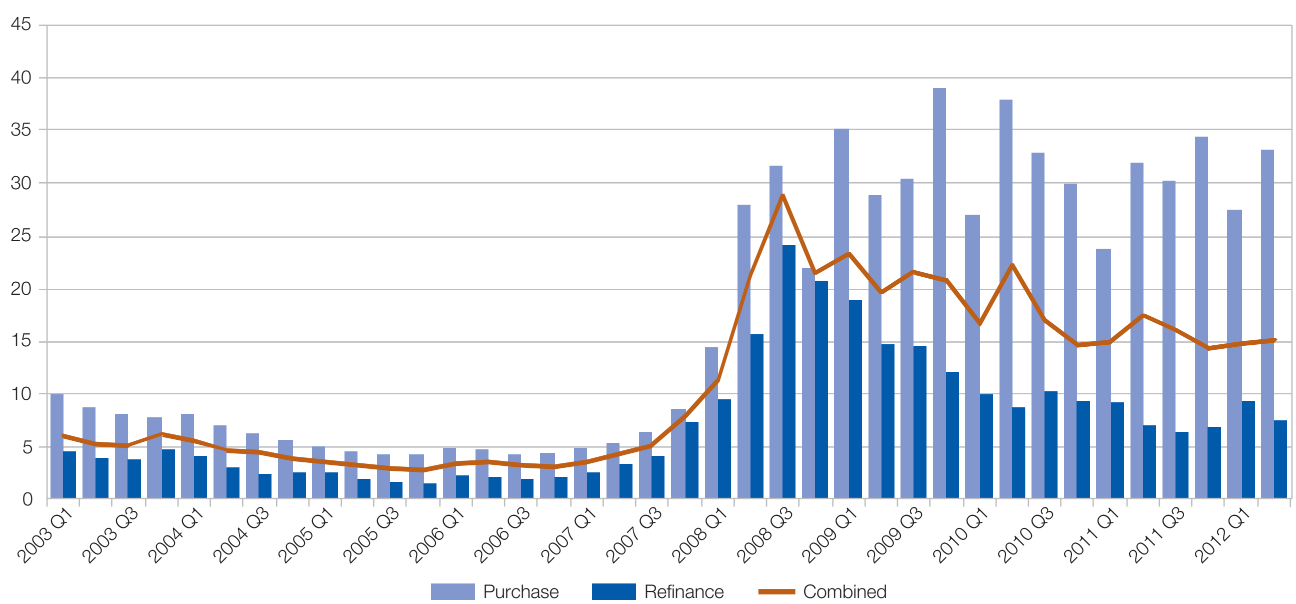
The exhibit from the paper shown below illustrates FHA's response to the crisis in terms of market shares by loan type (purchase or refinance).

Although FHA's expansion of mortgage credit has been and continues to be critical to housing markets, the FHA's support for the market during the crisis also includes help for distressed homeowners. Although not as widely recognized as the U.S. Department of the Treasury's Home Affordable Modification Program for conventional loans, FHA has actually extended loss mitigation aid to more than 1.4 million distressed homeowners with existing FHA loans since the second quarter of 2009.

Finally, any discussion of FHA's countercyclical role during the current crisis should consider the costs incurred by FHA in performing this role. Loans FHA insured during the 2005-to-2009 period are likely to suffer the most (in terms of lifetime performance) from the recent national housing recession. These loan vintages contained high shares of seller-funded downpayment gifts, which historically have performed much worse than other FHA loans. These vintages also were underwritten when home prices were near or at their peak in mid-2006, which was followed by 33 consecutive months of decline in national price levels, creating the greatest potential for significant negative equity. FHA's relatively low market shares during these boom years with high-loss potential, helped mitigate the impact of these loan vintages on FHA itself, however. Also, in certain states such as California, for which falling home prices were especially severe, FHA had even more limited exposure due

FHA Is Known To Have Ramped Up Its Support for Home Purchases; Less Well Known Is Its Support for Refinances During Crisis

FHA as Share of Quarterly Mortgage Originations by Type (percent)



Sources: Mortgage Bankers Association and the U.S. Department of Housing and Urban Development to precrisis loan limits that restricted origination volumes. As a result of FHA's countercyclical activity, however, the high origination volumes insured between 2009 and 2012 now constitute about 78 percent of FHA's insured loan portfolio, and although the bulk of these loans have better risk characteristics than is typical for FHA, they will nevertheless be entering their peak default periods during 2013 through 2017.

Appendix

The authors hope that this paper serves as a useful foundation for considering FHA's future role in housing finance as both institutional and regulatory reforms are debated. FHA's history has shown that the public policy debate after FHA's financial crisis of the 1980s was driven by balancing the dual objectives of carrying out FHA's purpose and mission with maintaining and improving its financial soundness. In the current environment, FHA is still helping to mend the ailing housing market. Looking forward to a time when that objective will have been substantially accomplished, there are numerous policy questions to be addressed. Some questions involve balancing the costs and benefits of FHA assuming a countercyclical role when future market distress may occur at the same time that it is meeting the other aspects of its mission. This and other questions about FHA's institutional role are integral to the policy debate framed by the White Paper on Reforming America's Housing Finance Market that was jointly released by the Department of the Treasury and HUD in February 2011.

In addition, there are questions related to regulatory reforms now under consideration that are likely to impact FHA's role going forward. These are the Qualified Mortgage rule, the Qualified Residential Mortgage rule, and Basel III capital rules for financial institutions. If, in the context of these reforms, FHA continues its tradition of serving creditworthy, lower wealth households not well served by the conventional market, its relative size and role could depend significantly on how the rules are interpreted and implemented.

Other considerations may also affect the future size of the FHA market. Specifically, demographic trends, which recently have shown a decline in the rate at which individuals form households and a sharp drop in immigration, may suppress the number of FHA's major historical client group, first-time homebuyers.

The appendix provides background information on these issues to help frame the discussion of the relevant policy questions to be addressed regarding the future role of FHA.

Introduction

Since the advent of the Great Depression, government has been involved in fine tuning the balance between public and private support for the system of home mortgage finance in the United States. Today, government guaranties or support are in evidence at every important link between sources of capital and mortgage lending. Commercial bank and thrift mortgage lenders are linked with loanable funds through federal deposit insurance. Many banks and thrifts are eligible for membership in the Federal Home Loan Bank system, through which they can access below-market-rate loans for financing housing. Other mortgage lenders, such as mortgage companies, banks, and thrifts, are linked to capital markets with either Ginnie Mae's federally guaranteed securities or Fannie Mae's and Freddie Mac's (government-sponsored enterprise [GSE]) agency status. The Federal Housing Administration's (FHA's) home mortgage insurance program, however, is the only generally accessible federal government guaranty linking mortgage borrowers with mortgage lenders (Bunce et al., 1995).[1, 2]

FHA is a government agency housed in the U. S. Department of Housing and Urban Development (HUD). FHA insures private lenders against loss on mortgage loans that meet FHA underwriting standards, enabling those lenders to provide mortgages to creditworthy borrowers who are unable to meet more stringent conventional lending standards and might otherwise be denied access to the capital markets. The various FHA portfolios include mortgages on single-family residential properties, multifamily apartments, hospitals, assisted-living facilities, and nursing homes.

In laying out FHA's mission in the single-family mortgage market and its historical role in meeting immediate and emerging challenges during its history, the authors' hope that this paper serves as a useful foundation for considering FHA's future role in housing finance as both institutional and regulatory reforms are debated. To that end, the paper provides useful facts on FHA's historical and ongoing role, descriptions of policies undertaken, and information that can inform debates about FHA's future. In performing its historical role, FHA has insured more than 41 million such mortgages since its inception in 1934.

The paper is organized into four sections and an appendix. The first section provides an historical overview of FHA's role in stabilizing housing markets, setting market standards, providing information, and addressing market failures such as credit rationing. The second section shows how this role provides improved opportunities for low-wealth (often newly formed) households to access affordable, sustainable homeownership. The third section features some significant challenges that FHA has faced over the years and the steps it has taken to meet these challenges. Throughout the current crisis, FHA has borrowed from lessons it learned in the past. Its response to the current housing crisis is described in the fourth section: FHA has stabilized declining markets by maintaining access to federally guaranteed mortgage credit in the face of a severe curtailment of private capital in the market, and has assisted distressed homeowners to keep their homes. Finally, the appendix reviews key questions and policies that will inform the future role of FHA, including questions related to the costs and benefits of FHA's countercyclical role, pending regulatory and institutional reforms that could affect underwriting standards in the conventional mortgage market.[3]

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[1] This and subsequent paragraphs, where noted, closely follow Bunce et al. (1995: 9-2, 9-3).

[2] Other government-guaranteed mortgage programs like those of the U.S. Department of Veterans Affairs or the Rural Housing Service are limited to veterans or households meeting specific income and geographic location criteria.

[3] The FHA Mutual Mortgage Insurance (MMI) Fund Actuarial Review for fiscal year 2012 was released on November 16, 2012, and showed that the capital reserve ratio of the MMI Fund had fallen below zero to negative 1.44 percent. Because this paper was written before the release of the Review, however, it does not discuss these results.

Section I. Historical Overview of FHA's Role

Before the government's involvement in the 1930s, the recorded homeownership rate was never higher than 48 percent.[4] Financial markets were highly volatile with financial panics every 10 to 20 years and frequent depressions.[5] Mortgage loans were difficult to obtain, and homebuyers had to provide their own mortgage default "insurance" for lenders in the form of substantial downpayments in the neighborhood of 50 percent or second and third loan financing at interest on the order of 18 to 20 percent (see Semer et al., 1976a: 10–11). In addition, homebuyers had to bear most of the interest rate risk with short-term, high-interest balloon mortgages. Even with the limited development of private mortgage insurance (PMI), primarily in New York State, homebuyers were unable to reduce downpayments below 33 percent and this insurance proved worthless when difficult economic times came (Rapkin et al., 1967: 23–27). The purely private system of mortgage finance, under which lenders and investors bore the full weight of default losses and faced variable economic conditions, limited consumer access to mortgage credit and sustainable homeownership (Bunce et al., 1995: 9-2).

The complete and extended collapse of the housing economy, including both its home financing and home building sectors through the early years of the Great Depression, provided a dramatic and incontrovertible demonstration of just how ineffectual private sector institutions unaided by government were at mitigating the effects and rebounding from economic disaster (Semer et al., 1976a: 3). In an effort to restore the supply of credit to mortgage lending and employment in the housing industry, President Hoover convened the President's Conference on Home Building and Home Ownership to bring about a system of Home Loan Discount Banks. These institutions were created with passage of the Federal Home Loan Bank Act of 1932. The Home Owner's Loan Act of 1933 quickly followed and established the Home Owner's Loan Corporation, created to refinance home mortgages in default or foreclosure or to help owners to recover homes lost through foreclosure or forced sale (see Semer et al., 1976a: 4–6).

In 1934, however, with new mortgage credit still frozen, residential construction stalled at less than one-tenth of the units built in 1925, and a decline in construction employment to fewer than 150,000 people nationwide with an equivalent loss in employment in the production of materials and equipment for home construction (Semer et al., 1976a: 8–9), Congress authorized the Federal Housing Administration (FHA) mortgage insurance with the aim of getting the building trades and private credit back to work. Speaking in support of the legislation, Federal Emergency Relief Administrator, Harry L. Hopkins, stated:

> The building trades in America represent by all odds the largest single unit of our unemployment. Probably more than one-third of all the unemployed are identified, directly and indirectly, with the building trades…. Now, a purpose of this bill, a fundamental purpose of this bill, is an effort to get these people back to work…. There has been no repair work done on housing since 1929…. And, finally, we believe it is essential that we unloose private credit rather than public funds in the repairing of those houses and the building of new houses … (Semer et al., 1976a: 9).

FHA mortgage insurance served as a credit enhancement that could be used by borrowers to access lender financing and actuate the borrower's demand for newly constructed or existing homes. Whereas other financing institutions, such as Federal Home Loan Banks, federal deposit insurance, or subsequent government sponsored entities, such as the Federal National Mortgage Association (Fannie Mae), connected lenders to loanable funds, FHA mortgage insurance connected borrowers to lenders facilitating the borrower's demand for and connection to those funds.

Initially, FHA insurance was intended to revitalize the housing industry and make home financing attainable for a much larger share of American families in the face of national recession. It has since assumed the same role helping to soften the effects of local or regional downturns or negative effects on less advantaged groups to restore healthy housing market activity.

Studies have shown that lenders can more easily vary conventional underwriting standards (whereas the FHA has relatively fixed underwriting standards), which leads to nonprice rationing by conventional lenders in response to local differences

[4] By comparison, the U.S. Census Bureau reported the 2011 homeownership rate for the nation at 66.1 percent.

[5] See figures 30-2 and 34-1 in Lipsey and Steiner (1975: 586–587; 662).

in economic conditions or other perceived risks. That is, profit-maximizing lenders do not only raise prices when lending becomes riskier in areas experiencing economic downturns, instead, they tighten underwriting to ration the number of mortgages made in such an area. FHA, on the other hand, maintains its presence in all markets, providing stability and liquidity in markets experiencing recession. Credit rationing in the conventional lending market is considered a *market failure* in the parlance of economists, and FHA's ability to address this failure is the key justification for FHA's historical and current role in the market. That is to say, the FHA, by addressing the tendency of the private marketplace to ration credit, has always brought a great deal more *stability* to mortgage markets and extended the *opportunity* for homeownership to a much broader segment of the population than was or would have been true in its absence.

The FHA, by addressing the tendency of the private marketplace to ration credit, has always brought a great deal more stability to mortgage markets and extended the opportunity for homeownership to a much broader segment of the population.

FHA is able to extend credit to those creditworthy borrowers who are not adequately served by conventional lenders and do so in an actuarially sound manner (which is a statutory requirement for FHA) because FHA has a lower cost of capital than conventional lenders. According to Bunce et al. (1995) "FHA's federal guaranty is the principal reason it can serve a more risky clientele" (Bunce et al., 1995: 9-6). Private lenders or insurers must earn a profit sufficiently large to attract the capital necessary to satisfy their shareholders. Because serving riskier borrowers involves a greater risk of failure, private lenders/insurers would have to maintain both larger reserves of capital and a larger profit margin to secure the capital in that riskier use. They go on to say "the freedom from having to earn a private risk-adjusted profit is FHA's principal cost advantage…." In addition FHA can make mortgage finance available to some borrowers by cross-subsidizing their losses with surplus premium income from lower risk FHA borrowers, who are themselves too risky for private lenders and insurers" (Bunce et al., 1995: 9-6).

The original FHA mortgage insurance contracts enabled borrowers to obtain financing with a minimum 20-percent downpayment. The maximum mortgage was limited to $16,000, which enabled families to purchase a $20,000 home with a minimum downpayment. Thus FHA originally served a large portion of the market as the typical home's price at the time was about $5,300. By charging borrowers a small premium and insuring the full mortgage amount, thereby protecting lenders from default losses, the FHA encouraged acceptance of long-term, lower downpayment, self-amortizing (all interest and principal repaid over the life of the loan), level-payment mortgages, bringing homeownership within the reach of many more families with lower upfront and monthly payments (Reeder et al., 1987: 2).

Note that mortgage loan limits rather than borrower income limits have been the principal method of targeting FHA's insurance activities during its history. This eligibility requirement has the effect of focusing FHA insurance activity on specific segments of the housing market, and helps maintain stability in credit flow to these market segments. Introducing the idea of federally backed mortgage insurance was only the beginning.

Next came the nuts and bolts issues of developing and building the national infrastructure to operate an actuarially sound insurance program across the United States. In addition to redefining mortgage underwriting standards to allow for a much broader segment of American households to qualify for mortgage finance, FHA created new uniform construction and appraisal standards to be used by private sector practitioners in the building and finance industries so that the FHA mortgage contract was readily traded across the country ensuring that homebuyers would have access to the lowest cost funds available nationally rather than locally (Semer et al., 1976a: 11–12).

In addition to redefining mortgage underwriting standards to allow for a much broader segment of American households to qualify for mortgage finance, FHA created new uniform construction and appraisal standards to be used by private sector practitioners.

Over time, the mortgage terms were gradually liberalized on lower value homes with an increase to a 90-percent maximum loan-to-value ratio (LTV) and 25-year repayment term for newly constructed homes mortgaged for less than $5,400 or up to $8,600 if the mortgage did not exceed the sum of 90 percent of the first $6,000 in value and 80 percent of the value between $6,000 and $10,000 (Semer et al., 1976a: 21).

Early on (as has been the continued practice), race was not explicitly regarded as a factor in FHA's mortgage insurance operations. Although as noted in section III, lenders of the time generally held the belief that it was unwise to invest mortgage funds in certain areas of cities (characterized by blight, low income, and minority residents), and FHA's earliest underwriting manuals reflected similar policies for evaluating older urban neighborhoods. By administrative decision in 1950, however, FHA actively took steps to address existing explicit racial discrimination in the market as the agency ceased insuring any more mortgages on real estate subject to covenants against ownership or occupancy by members of certain races. In 1962, President Kennedy issued Executive Order 11063 making FHA- and U.S. Department of Veterans Affairs-insured housing and related properties subject to Equal Opportunity in Housing requirements despite industry reaction that such action would lead lenders and homebuyers alike to shun FHA financing in favor of conventional financing which was not yet subject to equal opportunity requirements. No significant shift away from FHA materialized and in 1968 all housing and related transactions became subject to Fair Housing law under Title VIII of the Civil Rights Act (Semer et al., 1976a: 15). By 1970, the system of thrifts, commercial banks, FHA-insured lending, and Fannie Mae had helped to raise the homeownership rate from its 1930 measure of 46 to 63 percent (Semer et al., 1976a: 26).

More recently, FHA introduced major underwriting changes in 1995 designed to expand the shares of first-time and minority homebuyers that it served. For example, it recognized more sources of income (for example overtime or part-time employment income if certain conditions were met) in qualifying a borrower, enabled borrowers to use rent and utility payments to establish their credit quality, and permitted debt-to-income and payment-to-income ratios above FHA's limits if the lender could identify factors that compensated for the additional risk assumed.[6] As a result of these changes, first-time homebuyers increased from about 60 to 80 percent of FHA's home purchase business, and its share of minority homebuyers increased from about 25 to 35 percent. Homeownership rates for the nation as a whole and for racial and ethnic minority households, for which the rates have historically lagged behind those of White households, rose each year thereafter through 2002, achieving a nationwide peak of 69.0 percent by 2004.

Another important role of FHA was to make information available to the market on the performance of relatively high LTV mortgage lending (as compared with the low LTV loans before the Great Depression). By the mid-1950s FHA had demonstrated the feasibility of such lending given the sound underwriting and appraisal standards it pioneered. The upshot of this demonstration was a rebirth of the PMI industry in the late 1950s.

Another important role of FHA was to make information available to the market on the performance of relatively high LTV mortgage lending.

The PMI industry grew so that by the mid-1990s it, together with other conventional market institutions, was serving an annual volume of homeowners that was approximately equal to that served by FHA (Bunce et al., 1995: 9-2). As the PMI industry grew in size and strength, however, so did efforts to legislatively limit access to FHA. Between 1970 and 1995, no fewer than five major efforts were made to reassess FHA's role (and in some cases other government support) in the mortgage finance system, with a focus on the extent to which it could shift its business to conventional mortgage lending with private insurers (HUD PD&R, 1987, 1977; McKenna and Hills, 1982; President's Private Sector Survey on Cost Control, 1983; United States and Linowes, 1988).[7] Each effort argued that FHA was serving borrowers that conventional-market providers could have served as well or better—that is, substantial "overlap" existed between conventional and FHA borrowers. None of these efforts ever empirically established significant overlap between FHA and conventional lending, however, and each ultimately concluded that FHA had a continuing role so long as it complemented rather than competed with the conventional market.

Some of the calls to limit FHA also included proposals to replace its full insurance coverage with partial or limited insurance, or to remove its full faith and credit backing of the United States' government, or for its privatization (that is, outright elimination). These calls have often been accompanied by claims that FHA was incapable of keeping up with the technological changes in mortgage finance and the efficiencies of private market delivery systems.

FHA and Ginnie Mae have led the way in demonstrating the viability of many technical innovations.

Such claims, however, often fail to recognize that FHA uses the same private lender and servicer delivery system that conventional mortgage providers use. FHA and/or Ginnie Mae (the government-owned analog to the government-sponsored enterprises [GSEs]) have in many cases led the way in demonstrating the viability of technical innovations. Early on FHA demonstrated

[6] See mortgagee letter 95-7 at http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/letters/mortgagee.

[7] This and the following discussion closely follow Bunce et al. (1995: 9-2 to 9-4).

the value of the long-term, fixed-rate, self-amortizing mortgage and paved the way for the modern mortgage lending industry with development of minimum property construction and appraisal standards. Indeed, FHA demonstrated the viability of mortgage insurance, and Ginnie Mae pioneered the use of mortgage-backed securities, which were quickly adopted by the conventional market. Moreover, FHA pioneered lower downpayments, higher payment-to-income ratios, graduated payment mortgages, the 1- to 5-year adjustable-rate mortgage, underwriting guidelines for borrowers with nontraditional credit histories, and Home Equity Conversion Mortgages (reverse mortgages) for elderly homeowners (Bunce et al., 1995: 9-3). In addition, FHA has worked with industry to develop an automated credit underwriting capacity for FHA lending and continues to provide publically available data on which government, industry, and academe rely for analysis and understanding of mortgage credit markets inclusive of prepayment and default.[8] Looking forward, FHA may continue to play a significant role in developing standards and guidelines in the industry to address unique or specific challenges.

Claims that the conventional mortgage market is fully capable of assuming FHA's role and delivering equal or better service on at least the same scale depends on the ability of the conventional market to make similar loans to similar borrowers—that is to say, the existence of overlap between conventional and FHA-insured loan products and borrowers. Bunce et al. (1995) developed a comparative analysis of 1993 FHA and GSE loan-level data that revealed that, in fact, GSE and FHA products or borrowers overlapped very little and that FHA continued to offer homeownership opportunities to a large, creditworthy segment of households that was not otherwise available.[9] Subsequent academic papers analyzing data from later periods have found a modest degree of overlap but nevertheless confirm distinct populations. Rodda et al. (2005) found that only about 10 percent of FHA-insured loans have risk characteristics similar to GSE-purchased loans and that, when compared with GSE-purchased loans, FHA-insured loans are characterized by lower borrower credit scores and higher LTVs (that is, lower downpayments), and they are more targeted to lower income and minority borrowers.[10]

Nonetheless, analysts have argued that some continuing overlap may be essential for maintaining FHA's ability to carry out a market stabilization role, maintaining its institutional capacity to expand if necessary. Pennington-Cross and Yezer concluded that, for FHA to continue its important purposes of regional stabilization, information production, and insuring equal credit opportunity, it must maintain "a substantial FHA presence in national mortgage markets … even if that means substantial competition between FHA and conventional mortgage lending" (Pennington-Cross and Yezer, 2000: 370). As discussed in section IV, FHA's countercyclical role during the housing crisis from 2007 forward relied on its institutional capacity to expand, and many of the loans FHA has insured in this role would have qualified for conventional financing in the precrisis environment, although given the tightening of conventional underwriting, postcrisis overlap between FHA and the conventional market has likely remained small.

[8] FHA is in the process of updating its internal technology systems, which are admittedly antiquated. As described previously, FHA relies on private lender and servicer systems for underwriting and servicing its portfolio with additional information stored on internal technology systems.

[9] This section closely follows Bunce et al. (1995: 6-8 to 6-26 and 7-1 to 7-23).

[10] See Pennington-Cross and Nichols (2000: 2; 307–336), Pennington-Cross and Yezer (2000: 2; 357–372), and Rodda et al. (2005: 1–108).

Section II. FHA Offers Opportunities for Creditworthy Low-Wealth Families

To a large extent, the Federal Housing Administration (FHA) does not compete with conventional lenders. FHA focuses its home purchase business on a lower wealth, moderately higher risk, yet creditworthy clientele than is served by conventional lenders. FHA also is more accepting of compensating factors that demonstrate a borrowers' ability and willingness to make timely mortgage payments to offset risk characteristics that might be unacceptable to conventional lenders. FHA's insurance products and underwriting are designed to accommodate creditworthy households that present higher risk characteristics related to economic climate and/or their location, asset and income circumstances, or other demographic characteristics. As a result, FHA serves a much higher fraction of households that are first-time buyers, and may also have minority status, live in neighborhoods characterized by lower incomes, minority concentrations, or center-city locations.

Under the credit-rationing paradigm, households not meeting conventional underwriting standards are more apt to use FHA.

As discussed in section I, the conventional mortgage lending industry has traditionally tightened underwriting standards to ration the number of mortgages and limit exposure in areas or to groups in locations where lending is perceived to have become riskier, whereas FHA as a matter of policy has not. As a result of the nonprice credit-rationing policy, households that at one time may have qualified for a conventional mortgage loan of a given size might later fail to qualify for that loan, making FHA the only viable alternative. Credit rationing in the conventional mortgage market has been widely recognized in academic literature. A paper by Ambrose et al. is one of the more recent studies to have examined the effects of location-specific variation in credit risk on FHA market share. These authors conclude that strong evidence shows that the conventional mortgage lenders employ a nonprice credit-rationing paradigm (Ambrose, Pennington-Cross, and Yezer, 2002: 2; 1–28). Thus, households not meeting conventional underwriting standards are more apt to use FHA because the range of service provided by FHA extends well beyond that available from these lenders. FHA insures lenders against loss up to 100 percent, and this deep coverage gives lenders the level of comfort they need to make loans to homebuyers in higher risk neighborhoods and localities. Without that level of comfort, lenders do not merely charge more; rather, they limit access to credit through more stringent underwriting and/or substantially higher downpayments. The credit-rationing model was widely used by the industry before the recent house price boom when significant segments of the conventional market adopted risk-based pricing, especially in the subprime sector where loosened (or outright abandoned) underwriting standards prevailed and risks were priced (albeit mispriced in many instances). Since the crisis, the industry has returned to prudent underwriting and, arguably, to credit rationing, to the extent that credit tightening might be considered excessive (Goodman et al., 2012).

In addition, FHA has traditionally offered more lenient underwriting thresholds than the prime conventional market, making it possible for borrowers purchasing modest homes (below area median price) to obtain a larger mortgage and better house for a given income, asset level, and/or credit rating. Bunce et al. (1995) calculated that a 1993 homebuyer could, under FHA downpayment rules, purchase a given home with approximately 30 percent less cash than would be required with private mortgage insurance (PMI). Put another way, were the homebuyer with given cash assets required to use PMI, he/she would be limited to a home priced 30 percent below the one available with FHA. FHA has also been more flexible than conventional lenders with its income-qualification rules, allowing for variations in the qualifying ratios when appropriate compensating factors were identified. Stretching payment to income ratios from 28 to 33 percent is equivalent to reducing the income required to finance a home by 15 percent below what would be required by conventional lenders at the standard 28-percent ratio or increasing the value of the home available to a homebuyer of given income by an equivalent 15 percent.

Finally, FHA is substantially more tolerant of past borrower credit history problems or lack of established credit history. Pennington-Cross and Nichols (2000: 318) found that FHA FICO credit scores in 1996 were on average substantially below that for conventional loans, 665.7 versus 716.6. FHA is also more apt to insure mortgages in areas with greater uncertainty about the stability of borrower credit or collateral values. Again, FHA's greater acceptance of compensating factors that demonstrate a borrower's willingness to repay helps to offset some of these risks.

An ancillary benefit of the above underwriting differences between FHA and conventional lenders is the greater opportunity that FHA extends to families to move into better homeownership situations and begin to build a middle class life at roughly similar times in the family lifecycle as more advantaged households. Some argue that FHA does not really increase homeownership, it merely accelerates it by an estimated 5 years or so (Goodman and Nichols, 1997: 184–202). That, however, is an important benefit that FHA provides as a corollary to its primary mission to address the credit market imperfections from credit rationing. In other words, for newly formed households that wish to buy a home that meets their needs at a time when their children are young and can still experience the full range of benefits from homeownership, FHA provides the opportunity to access credit earlier.

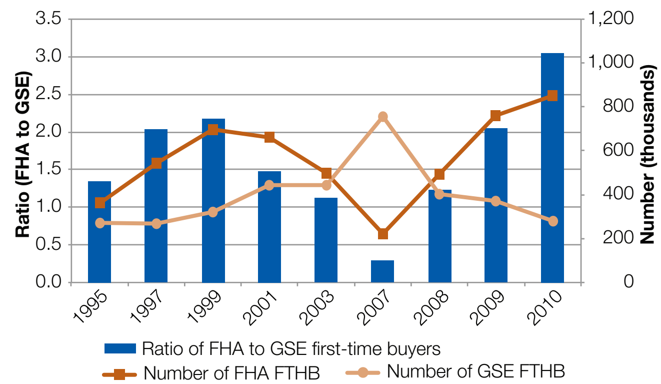
For newly formed households that wish to buy a home at a time when their children are young and most able to benefit from owning a home, FHA provides the opportunity to access credit earlier.

The Office of Policy Development and Research has examined characteristics of FHA and government-sponsored enterprise (GSE) first-time homebuyer loans (the latter being restricted to those *falling below FHA loan limits* for purposes of comparison) for selected origination years from 1995 through 2010 to gain understanding of how FHA has been used by first-time homebuyers in relation to the (prime) conventional market.[11] Most FHA purchase loans made during the past 15 years were to first-time homebuyers. For younger homebuyers—those younger than 35 years old—FHA's first-time buyer percentage has consistently been 80 to 90 percent; for those older than 35, 60 to 80 percent; and overall 70 to 80 percent. Exhibit II-1A shows both the number of FHA and GSE first-time homebuyers by selected year and the ratio of FHA first-time buyers to GSE first-time buyers. It shows that except for the time of the housing boom and right up to the housing and financial crisis, first-time homebuyers tended to rely more heavily on FHA financing—by 2 to 3 times as much—as compared with GSE conventional financing. That reliance has grown dramatically during the crisis years. Exhibit II-1B shows the consistently high percentage of FHA buyers—approximately 70 to 80 percent—who are first-time buyers. In contrast, since 2006, a much lower percentage—approximately 35 to 40 percent—of GSE homebuyers have been first-time buyers.

Exhibit II-2A shows that the distribution of FHA first-time buyers grouped by age of borrower is fairly consistent across

Exhibit II-1A. First-Time Homebuyers Rely More on FHA Than on Conventional Market

Number of FHA and GSE First-Time Buyers by Year and Ratio of FHA to GSE First-Time Buyer Mortgages for Selected Years

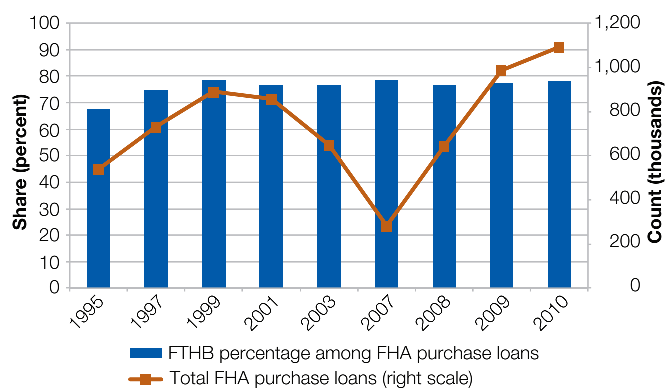


Note: Analysis restricted to GSE loans within FHA loan limits.

Sources: U.S. Department of Housing and Urban Development and Federal Housing Finance Agency (government-sponsored enterprise public-use database)

Exhibit II-1B. FHA Home Purchase Loans Are Predominately to First-Time Buyers

Percentage Share of First-Time Homebuyers and Total Count of FHA Purchase Loans



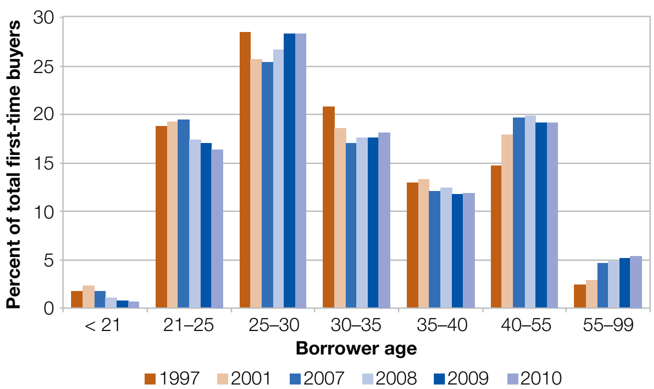
Source: U.S. Department of Housing and Urban Development

[11] The definition of a first-time homebuyer includes individuals who have had no ownership in a principal residence during the 3-year period before purchase of the property. For a complete definition, see http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfh/ref/sfhp3-02. FHA data are from the U.S. Department of Housing and Urban Development (HUD); GSE data come from the Federal Housing Finance Agency and HUD public use databases. GSE public use data for 2005 were not available at the time this paper was written.

the selected years and stable since the start of the housing crisis. Between 60 and 70 percent of FHA first-time buyers are below age 35—which is consistent with the notion that FHA provides greater opportunities than the conventional market to families starting out. The conventional market, as shown in related exhibit II-2B and as measured by GSE first-time buyer loans within FHA loan limits, has consistently fewer first-time buyers younger than age 35 (only 50 to 60 percent) with the trend since the start of the housing crisis being toward older first-time buyers, as underwriting has tightened in the conventional sector.

Exhibit II-2A. 60 to 70 Percent of FHA First-Time Buyers Under Age 35; Post-Crisis Age Trend Stable

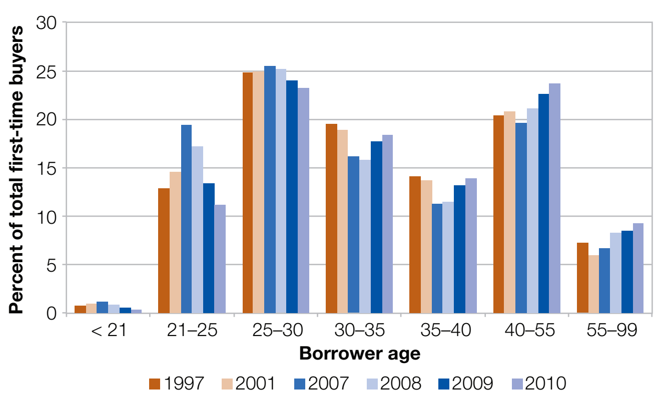
First-Time Homebuyers by Age Group and Selected Year



Source: U.S. Department of Housing and Urban Development

Exhibit II-2B. 50 to 60 Percent of GSE First-Time Buyers Under Age 35; Post-Crisis Average Age Rising

First-Time Homebuyers by Age Group and Selected Year



Note: Analysis restricted to GSE loans within FHA loan limits.

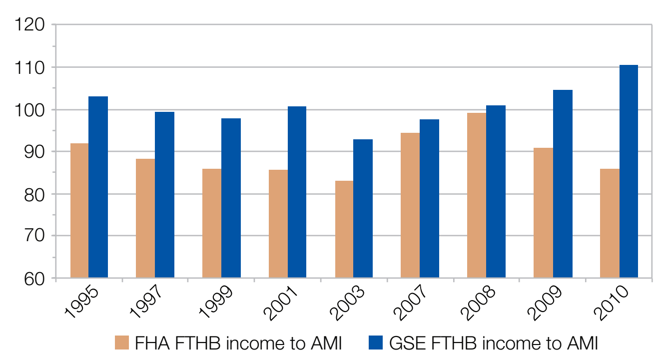
Sources: U.S. Department of Housing and Urban Development and Federal Housing Finance Agency (government-sponsored enterprise public-use database)

Exhibit II-3 compares the incomes of FHA first-time homebuyers with those in the conventional (GSE) market. The chart displays the means of FHA and GSE first-time buyer incomes as a percentage of area median income for selected origination years. The chart shows that relative incomes of FHA first-time buyers are approximately 10 to 20 percent below the relative incomes of conventional first-time buyers for every year except 2007 and 2008 when the difference narrowed to less than 10 percent below conventional first-time buyer incomes.

Exhibit II-4 shows the income qualifying advantage FHA has offered these lower income first-time buyers. The exhibit plots the mean ratio of the individual buyer's loan amount divided by the buyer's income for FHA first-time buyers and the similar ratio for conventional GSE first-time buyers. One can see that in the preboom years FHA first-time buyers had greater purchasing power than GSE first-time buyers. That is, the FHA buyers qualified for and got mortgage loans that were 10 to 15 percent larger relative to income than the conventional buyers and this advantage was eroding through the boom years and was gone in the post-crisis years.[12]

Exhibit II-3. First-Time Buyers Served by FHA Have Lower Incomes Than Those Served in Conventional Market

First-Time Homebuyer Incomes as Percent of Area Median Income for Selected Loan Origination Years



Note: Analysis restricted to GSE loans within FHA loan limits.

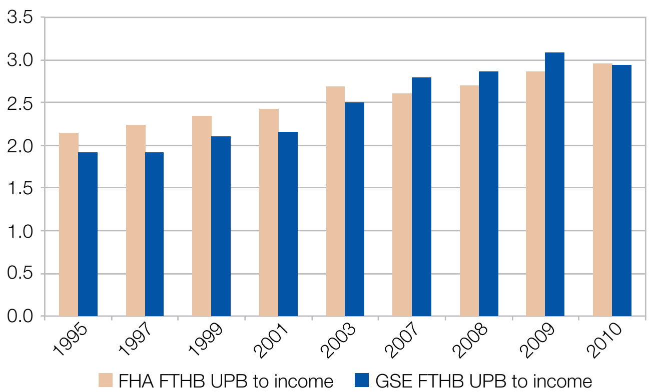
Sources: U.S. Department of Housing and Urban Development and Federal Housing Finance Agency (government-sponsored enterprise public-use database)

[12] One partial explanation for the perceived erosion of the FHA buyer's purchasing power advantage is that the distributions of FHA and GSE first-time buyers were becoming more similar as traditional FHA buyers shifted to the GSE conventional market financing during the boom period (because it was easier to income-qualify for a conventional loan in that period and possibly because of GSE affordable housing goals), followed by a shift of traditional GSE conventional buyers to FHA as the GSEs tightened credit, and FHA loan limits were temporarily raised.

FHA has long been known to serve a disproportionately larger number and share of minority African-American and Hispanic homebuyers. Exhibit II-5 shows that before the financial and housing crisis, FHA served far more minority (African-American or Hispanic) buyers than did the conventional GSE market. During the peak boom years, when many minority homebuyers chose subprime or other nontraditional conventional loans, the FHA minority first-time buyer counts dipped below those of the GSEs.

Exhibit II-4. FHA Provided First-Time Homebuyers With Greater Purchasing Power Than GSE Conventional Market Before Crisis; Not So After Crisis

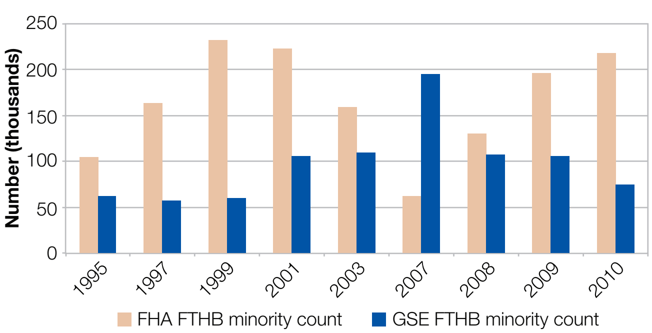
Ratio of Original Unpaid Principal Balance to Borrower Income for Selected Years



Sources: U.S. Department of Housing and Urban Development and Federal Housing Finance Agency (government-sponsored enterprise public-use database)

Exhibit II-5. FHA Serves More Minority First-Time Buyers Than Conventional (GSE) Market; Peak Boom Years Exception

First-Time Buyers by Selected Year



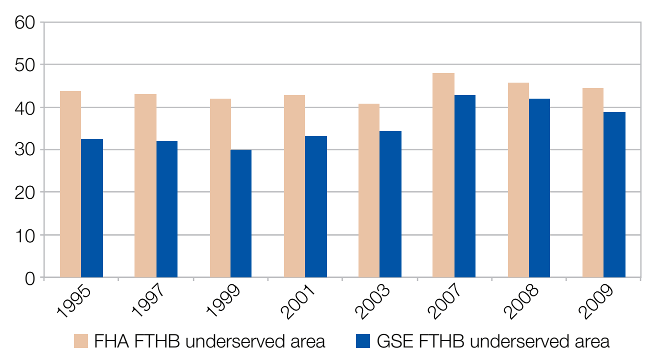
Sources: U.S. Department of Housing and Urban Development and Federal Housing Finance Agency (government-sponsored enterprise public-use database)

Finally, FHA has long served a higher proportion of first-time buyers purchasing homes in underserved areas because (1) FHA has traditionally served more first-time homebuyers (see exhibit II-1A), and (2) a higher proportion of its first-time buyers purchase homes in underserved areas. Exhibit II-6 shows that FHA has consistently helped 43 percent or more of its first-time homebuyers to purchase homes in underserved areas, by contrast to the GSE conventional market where first-time purchases in underserved areas accounted for approximately 32 percent of their first-time homebuyer business. More recently, the proportions of first-time FHA homebuyers in underserved areas have both increased modestly and continued to exceed the comparable proportions for GSE conventional first-time buyers; however, the gap between the relative shares has narrowed considerably—falling from an average 11 percentage points to roughly 5 percentage points.

Thus, FHA's mission of providing increased opportunities for less advantaged, creditworthy families, although tested during the boom years, proved to be critical to stabilizing the market after the crisis began. The differences between FHA and prime conventional homebuyers have narrowed somewhat since 2003 because of easier income qualification of conventional buyers in the boom period, and possibly to the GSE affordable housing goals.[13] Differences also narrowed as formerly conventional

Exhibit II-6. Higher Percentage of FHA's First-Time Buyer Homes in Underserved Areas Than GSE First-Time Buyer Homes; Post-Crisis Differential Has Narrowed

First-Time Buyers in Underserved Areas as Percent of Total First-Time Buyers by Year



Note: Underserved areas are defined as census tracts characterized by high proportions of low- and moderate-income and minority households or high proportions of very low-income residents.

Sources: U.S. Department of Housing and Urban Development and Federal Housing Finance Agency (government-sponsored enterprise public-use database)

[13] More detail on the GSE housing goals is provided in section III.

buyers shifted to FHA as conventional credit standards tightened after 2006 and FHA loan limits were temporarily raised. The narrowing differences notwithstanding, FHA's home purchase business continues to be more focused on less-advantaged home-buyers than the conventional market. FHA has served and continues to serve a much higher fraction of households that are first-time buyers, have lower incomes and/or minority status, or live in lower income, minority, center-city, or underserved areas. Both its level and proportion of first-time business relative to GSE conventional first-time business has grown dramatically in the years after 2007 helping to stem the most negative effects of the credit crunch across the country. More on FHA's role in addressing the housing crisis will be presented in section IV.

Section III. FHA Has Overcome Challenges in Its History

During its history, the Federal Housing Administration (FHA) has faced challenges that could have affected its financial insolvency or potentially relegated it to small market niche status in the market place. FHA has repeatedly met these challenges and has righted itself financially and reaffirmed its traditional mission. This section discusses three such challenges: (1) in 1989, FHA faced a severe financial crisis and a large portfolio of unsound legacy business insured over many previous years; (2) large market shifts between 2001 and 2006, during the runup of the housing bubble, called into question the continuing relevance of FHA in the market; and (3) poor performance during the 2000s from home purchase mortgages with downpayment gifts provided by nonprofit organizations, wherein the gift funds were contributed by the homesellers involved in the specific transactions, and possibly financed by inflated house values. The manner in which FHA overcame each of these challenges is addressed in this section.

III-1. Through Improved Risk Management and Other Reforms, FHA Emerged From a Financial Crisis During the 1990s

Brief History of the FHA Financial Crisis in 1990

It may not be widely known, but FHA was faced with a severe financial crisis during the administration of President George H.W. Bush. The accounting firm of Price Waterhouse was commissioned by the General Accounting Office (GAO) in 1989 to conduct an independent actuarial review (the first of many such annual reports by Price Waterhouse and other independent firms) of FHA's Mutual Mortgage Insurance (MMI) Fund, which is the principal fund used by FHA to insure its home mortgages. Before 1989, FHA had conducted internal actuarial analyses, but this was the first independent audit of FHA's financial strength undertaken in a comprehensive manner, including construction of statistical models to predict future claims and prepayments. Price Waterhouse's fiscal year (FY) 1989 study stated that the FHA was still solvent, but not

The public policy debate in 1990 centered on how best to balance the public purposes of FHA with policies designed to improve FHA's financial soundness.

actuarially sound, which meant that new business coming through the door would ultimately pay out more in insurance claims than the premium revenues it would collect, further eroding FHA's finances. During 1990, Congress and the Bush administration considered various policy proposals to shore up the MMI Fund. The Cranston-Gonzales National Affordable Housing Act (NAHA) was ultimately enacted to restore the MMI Fund to actuarial soundness.

The public policy debate in 1990 centered on how best to balance the public purposes of FHA with policies designed to improve FHA's financial soundness (Weicher, 1992).

How did this situation come about? As discussed previously in this paper, FHA originally helped supply mortgage credit to a broad segment of the housing market, thereby increasing demand for housing. FHA accomplished this objective through a statutory nationwide limit on the principal mortgage amount with no upper limit placed on the homebuyer's income. The original FHA mortgage limit in 1934 was $16,000 nationwide—well above the $5,300 median home price at the time according to Jaffee and Quigley (2010). FHA also insured what was then an unusual form of mortgage instrument: a fixed-rate self-amortizing mortgage over a long term (20 years at the time) to maturity.[14] Insurance was funded by the proceeds of a fixed premium (0.5 percent) charged annually on unpaid loan balances. These revenues were deposited in Treasury securities and managed as a mutual insurance fund. Of significance, default insurance was offered on what were dubbed "economically sound" self-amortizing mortgages with terms as long as 20 years and with loan-to-value ratios (LTVs) of up to 80 percent.

Over time, the terms of FHA mortgages were gradually liberalized as experience provided evidence of the soundness of the long-term, fixed-rate mortgage. By the time FHA got into financial trouble in 1989, it was insuring 30-year mortgages with downpayments as low as 3 percent on mortgages of $50,000

[14] Before the Great Depression, the typical home mortgage took the form of a balloon rollover with a short term, typically 5 to 10 years. Longer term loans were considered too risky by lenders, especially for nonamortizing loans for which the balance owed does not decline.

or less (although loans above $50,000 required downpayments of 3 percent of the first $25,000, and 5 percent on the remainder.) FHA's mortgage ceiling was raised and restructured to be set by market area (county or metropolitan area) with a statutory minimum of at least $67,500, and higher levels permitted for high-cost areas up to 95 percent of the area's median-priced home, with a legislated maximum of $90,000 in 1980, which remained at that level until raised to $101,250 in 1987.[15] Despite these loan-limit increases from the original level established in 1934, home price inflation outpaced FHA's loan limits, and FHA became increasingly focused on the lower value segment of the market. At the time, FHA also permitted homebuyers to finance their closing costs as part of the mortgage, a practice that was unique in the industry, and which also increased FHA's risk profile.[16] Finally, the long-time FHA premium of 0.5 percent annually on the outstanding loan balance was replaced in 1983 by a one-time upfront payment of 3.8 percent of the original loan balance, and this amount could be financed in the mortgage and partially refunded if the borrower prepaid the loan without an insurance claim. This premium structure, although designed to be revenue neutral, actually increased FHA's risk because it raised effective LTVs and required large sums to be refunded during periods of high refinance activity.

Laws enacted during the 1950s and 1960s changed FHA's original underwriting standard of insuring only "economically sound" loans to a more flexible "reasonable risk standard." The more flexible standard was needed to extend FHA insurance authority to special purpose and subsidized home mortgage insurance programs targeted to lower income households, declining areas, and other special groups (see Vandell, 1995). Economic soundness was a requirement of the original Housing Act. From its inception, FHA was influenced by the existing customs and practices of the mortgage-lending industry, which likely spilled over into its early interpretation of the requirement (Semer et al., 1976b: 175). Conventional lenders of the time likely gave tacit, if not explicit, agreement to the notion that it was unwise to invest mortgage funds in certain areas of cities (especially transitional neighborhoods characterized by blight, low income and minority residents). Thus FHA's early policy may have inadvertently promoted redlining practices and may have accelerated post-World War II (WWII) suburban sprawl.[17] As discussed in section I, however, in the 1950s and 1960s, FHA, and later the U.S. Department of Housing and Urban Development (HUD), which became the parent agency of FHA in 1965, moved strongly to turn this situation around. Redlining was prohibited. Also, as noted previously, Congress had directed FHA and HUD to implement a series of special purpose and subsidized home mortgage insurance programs targeted to lower income households, declining areas, and other special groups.

According to Semer et al. (1976b: 177), the programs to serve lower income households and those in declining areas were not implemented with as much care and management oversight as they should have been. As a result, some cities (such as Detroit in the early 1970s) experienced high FHA default and foreclosure rates soon afterward (Semer et al., 1976b; Vandell, 1995). As noted by Weicher (1992: 136) when GAO released the findings of its 1989 study of FHA, HUD had been "front-page news for months, with revelations of influence peddling and favoritism in awarding contracts in certain programs, fraud in others, and substantial losses in several relatively small FHA insurance programs in other funds."

Although these changes increased the inherent risk of FHA's business, and large losses had occurred for a time in the 1960s and early 1970s, the post WWII era was generally a period of expansion, and as a result the MMI Fund's reserves continued to grow. This situation began to change during the 1980s.

The initial Price Waterhouse analysis found that the net present value of FHA's entire book of business plus cash reserves through 1989 was $3.1 billion, about 1 percent of its insurance

[15] The nationwide high-cost conforming loan limit for Fannie Mae and Freddie Mac was set at a higher amount than the high-cost market area ceiling for FHA. Specifically, the conforming loan limit was established at $93,750 in 1980 and going forward was indexed to the annual house price change in the conventional market. FHA's minimum and high-cost ceiling were not similarly indexed and required statutory authority to change.

[16] Typical closing costs averaged 2.5 to 3.0 percent of the sales price for FHA buyers in 1989, which meant that a homebuyer making the minimum downpayment on a typical $65,000 home could have only $900 equity in the home—about 1.4 percent and far lower than even today's FHA downpayment requirements permit. To calculate: assume 3 percent closing costs, making the sum of purchase price plus closing cost $66,950; compute borrower downpayment as 3 percent of first $25,000 ($750), plus 5 percent of the remainder (.05 x $41,950 = $2,098) for a total of $2,848; subtract this downpayment from 66,950 and the homeowner may finance a mortgage of $64,100 (to the nearest $100)—effectively leaving the buyer with only $900 equity.

[17] Excerpts from FHA (1938) established criteria for rating economic viability of property locations and neighborhoods, including those that assessed lower viability to older neighborhoods with low growth as "accelerating the transition to lower class occupancy," and required an assessment of the quality of development near the property location "to determine whether incompatible racial and social groups are present, for the purpose of making a prediction regarding the probability of the location being invaded by such groups." See FHA (1938: ¶ 909 and 937).

in force (aggregate loan balances).[18] This decline was significant in the course of a decade—Price Waterhouse calculated that in 1979 the MMI Fund had an economic value of $3.4 billion, which was 5.3 percent of the insurance in force at the time. The MMI Fund was projected to lose money on each year's book of business (loan vintage) from 1980 through 1989. In short, FHA was underpricing its mortgage insurance, and had been doing so for a decade (Weicher, 1992).

Price Waterhouse attributed the sharp decline in the MMI Fund's net worth during the 1980s primarily to the lower rates of inflation and house price appreciation in the 1980s compared with that of the 1970s. The 1980–1982 recession years and the economic problems in the energy producing states in the late 1980s generated particularly large losses, but the underlying trend in house price appreciation was the fundamental problem. In addition, the fund was insuring an increasingly risky book of business, and a contributing factor was "past poor management practices and lax monitoring" (Weicher, 1992: 138).

Considerable policy debate existed over how to restore the financial strength of FHA, to make administrative reforms to reduce fraud and abuse, and to improve management practices. Changes addressing these issues were enacted in several key pieces of legislation in 1989 and 1990.

- Administrative reforms were enacted by the Housing and Urban Development Reform Act of 1989,[19] which included establishment of (1) a Mortgagee Review Board, to enforce lender compliance with FHA rules and standards; (2) the Offices of the Chief Financial Officer and FHA Comptroller, to improve agency financial accountability; (3) improved management practices such as annual audited financial statements; and (4) elimination of private investor-owners from the FHA single-family program. (Investor loans had been a key source of abuse leading to high losses by FHA.)
- Reforms directly addressing FHA's MMI Fund soundness were enacted by the NAHA of 1990[20] and included (1) the development of an actuarial standard of financial soundness; (2) modification of minimum equity requirements; (3) changes in the pricing of insurance premiums; and (4) revisions to policies regarding distributive shares, which were a form of dividends FHA paid to some borrowers whose loan cohorts had experienced low losses.
- Governmentwide reforms were enacted by the Federal Credit Reform Act of 1990,[21] which instituted a more realistic picture of the cost of U.S. government direct loans and loan guarantees. The credit subsidy cost of direct loans and loan guarantees is the net present value of the estimated long-term cost to the government for these credit activities. Beginning in FY 1992, this calculation of credit subsidy cost for loan guarantees such as FHA mortgage insurance occurs at the time a new loan guarantee is made and when the previous-year loan guarantees are annually re-estimated to reflect any changes in the cost of the subsidy. This law ended previous practices of cash accounting that tended to make the budget effect of loan guarantees appear positive in the early years when premium revenues were high and losses were low, but had adverse budget effects in later years when the opposite situation prevailed.

Through these legislative changes, FHA took the following steps to shore up its finances: (1) shed high-risk loans (by eliminating investor loans, a major source of fraud and abuse); (2) raise the mortgage insurance premium (to raise revenues) while simultaneously restructuring it (to reduce effective LTVs), and stop distributive share refund payments; (3) implement systematic risk management and better monitoring practices; and (4) tighten underwriting through limits on the financing of closing costs (to reduce effective LTVs).

The steps that FHA took in the 1990s are very similar to steps that FHA has taken to shore up its finances during the current crisis. Clearly FHA's current capital reserves have eroded as a result of the housing crisis beginning in 2007, which is well documented in its recent MMI Fund actuarial reviews. The risk management steps FHA has taken since 2007 include (1) shedding its riskiest loans (banning high-risk downpayment gifts); (2) raising mortgage insurance premiums; (3) instituting better management practices (including establishment of Office of Risk Management, more frequent reporting to Congress on MMI Fund condition, and expanding loss mitigation interventions

[18] This net present value calculation is defined as the economic value or economic net worth of the Fund. It is a net asset position, after booking a liability for loan loss reserves. Those loan loss reserves are to be sufficient for paying all projected future insurance claims, after accounting for expected future premium revenues. The projection of loan loss reserves assumes no new business is booked to provide any additional resources.

[19] P. L. 101–235.

[20] P. L. 101–625.

[21] P. L. 101-508.

for defaulted borrowers); and (4) modest tightening of underwriting requirements (including minimum consumer credit scores and higher downpayments on low-credit-score loans).

Again, similar to the 1990s experience, FHA took these post-2007 steps while balancing the goals of financial stability and public mission to maintain mortgage liquidity in all markets and provide service to creditworthy borrowers who would otherwise not be served in a period of severe credit tightening by the conventional market.

Pre-1991 Legacy Business Gradually Replaced by Better Performing Loans and Improved Economic Forecasts

Two years after the initial Price Waterhouse study, and after the implementation of NAHA and other reforms, the FY 1991 actuarial review of the MMI Fund[22] found that the capital ratio of the Fund had continued to fall. Price Waterhouse estimated the FY 1991 capital ratio to have declined to negative 0.2 percent (-0.2 percent) of insurance in force as improved econometric models predicted higher losses among FHA's legacy (pre-NAHA) business compounded by slightly less favorable economic forecasts. NAHA and other reform measures adopted to reduce MMI Fund risks and to raise premiums were too new to offset the factors that were reducing the economic value of the legacy business. That finding, however, did not mean that FHA needed a public bailout. Rather, the 1991 actuarial review predicted future capital ratios would rebound as both the reforms and the economy would recover, and that the MMI Fund would meet its long-run capital ratio target of 2.0 percent by year 2000. That is precisely what occurred, as exhibits III-1 and III-2 show, although the 2.0-percent capital target was achieved much sooner than predicted in 1995.

NAHA Target Ratio: Designed To Withstand a Moderate (Not Severe) Housing Downturn

The 1990 policy debate over the appropriate level of capital for FHA resulted in a long-term target of at least 2.0 percent of insurance in force. It was understood at the time, however, that this target was designed only to enable FHA to maintain positive capital during a moderate recession—not a severe downturn as has occurred since 2007. Again, a review of the historical record sheds light on the thinking behind this target.

The law requires FHA to operate in an actuarially sound manner, but it does not require FHA to hold reserves that would make it able to maintain positive capital during a severe economic event.

The NAHA legislation actually established two target capital ratios for FHA during its recovery: a 2-year target of 1.25 percent, and a more conservative long-term target of 2.0 percent for the year 2000 forward. Price Waterhouse's FY 1990 actuarial review of the MMI Fund concluded that the fund's net worth should be at least 1.25 percent of its insurance in force: "The

Exhibit III-1. FHA Quickly Recovered After 1991 Reforms

FHA MMI Fund Economic Values and Capital Ratios by Fiscal Year of Actuarial Review, FY 1989–2004

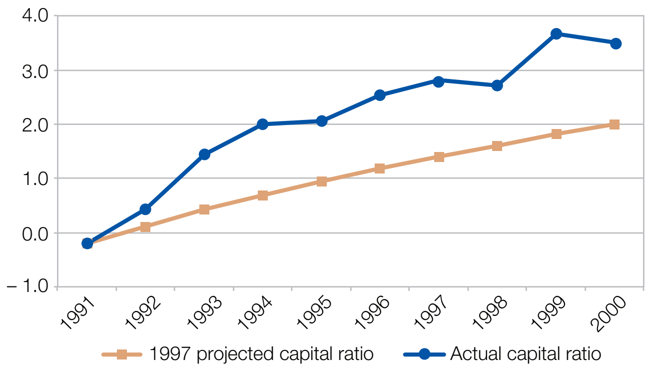
Fiscal Year of Actuarial Review	Insurance-In-Force (millions of dollars)	Economic Value (millions of dollars)	Capital Ratio (percent)	NAHA Target Capital Ratio (percent)
1989	263,963	3,133	1.19	—
1990	304,216	(2,674)	– 0.88	—
1991	327,811	(669)	– 0.20	—
1992	325,912	1,405	0.43	1.25
1993	316,527	4,554	1.44	1.25
1994	335,073	6,682	1.99	1.25
1995	345,278	7,086	2.05	1.25
1996	370,484	9,397	2.54	1.25
1997	400,850	11,258	2.81	1.25
1998	419,575	11,360	2.71	1.25
1999	454,184	16,637	3.66	1.25
2000	482,732	16,962	3.51	2.00

Note: Capital ratio is economic value as a percentage of insurance-in-force.
Source: U.S. Department of Housing and Urban Development

[22] This report was submitted to FHA on December 31, 1992.

Exhibit III-2. FHA Exceeded 1991 Projections for Captial Ratio, Meeting 2.0 Percent Statutory Target for FY 2000 in FY 1995

FHA MMI Fund Capital Ratio Projections From the 1991 Actuarial Review Compared With Actual Capital Ratios From Subsequent Reviews



Source: U.S. Department of Housing and Urban Development

1.25 percent is not a desired ratio, but a minimum ratio…. As we saw in the 1980's when the capital ratio declined from 5.3 percent to one percent, far more than 1.25 percent capital could be needed."

This minimum capital percentage was derived from Price Waterhouse's simulation of FHA's legacy book of business under adverse (moderate recession) economics, and represents the capital level the MMI fund would needed to stay solvent in a hypothetical situation in which no new business is written.[23] The report goes on to say, "Any analysis of the MMI Fund must recognize that FHA's public purpose can be, and often is, at odds with its statutory requirement to be sound…. While reliance on the Treasury to cover catastrophic conditions might be appropriate in the most severe circumstances, we believe that, given current statutory requirements, MMI must (at a minimum) maintain enough equity to withstand, on its own, moderately severe economic conditions."

The law requires FHA to operate in an actuarially sound manner, but it does not require FHA to hold reserves that would make it able to maintain positive capital during a severe economic event.

III-2. FHA Met the Challenge Posed by Market Shifts From 2001 to 2006

FHA's Market Share Fluctuations Before and After Crisis

Large market share fluctuations during the decade of the 2000s also posed a challenge for FHA. Unlike a profit motivated private insurer or lender, FHA does not actively seek to maximize market share—that is not consistent with FHA's mission. The extreme fluctuations observed in FHA's market share since 2000, however, have given rise to questions as to FHA's appropriate role in the market. In particular, FHA had gone more than a decade from capturing about 10 to 15 percent of the home purchase market—the approximate share it had for many years leading up to the new millennium—down to below 5 percent during the boom years immediately preceding 2007, and rebounding to about 30 percent from mid-2008 forward.[24] See exhibit III-3, which illustrates quarterly FHA market shares leading up to the crisis and in response.[25]

Although many policy analysts believe the current 30-percent share represents too large a footprint for the FHA in the long term, less clarity exists about whether the very low (below

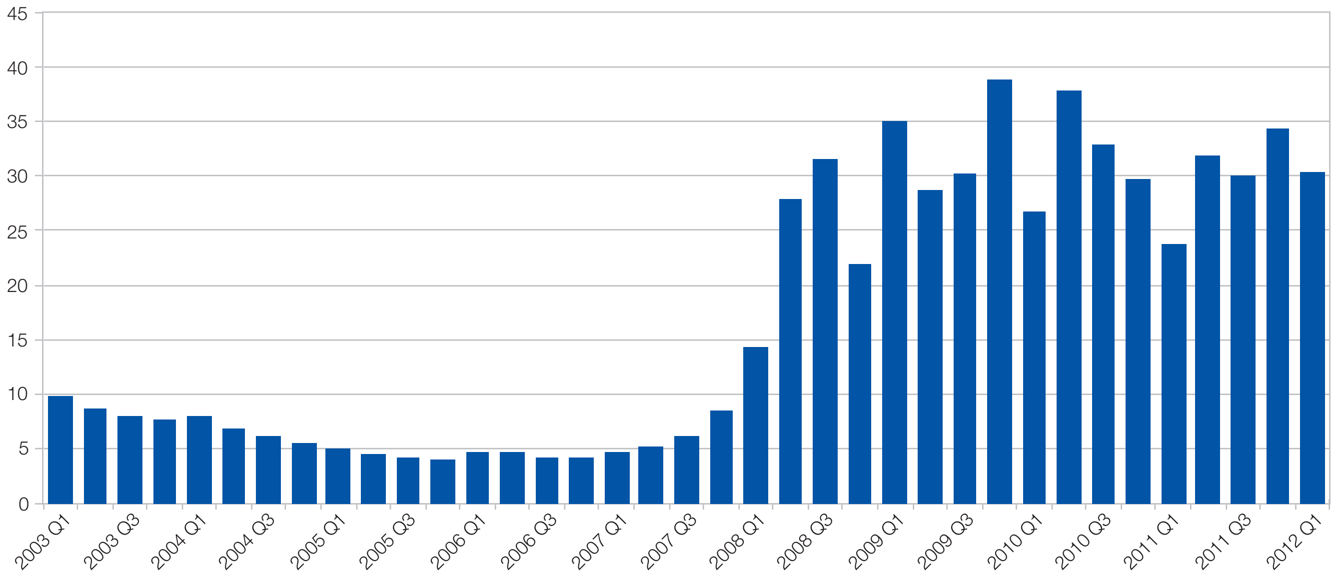
[23] The moderate recession scenario that Price Waterhouse modeled to reach its conclusion was (1) lower house-price appreciation (than consensus scenario) by 2 percentage points, (2) lower interest rates by 1.5 percentage points, and (3) higher unemployment rates by 3 percentage points. These adverse conditions were assumed to occur during the first 2 years in the forecast and are gradually phased out by the 5th year, after which the assumptions return to the consensus forecast. In contrast, the post-2006 housing downturn was far more severe.

[24] These shares are in terms of loan counts, not aggregate principal balance. Because FHA average loan sizes are typically smaller than those in the conventional market, FHA shares by loan balance would be lower.

[25] Immergluck (2009), Vandell (1995), and others provide a historical summary of FHA's market shares going back to the agency's inception. Some estimates refer to FHA's share of all mortgage originations and others refer to shares of home purchase loans or even home sales, so caution is warranted in making intertemporal comparisons. We summarize some of the findings here to give a longer historical perspective on FHA market shares. From 1935 to 1939, FHA-insured loans accounted for 23 percent of all single-family mortgage lending, growing to 45 percent during the years 1940 to 1944. When the Veterans Administration loan guaranty program was introduced after WWII to serve returning veterans, the FHA share dropped significantly. During the 1950s the private mortgage insurance (PMI) industry reemerged after its demise in the Great Depression, which gradually reduced FHA's shares further. In 1970, FHA loans still accounted for nearly 30 percent of single-family loans. With the increase in PMI activity along with the increasing presence of Fannie Mae (1968) and Freddie Mac (1972)—which by their founding charters required a credit enhancement such as PMI for loans with LTVs above 80 percent—FHA's market share had fallen to the 5- to 10-percent range during the 1980s (except for a few years after 1985, when FHA shares spiked as private insurers retreated from the market in response to the recession in the energy-producing states). FHA's share rebounded in the 1990s to between 10 and 15 percent, partly in response to underwriting changes in the mid-1990s intended to increase homeownership rates for low- and moderate-income borrowers and minorities. It remained in this range until the advent of the boom preceding the 2007 crisis.

Exhibit III-3. FHA Shares of the Home Purchase Market Hit Record Lows in 2005, Followed by a Dramatic Turnaround

FHA as Share of Quarterly Home Purchase Mortgage Originations (percent)



Sources: Mortgage Bankers Association and U.S. Department of Housing and Urban Development

5 percent) precrisis share is the appropriate level for FHA going forward, or if FHA would more appropriately return to the pre-2002 share in the 10- to 15-percent range to adequately perform its mission. That is, the low FHA shares during the boom years may also be an anomaly because those shares occurred at a time when predatory and subprime lenders offering high-risk or high-cost alternative mortgage products attracted large numbers of homebuyers who might otherwise have chosen more sustainable FHA financing. In 2008, *Bloomberg Business Week* noted the following:

> For much of the real estate boom, the Federal Housing Authority [sic] sat frustrated on the sidelines. Handcuffed by congressional limits on the cost and size of its loans, the original government buyer of mortgage loans couldn't compete with private firms in the subprime game. As a result, the agency's share of the loan market dwindled from its long-term average of 18 percent to less than 2 percent by 2007. "We were marginalized," FHA Commissioner Brian Montgomery said in July (der Hovanesian, 2008).

FHA growth during the boom years was also constrained, as noted by Bloomberg, by congressional limits on the maximum loan size FHA could insure. For example, house-price growth across the United States outpaced the growth of the FHA loan-limit ceiling leading into the crisis. From 1999 to mid-2005, the national median existing house price rose by 62 percent. By contrast, the FHA national loan-limit ceiling and floor rose by only 50 percent. In high-growth, high-cost states like California, the constraint was especially binding. According to the California Association of Realtors, the median-priced home in California increased by 252 percent during the 1999-to-2005 period. With house prices growing faster than the FHA loan-limit ceiling, the portion of the housing market that FHA was even eligible to serve declined rapidly in high-cost areas. This decline is clearly illustrated by the fact that FHA mortgage endorsements in California declined from 127,000 in FY1999 to less than 5,000 in FY2005. After the bust in 2007, loan ceilings for both FHA and the government-sponsored enterprises (GSEs) were raised temporarily in several pieces of legislation designed to broaden the ability of these agencies to provide a backstop to the market which was experiencing severe credit tightening. These loan-limit increases, which will be discussed further in the next section, leveraged the subsequent rebound in FHA's market share.

In addition to the loan-limit constraints FHA faced going into the crisis, and subsequent statutory expansions to these limits, the shifting market shares observed during this decade were also highly affected by underwriting standards. As noted in section I, lenders can more easily vary conventional underwriting standards, whereas the FHA has relatively fixed underwriting standards, which leads to nonprice rationing by conventional lenders in response to local differences in economic conditions

(Ambrose, Pennington-Cross, and Yezer, 2002). That is, lenders do not only raise prices when lending becomes riskier in areas experiencing economic downturns, instead, they tighten underwriting to ration the number of mortgages made in such an area. FHA, on the other hand, maintains its presence in all markets, providing stability and liquidity in markets experiencing recession.

Because FHA charges a mortgage insurance premium, many homebuyers who can qualify for conventional lending without mortgage insurance or with less costly private mortgage insurance choose conventional mortgages when the local economy is robust. When the local or national economy is weak, however, conventional lenders or private insurers tighten underwriting and reduce their exposures in these markets, and FHA home purchase mortgage market shares increase as FHA continues to provide liquidity.

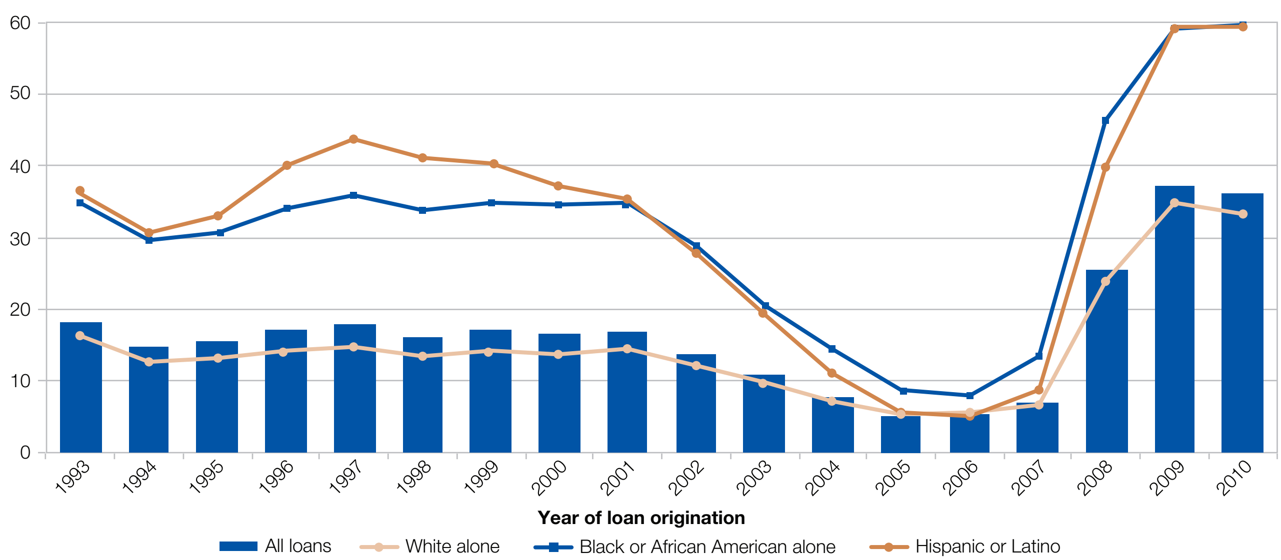
Thus, in good times, FHA home purchase mortgage market shares often decline as lenders loosen underwriting standards. This tendency was especially evident during the boom years (2002–2006) preceding the 2007 downturn as FHA home purchase mortgage market shares, especially those for racial and ethnic minority borrowers, fell dramatically.

During the boom years, conventional lenders also competed with FHA on product type variations in addition to price.[26] Many offered a range of nontraditional (often high-risk and high-cost subprime) loan products along with expedited underwriting decisions. These subprime loan products increasingly appealed to homebuyers who were facing ever-increasing home sales prices.

A disproportionate share of homebuyers taking these products were racial or ethnic minorities. Exhibit III-4, which uses data reported by lenders under the Home Mortgage Disclosure Act (HMDA) because that is the only readily available source of racial and ethnic composition of conventional mortgage originations, shows how the shifts in market share were greatest for African American and Hispanic homebuyers.[27] After the crisis hit, minority homebuyers were disproportionately affected by the dramatic tightening of conventional mortgage credit.

Exhibit III-4. Changes in FHA Shares for Minority Home Purchase Market Were More Pronounced Than for Other Groups

FHA as Share HMDA Reported Home Purchase Mortgage Originations by Race/Ethicity of Borrrower (percent)



Note: One- to four-unit (single-family) home purchase loan originations: first-lien, owner- and nonowner-occupant borrowers, including manufactured housing. The data are not adjusted for different coverage of FHA loans relative to convential loans; hence, FHA shares may be slightly overstated. For more details about coverage HMDA levels, see "A Look at the FHA's Evolving Market Shares by Race and Ethnicity," *U.S. Housing Market Conditions*, Q1 2011.

Source: Home Mortgage Disclosure Act

[26] FHA was also restricted in many markets by low loan limits.

[27] When selecting HMDA data records for exhibit III-4, the criteria were to include only reported one- to four-unit (single-family) home purchase loan originations that were secured by first-lien mortgages, representing both owner- and nonowner-occupant borrowers, and including purchases of manufactured housing.

Jaffee and Quigley (2010) attribute the decline in FHA loans during the boom years to subprime lending, predatory lending, and the failure of the FHA to keep up with the lending industry technology. They point to advances in underwriting technology, contract (mortgage product) innovation, and growth in private mortgage securitization, in addition to GSE competition.

Thus to some, it appeared that FHA had been relegated to a small niche role by a nonprime conventional market that used new technologies to (1) design products that would appeal to FHA's traditional borrowers, (2) render faster credit underwriting and pricing decisions, and (3) pass along the risk through complex securitization structures. It also appeared that the prime conventional market contributed to the decline in FHA market share because of increased efforts by the GSE to lend to FHA's former clientele in part attributable to HUD's affordable housing goals for the GSEs.

Shift Toward the Nonprime Sector. The observations by Jaffe and Quigley with regard to the shift toward the nonprime sector was shared by the Government Accountability Office in a 2007 report on FHA market share (GAO, 2007). The GAO report also suggested this shift to nonprime resulted in a deterioration in FHA's risk profile. Specifically, the GAO noted—

> The decline in FHA's market share was associated with a number of factors and has been accompanied by higher ultimate costs for certain conventional borrowers and a worsening in indicators of credit risk among FHA borrowers. More specifically, (1) FHA's product restrictions and lack of process improvements relative to the conventional market and (2) product innovations and expanded loan origination and funding channels in the conventional market—coupled with interest rate and house price changes—provided conditions that favored conventional over FHA-insured mortgages. In contrast to FHA-insured loans, the majority of conventional subprime loans had higher ultimate costs to borrowers, partly because their initial low interest rates could increase substantially in a short period of time. (GAO, 2007a:5)

In comments to Jaffee and Quigley, Wachter (2011) notes that subprime mortgages are designed for borrowers with impaired credit records. Unlike FHA insured (and GSE guaranteed) mortgages, subprime mortgages "price" the risk. For borrowers who meet the risk thresholds of the FHA (and similarly the GSE portion of the conventional market), a more or less uniform mortgage rate is charged for accepted loans. That is, FHA's risk-based pricing is limited, and lower risk borrowers (who, as noted by Bunce et al., 1995, are relatively lower risk among all FHA borrowers, but are generally too risky for the prime conventional market) cross-subsidize higher risk borrowers. That has been FHA's business model over its history. For much of its history, the conventional market did not price risk either—rather it generally followed a credit-rationing paradigm to manage risks—until the advent of the past decade.

With new risk-based pricing and product development technologies available in the market, FHA's continued reliance on cross-subsidies would arguably drive FHA's better risks (based on a combination of borrower and loan characteristics) to the portion of the conventional market where risks are "priced" at the loan level, leaving FHA with a dwindling book of ever riskier loans. The key question sparked by FHA's huge drop in market share in mid-decade was whether FHA's insurance model of cross-subsidization had been rendered obsolete. Alternatively, would FHA's full embrace of the new market paradigm based on the new technologies and product mix contribute to pro-cyclical swings, in effect negating one of FHA's main missions of promoting market stability?

During the boom, subprime underwriting criteria were "liberal to nonexistent" and the high cost of these loans was often masked by short-run mortgage payments (before teaser rates adjusted) that were lower, giving borrowers the perception that the loan was affordable (Wachter, 2011). The reality was that the subprime loans being made both lacked suitability for borrowers, and at the same time were not fully pricing the high level of risk the products entailed. According to Wachter (2011) subprime loans were much higher risk than FHA loans without bearing sufficiently higher return (to investors) to cover the risk. Thus the experience in the nonprime market during the boom years preceding 2007 does not make the case that FHA's model of cross-subsidization is obsolete.

Shift Toward the Prime Sector. To better understand the shift toward the prime conventional sector that FHA may have experienced up until the housing crisis began in 2007, it is helpful to present a brief history of the affordable housing goals that HUD had established for the GSEs. Until 2009 HUD had been the mission regulator for Fannie Mae and Freddie Mac, and a major aspect of this regulation involved setting minimum percentage-of-business goals for the GSEs' mortgage purchases. These housing goals measured the enterprises' respective levels of support for very low-income and low- and moderate-income lending and lending in underserved geographic areas. The main objective of the housing goals was to increase GSE investment in underserved areas and GSE financing of underserved borrowers in return for the many cost advantages afforded the enterprises through their public charters. The housing goals also intended to encourage Fannie Mae and Freddie Mac to introduce new affordable lending programs in underserved areas and to make prudent adjustments in their mortgage purchase standards that recognize the special circumstances of low-income families and others who have found it difficult to access credit in the conventional mortgage market. Through a rulemaking process, HUD periodically established specific targets for these goals since the passage of the Federal Housing Enterprises Financial Safety and Soundness Act (FHEFSSA) of 1992 and until the passage of the Housing and Economic Recovery Act (HERA) in 2008, which transferred the housing goal function to the newly formed Federal Housing Finance Agency.

As noted by Weicher (2010), a major policy issue regarding the setting of GSE goals was whether these enterprises should "lead the market" or continue to "lag the market" as had historically been the case. Leading the market means the fraction of an enterprise's mortgage purchases for a given year that qualify for one of the goals would be greater than the corresponding fraction for the entire conventional mortgage market (including GSE loan purchases plus loans originated by portfolio lenders, community-based lenders, and FHA/U.S. Department of Veterans Affairs, but excluding subprime loans classified as "B and C"). The housing goals set by HUD during 1993 through 2004 required the GSEs to raise their share of business for each goal category relative to past performance, but these goals could be met while the enterprises continued to lag the market. In its November 2004 GSE Rule, however, HUD increased the goal percentages for 2005 to 2008 to levels that were designed to bring the GSEs' performance to the upper end of HUD's market range estimates for each goal, consistent with the FHEFSSA requirement that HUD should consider the GSEs' ability to lead the market. Because HUD had to project the size of goal qualifying shares in the market to set the goals, actual market goal-qualifying percentages would vary from the ex-ante HUD projections. Weicher (2010) shows that in 2005 and 2006, it was still possible for the GSEs to meet the goals and lag the market (as ex-post actual market goal-qualifying shares came in above the HUD projections) but in 2007 and 2008, for two of the three main goals (low- and moderate-income, and special affordable) the goal targets exceeded the actual market levels.

Both Fannie Mae and Freddie Mac responded to the higher housing goals over the years by expanding their suites of mortgage products targeting low- and moderate-income buyers. As noted by GAO (2007b),

> These products, in combination with the historically low interest rates, made it easier for homebuyers to purchase homes in a period of strong house price appreciation. For example, to serve the lower-income and minority populations targeted by their affordable housing goals, the GSEs developed products featuring underwriting criteria that allowed for higher risks, such as Freddie Mac's Home Possible® Mortgage, which allows qualified borrowers to make no down payment. As the GSEs worked to meet their goals, their market share among lower-income and minority borrowers grew over much of the 10-year period we examined [1996 to 2005], while FHA's fell (GAO, 2007a: 11).

Consistent with these observations, research by An and Bostic (2008) found a significant negative relationship between the change in the GSE and FHA shares of the overall mortgage market using data at the census tract level over a period spanning 1996 through 2000, and these authors attribute the shift to the HUD affordable housing goals. Unfortunately similar research covering the period of 2005 to 2008 is not available. This key period corresponds to a dramatic loss of FHA market share to the nonprime market and the previously mentioned HUD policy decision to raise the housing goals to levels corresponding to meeting or leading the market. The market shares for both FHA and the GSEs ultimately declined after 2002, however, which suggests that the main driver of FHA market share declines may have been to the nonprime sector.

FHA's Response to the Changing Market

FHA did not participate in exotic mortgages with low initial teaser rates used to qualify borrowers who might not be able to afford the fully indexed rate after the expiration of the initial rate period. FHA also did not loosen its underwriting to permit less than full documentation loans, nor did it permit "piggy-back" structures that use second mortgages to fund downpayments, nor did it permit prepayment penalties.[28] To compete successfully in the boom years leading up to the crisis, FHA might have offered the teaser rate adjustable-rate

[28] The one truly high-risk product that FHA permitted until it was prohibited by law by HERA were loans with downpayment gifts from nonprofit organizations that were funded by the sellers of the property.

mortgages (ARMs) that were at the center of the subprime crisis and arguably a major source of the growth in subprime and resulting loss of FHA market share. Alternatively, it may have extended mortgage insurance to mortgages that contained other exotic features. It may be that the growth of teaser rate ARMs, in particular, enabled the subprime sector to outcompete the FHA, because these loans were initially more affordable (while the teaser rate was in effect) in a period of rising housing prices, when other loans were not. Of course, FHA would not likely have offered such loans because they would not likely meet a standard of suitability (and may not have been permitted under existing statutory or regulatory authorities of FHA), but if the FHA were to have extended itself into these products, Wachter (2010) suggests it would likely have required immediate taxpayer support for FHA and a bailout after the boom ended, undermining the ability for FHA to assist the struggling mortgage market and borrowers in distress during the crisis.[29]

FHA … did not change course from [its] fundamental mission in response to shifting market shares.

Thus, FHA met the challenge posed by the market shifts that caused its market share to decline by continuing to offer its traditional line of business. To the extent advances in technology were a causative factor, note that FHA embraces technological advances where appropriate to better serve the public through more efficiently meeting its basic mission with soundly underwritten mortgages, but it did not change course from that fundamental mission in response to shifting market shares in a period in which the capital markets had a high appetite for mortgage product with little regard for its underlying credit risk.

Although both Jaffee and Quigley (2010) and GAO (2007a) have suggested that the loss of FHA market share during the precrisis boom years may have resulted in adverse selection and a higher overall risk profile for FHA, the decision by FHA to maintain relatively consistent underwriting ultimately put the agency in a better position to respond to the severe tightening of credit after 2006, and the result was a dramatic shift of market share back to FHA starting in 2008. Furthermore, a review of FHA's MMI Fund actuarial review for FY 2007 does not indicate a dramatic increase in FHA's portfolio risk characteristics in the10 years preceding 2008.[30]

III-3. FHA Eliminated High-Risk Seller-Funded Downpayment Gift Mortgages

Although FHA did not follow the market's lead into teaser rate ARMs, low documentation loans, or piggy back second liens, it did offer one loan product which proved to be high risk: loans with downpayment gifts from nonprofit or charitable organizations where the gift funds were ultimately replenished to the organization by the seller of the home.

Starting in 2000, the share of loans with gift letters from nonprofit, religious, or community entities increased rapidly. Most of these gifts from nonprofit organizations involved funds which were supplied by contributions from the homesellers involved in the specific transactions, and possibly financed by inflated house values, as noted in a 2007 report by GAO.[31] This concentration reached about 10 percent by FY 2003 and increased dramatically to more than 20 percent in FY 2005. As a share of home purchase loans, the concentrations peaked at more than 30 percent between 2005 and 2007.

Often the borrowers who received the seller-funded downpayment gift had weak credit histories as well. The combination of low or zero equity in a property often sold at an inflated sale price to a buyer with weak credit history resulted in a group of loans that on average had a frequency of mortgage insurance claims that was two to three times the average for other comparable FHA loans.

[29] For further discussion of how FHA resisted the temptation to preserve market share by relaxing underwriting as other providers raced to the bottom, see Van Order and Yezer (2011) and Reeder and Comeau (2008: 9–11).

[30] Specifically, the 2007 actuarial report noted the distribution among FHA's initial LTV categories shifted after 1998, with increased percentages of FHA's business comprising loans with LTV of 97 percent or higher. For example, the percentages of FHA's loans endorsed during FY 2005–2007 falling in the 97-percent-or-above category were 55.5, 49.3, and 42.3, respectively, compared with 22.9 in 1998. (One explanation for the post 1998 jump is that FHA instituted downpayment simplification guidance in 1998 that replaced a cumbersome formula for maximum LTV. The formula change resulted in maximum LTVs for some loans that formerly would have fallen in the 95- to 97-percent category rising to 97 percent. See FHA Mortgagee Letter 98-29. Partially offsetting this increase in the highest LTV category, however, the years following 1999 also showed a corresponding decrease in loans with LTVs between 95 and 97 percent, with the overall effect being that roughly equal percentages of FHA's loans (42 percent) had LTVs less than 95 percent in 2007 and in 1998, with somewhat lower percentages in this lower risk category during the intervening years.

[31] The seller made a donation to the nonprofit or charitable organization in an amount equal to the downpayment gift plus a small additional amount that would be retained by the organization. The downpayment gift often came from a fund operated by the organization, and this fund would be replenished by the donation from the seller after the sale had been completed. Often, sellers would recoup their donations through raising asking prices for the home by an equal amount. The GAO did an analysis and found that seller-funded downpayment contributions may have inflated selling prices by about 2 to 3 percent. See GAO (2007b).

FHA Never Intended To Permit Seller-Funded Downpayments

Back in the mid-1990s, the National Housing Act required homebuyers to pay a minimum contribution (generally at least 3 percent) of the cost of acquisition of a property for the mortgage to be eligible for insurance by FHA. The statute and the implementing regulations were originally silent about permissible and/or impermissible sources of the mortgagor's investment. Then legislation was enacted in 1996 to permit family members to provide gifts and loans to other family members. FHA followed with guidance published in handbooks and mortgagee letters a broad range of other permissible sources of the mortgagor's investment beyond the homebuyer's own cash savings. These sources included the aforementioned gifts and loans from family members, but also extended permissible sources to include the borrower's employer, government agencies, and charitable organizations. Nowhere did FHA extend permission to obtain downpayment funds from the seller of the property.

Nowhere did FHA extend permission to obtain downpayment funds from the seller of the property.

The prohibition of seller provision of downpayment funds is widely accepted in the conventional lending sector as well. FHA permitted limited amounts of seller contribution for other borrower charges such as closing costs, with instructions for appraisers to adjust the property value downward dollar-for-dollar for excess seller contributions (see FHA Mortgagee Letter 2005-2).[32] The statutory minimum contribution by the borrower, however, clearly was never intended to be permitted to come from the seller. Downpayment gifts from relatives, employers, government, or most charitable organizations were considered to come from parties not participating directly in the sales transaction.

In the 1990s, however, some charitable organizations began to circumvent the FHA restrictions in various ways, including the establishment of a fund that provides the "gift" to the homebuyer. As noted previously, the fund is immediately replenished by the seller providing through a "charitable donation" or a "service fee" to the nonprofit from the proceeds of the sale of the home, and the seller does so only if the homebuyer is using the charitable organization's downpayment assistance program.

In September 1999, FHA published a proposed rule to establish standards regarding the use of gifts by charitable or other nonprofit organizations as a source of an FHA's mortgagor's investment in the mortgaged property.[33] Specifically, the standards would provide that gifts could not be made from funds that the organization received, directly or indirectly, from the seller of the property. Arguments were made that the seller donation to the charitable or nonprofit organization after the consummation of the sale did not constitute a gift from the seller, however, and therefore the gift was to be treated as coming from the organization. FHA eventually withdrew the proposal in January 2001 as HUD received 1,871 public comments of which only 21 favored the rule, and especially after litigation opposing the ban was successful. Thus, FHA was thwarted in its initial attempt to prohibit this type of downpayment gift, which was known to contribute to elevated mortgage insurance claim rates.

In 2006, FHA approached the problem from a different perspective. By this time the share of FHA home purchase loans with seller-funded downpayment gifts was exceeding 30 percent and these loans were experiencing cumulative claim rates that were two to three times the rate for other comparable FHA loans. FHA consulted with the Internal Revenue Service to obtain clarification from the tax authorities on the eligibility of organizations offering this type of downpayment gift to qualify for nonprofit status under section 501(c)(3) of the IRS code. FHA issued Mortgagee Letter 2006-13 to clarify that eligible sources of the borrower's contribution included gifts from charitable organizations and nonprofits, but only those that were "exempt from income taxation under section 501(a) of the Internal Revenue Service Code (IRC) of 1986 pursuant to section 501(c)(3) of the IRC."[34]

At the same time, IRS issued its Bulletin 2006-21, which stated that the manner in which an organization receives funding for its downpayment gifts matters regarding the organization's eligibility for tax-exempt status under section 501(c)(3). The IRS bulletin states that in cases in which the organization relies on sellers and other real estate-related businesses that stand to

[32] http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/letters/mortgagee.

[33] Docket No. FR-4469-P-01, published September 14, 1999.

[34] http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/letters/mortgagee.

benefit from the transactions, that organization would not qualify under 501(c)(3). Although it appeared that the combined effects of Mortgagee Letter 2006-13 and IRS Bulletin 2006-21 would be to curtail the practice of seller-funded downpayment gifts, the result was that high volumes of these loans were still being endorsed following the IRS announcement. It appeared that removal of 501(c)(3) status from the organizations involved was not easily accomplished and that the organizations likely revised their business models sufficiently to argue that they remained in compliance with section 501(c)(3) as clarified by Bulletin 2006-21.

FHA Received Statutory Relief in 2008

Ultimately the elimination of the seller-funded downpayment gifts would be accomplished through statutory prohibition of the practice. The passage of HERA on July 30, 2008 finally terminated seller-funded downpayment assistance for loans underwritten on or after October 1, 2008. Specifically section 2103 of HERA stated in no case shall the funds required for the borrower's minimum cash contribution consist, in whole or in part, of funds "provided by the seller or any other person or entity who stands to benefit from the transaction" and that the prohibition applies to funds that may have been provided "during or after closing of the property sale."

Although a surge of these loans was observed immediately before the effective date of the HERA prohibition which spilled over as cases endorsed for FHA insurance immediately after that date, the endorsement of seller-funded downpayment assistance loans decreased rapidly soon thereafter. By the second quarter of FY 2009, these loans accounted for less than 1 percent of total endorsements. The steep decline in seller-financed downpayment assistance in FY 2009 and later years will have a significant effect in reducing losses on future FHA loans.

Section IV. Response to the Crisis: FHA Keeps Credit Flowing and Helps Distressed Homeowners

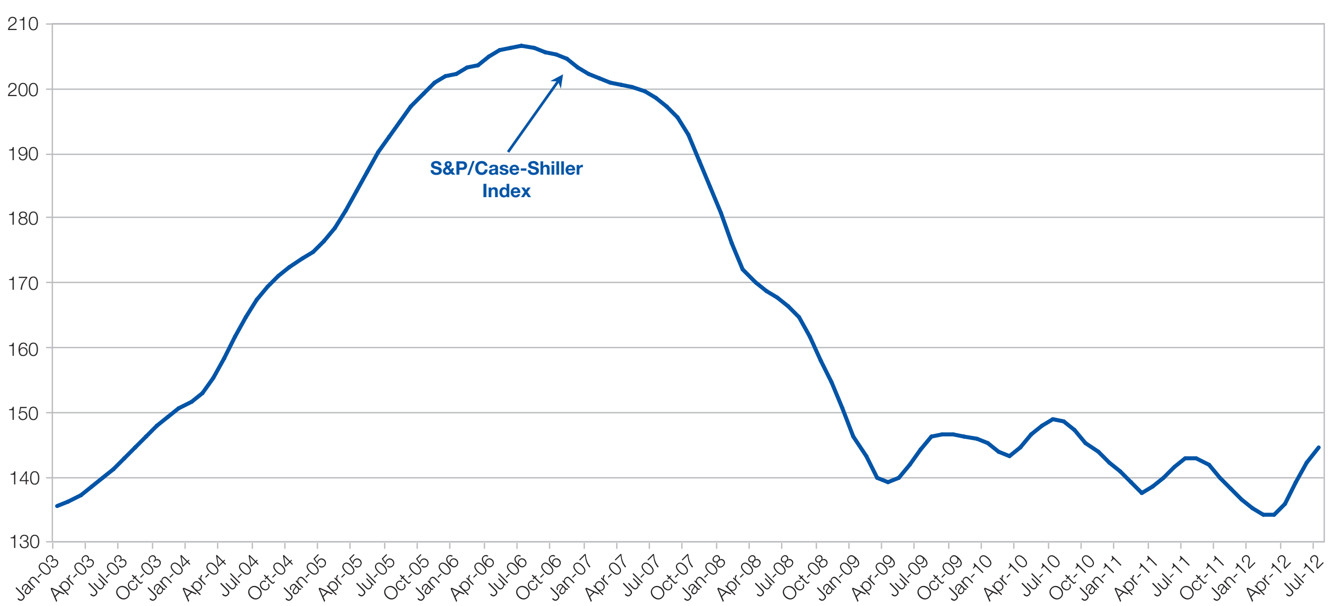
The years since 2000 have been very challenging for the Federal Housing Administration (FHA), requiring it to make and implement policy decisions in response to rapidly changing market conditions, and more recently to assume a major countercyclical role. In the previous section, we saw how FHA did not succumb to pressures to compete with the subprime sector on product types in a "race to the bottom" that would have proved to be very risky for FHA, despite its market share dropping to historic lows in the years just before the start of the crisis in 2007. Beginning in 2007, FHA began to focus on its countercyclical role as conventional credit dramatically tightened in response to the rise in delinquencies and foreclosures among subprime mortgages and the drop in home prices. Home prices continued falling for 33 consecutive months through early 2009, and the FHA played a major part in the government's efforts to slow this trend and stabilize prices (see exhibit IV-1). Mark Zandi, chief economist at Moody's Analytics, offered this assessment of FHA's role during the crisis.

> The FHA had been virtually dormant during the housing bubble, but it made about one-third of all U.S. mortgage loans in the period after the bust. Without such credit, the housing market would have completely shut down, taking the economy with it. The effort took a toll on the agency's finances, but so far the FHA has avoided turning to taxpayers for help, making it one of the few housing-related enterprises—public or private—that have not (Zandi, 2012).

An important component of FHA's mission is "…to stabilize credit markets in times of economic disruption" (HUD, 2012a). During the years leading up to the housing bubble (roughly 2000–2006), FHA continued to keep its underwriting standards and product mix roughly constant. As detailed in this section, however, the rest of the market was fueled during this time by rising house prices, loose underwriting standards and exotic mortgages that proved ultimately to be unsustainable. As a result, FHA's market share and loan volumes declined during this period. After the bursting of the housing bubble and the collapse of the private-label securities (PLS) sector through which many of the exotic mortgages were financed, FHA focused on its stabilization role in the credit and housing markets in many ways. FHA enabled homeowners with unsustainable conventional loans to refinance into more suitable FHA loans, and offered sustainable financing for new home purchases. It helped FHA borrowers reduce monthly payments with streamlined refinances.

Exhibit IV-1. Home Prices Peaked in Mid-2006 and Began a 33-Consecutive-Month Decline Through April 2009

Index Value (Jan 2000 = 100)



Source: Standard & Poor's

FHA also enhanced its loss-mitigation strategies and its retention and nonretention alternatives for distressed borrowers facing foreclosures.

IV-1. Rising Home Prices Minimized FHA's Role

In the 1990s nonbank mortgage lenders emerged to operate without many of the regulations governing traditional banks. Many of the new lenders specialized in loans to borrowers who could not qualify for traditional mortgages because of poor credit or low incomes and supplied/sold the mortgages to mortgage-backed security (MBS) issuers.[35] The issuers passed the risk on to investors around the world who at the time were eager to buy MBS carrying higher yields than those offered by safer investments such as U.S. Treasury bonds (Knowledge@ Wharton, 2007). Following the burst of the dot-com stock market bubble in early 2000, U.S. GDP growth began to slow and the Federal Reserve began cutting interest rates to stimulate the economy. After the terrorist attacks on September 11, 2001, the Federal Reserve cut interest rates six more times between 2001 and 2003 (Federal Reserve Bank of New York, 2012). Mortgage lending peaked in 2003, driven by a surge in refinancing as the Federal Reserve cut interest rates to exceptionally low levels.

After 2003, home prices rose and private sector underwriting standards declined. Exceptionally low rates of returns on savings accounts and stock market decline led many households and investors to turn to housing attracted by higher returns and low borrowing costs (Zandi, 2012). Low Treasury bond yields attracted both domestic and foreign investors to the higher yielding agency MBS and PLS. PLS traditionally played a very minor role in funding home mortgages, with a market share of just more than 2 percent in 1990, yet, at the home price peak in 2006, PLS issuers accounted for more than 20 percent of the home mortgage market (Federal Reserve Board, 2012a). As demand for mortgaged backed securities grew, traditional mortgage originators evolved from underwriters of portfolio mortgages to financial intermediaries in an originate-to-distribute business model. Without a vested stake in the performance of the mortgages the underwriters originated, prudent underwriting was subordinated to increasing volume and generation of loan processing fees. Similarly, PLS securitizers, driven by fees associated with the securitization and sale of PLS put little emphasis on prudent underwriting, which made FHA underwriting requirements less attractive and reduced the demand for FHA insured loans.

FHA's reluctance to relax its underwriting standards and expand its product mix resulted in a decline in market share at the peak of the housing bubble. FHA's institutional capacity enabled it to step in when private capital withdrew after the bursting of the bubble, however.

Rising home prices obscured the riskiness of the mortgages pooled in PLS or being purchased by the government-sponsored enterprises (GSEs) as borrowers extracted equity gains with more highly levered affordable payment refinancing (often with new introductory teaser rates) or purchased new, second, or investment homes (Reeder and Comeau, 2008: 9–11).

During this period, FHA kept its underwriting standards fairly constant which led to a sharp decline in market share of originations as borrowers were attracted to subprime and Alt-A mortgage loans with their minimal qualifying requirements and documentation standards.[36] As underwriting standards continued to be relaxed, exotic mortgages products such as 3-27 and 2-28 hybrid adjustable-rate mortgages (ARMs), interest-only (IO) mortgages, and payment option ARMs with negative amortization features permeated the market posing risks that were often poorly understood by borrowers and investors alike.[37] FHA's reluctance to relax underwriting standards resulted in endorsements contracting as housing prices peaked, but FHA

[35] Asset-backed securities vary in type of financial assets that back the securities. ABS differed from agency (Ginnie Mae, Fannie Mae, Freddie Mac) mortgage-backed securities in that the types of mortgage collateral backing them were often subprime or low-documentation mortgages that did not conform to agency underwriting standards.

[36] At the peak of the bubble in 2004–2006, some private sector underwriters issued SISA (stated-income, stated assets), NINA (no income, no assets), and NINJA (no income, no job or assets) mortgages where borrowers did not have to show any proof of the income, assets, or employment that would be used to make their monthly mortgage payments.

[37] Alt-A mortgages and payment option-ARMs were originally designed for borrowers who were self-employed and thus were unable to document income from an outside employer or who had income that was variable and thus variable payments would enable them to adjust mortgage payments to match seasonal income. The products may be useful in such specialized situations, however, during the relaxed underwriting of the past crisis these mortgage products were often used to qualify borrowers for a larger, more expensive home than their income could support, an untenable situation that overextended borrowers and put them at risk of losing their home.

retained the institutional capacity necessary to expand and provide countercyclical support when private capital withdrew from the market.

At the start of the first decade of the 2000s, FHA originations counted for more than 14 percent of mortgaged home purchases; by the middle of the decade FHA's share had fallen to less than 5 percent before growing to more than 30 percent of mortgaged home purchase originations by the end of the decade.[38]

IV-2. The Housing/Economic Contraction: FHA Helps Stop the Downward Spiral

As home prices peaked and began to decline, delinquencies increased and lenders withdrew credit from the conventional mortgage market in two ways: by lenders tightening underwriting standards and by the closure or bankruptcy of mortgage lenders.

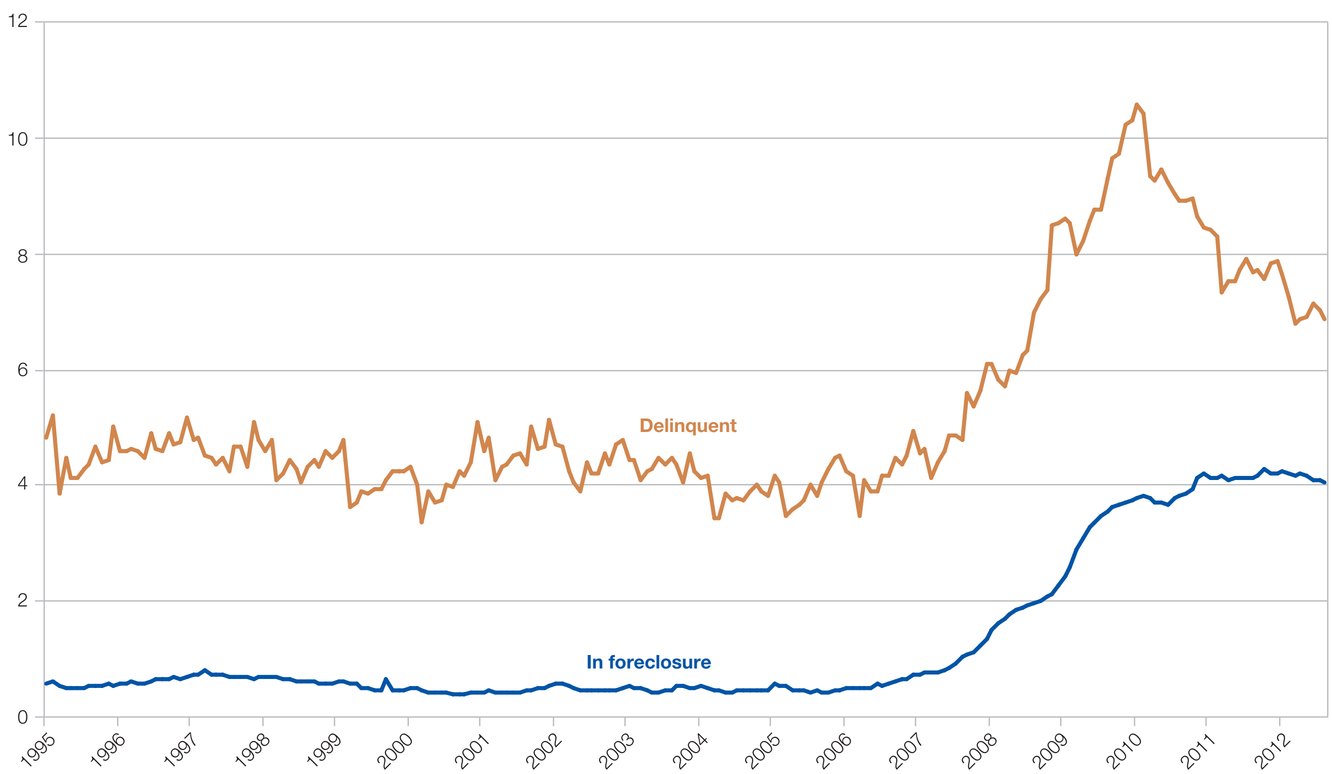
Tightening of underwriting standards by lenders is discussed further in this section (see exhibit IV-11, showing the sharp increase in the net share of senior loan officers reporting tighter underwriting conditions after late 2006).

Between 2007 and 2010, the Federal Deposit Insurance Corporation was appointed the receiver of 325 failed banks, a huge increase from their receivership count of 24 failed banks between 2000 and 2004. Fear in financial and housing markets reached a crescendo in September 2008 with the bankruptcy of Lehman Brothers, the fourth largest U.S. investment bank at the time, and the conservatorship of the GSEs, Fannie Mae and Freddie Mac, which were precipitated by rising losses on mortgage loans as defaults and foreclosures rose to historically high levels. Market turmoil and stress were very high as shown by the sharp increases in the delinquency and foreclosure levels in exhibit IV-2.

In other words, housing and mortgage markets were in a self-perpetuating downward home-price and rising default

Exhibit IV-2. Market Stress Levels Evidenced by Rapid Rise in Delinquency and Foreclosure

U.S. First-Lien Mortgage Performance, Percent of Active Loans

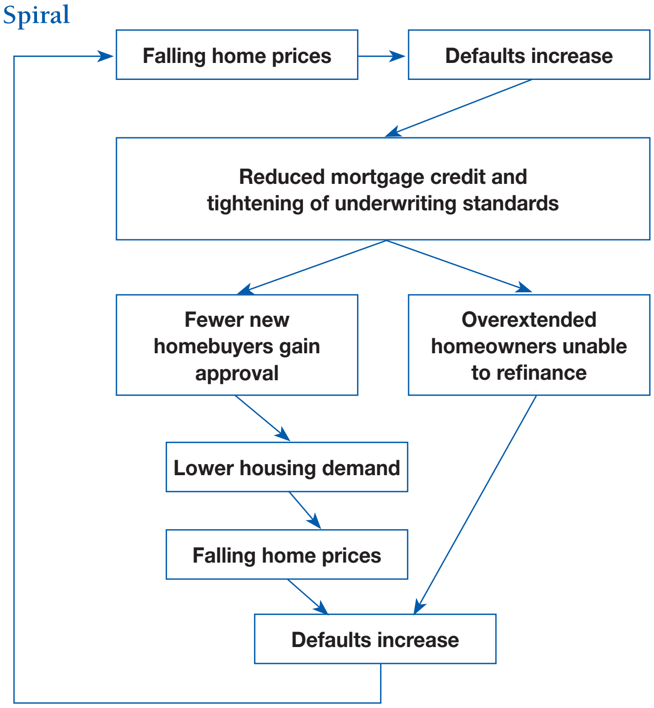


Source: LPS Applied Analytics

[38] Calendar year home purchases by loan count. Source: FHA

spiral (summarized by exhibit IV-3), which provided the impetus for federal actions and policies that were intended to break this self-perpetuating spiral. FHA's countercyclical role providing increased mortgage credit flows to counteract the overtightening of underwriting standards is a crucial component of these federal actions. FHA (and GSE) loan limits were temporarily increased by the passage of several pieces of legislation during 2008 and 2009 intended to support housing and economic recovery (specifically the Emergency Economic Stabilization Act [EESA] of 2008, the Housing and Economic Recovery Act [HERA] of 2008, and the American Recovery and Reinvestment Act [ARRA] of 2009) which extended FHA access to more homebuyers and enabled more borrowers in the conventional market to use FHA to refinance into lower interest rates, reducing monthly payments. In addition to extending access to more homebuyers and existing homeowners seeking to refinance, FHA was also key in the successful temporary surge in homebuying and associated temporary price increase (which helped stem the free fall of prices) from the First-Time Homebuyer Tax Credit program in 2009 and 2010. Furthermore, FHA improved its loss mitigation policies and strategies to assist about 1.4 million distressed homeowners with existing FHA mortgages to retain their homes. Finally, FHA took steps to shore up its finances and risk management process so that it could balance its mission objectives with its requirement to operate in an actuarially sound manner.

Exhibit IV-3: Self-Perpetuating Home Price and Default Spiral



IV-3. FHA Maintained Access to Credit During the Crisis

The boom and bust in home prices and the ensuing mortgage credit crunch highlighted the importance of maintaining access to credit for not only homebuyers, but also homesellers. Support for falling home prices requires that sellers be able to find buyers who can access credit under reasonable terms.

The bust also stressed the need to maintain credit with sound, but not overly restrictive, underwriting standards. By not loosening underwriting standards and by not originating unsustainable mortgages such as option ARMs and loans with less than full documentation during the runup of the housing bubble, FHA played an important role as a standard bearer of sound underwriting. Yet, unlike the conventional market, FHA did not subsequently severely tighten its underwriting standards after the bubble burst, which could have exacerbated the downward spiral in home prices and defaults and reinforced the market instability shown in exhibit IV-3. Indeed even as credit standards tightened significantly in the conventional market each quarter from the first quarter of 2007 through the second quarter of 2010, FHA, with modest tightening of underwriting requirements was able to play a countercyclical role, increasing originations from 528 thousand in 2007 to 1.98 million in 2009 (Federal Reserve Board, 2012b).

As noted above, to balance its countercyclical role during the crisis with its requirements to remain actuarially sound, FHA did take deliberate steps to adjust underwriting standards and pricing to reduce its highest risk loans and bolster the adequacy of FHA's Mutual Mortgage Insurance (MMI) Fund and capital reserves. The actions taken by FHA to shore up its financial condition include the following:

1. Eliminated high-risk seller-funded downpayment gift loans.
2. Raised mortgage insurance premiums.
3. Raised minimum cash contribution from homebuyers from 3 to 3.5 percent as required by HERA.
4. Instituted better management practices, including establishment of the Office of Risk Management and more frequent reporting to Congress on MMI Fund condition.
5. Expanded loss mitigation interventions for defaulted borrowers, which in addition to helping borrowers retain their homes, also mitigates FHA losses.

6. Modest tightening of underwriting requirements, including establishment of a minimum consumer credit score, increased downpayment requirements on certain higher risk loans (those with low credit scores), and limiting seller contributions to closing costs.[39]

Although FHA did take the above steps to improve its financial condition, the agency also resisted pressure from critics to make substantial increases to downpayment requirements, thereby maintaining access to low-downpayment loans when others were exiting this segment.

Exhibit IV-5 (which appears later in this section) provides a detailed breakout of the types of loans FHA was insuring leading up to the crisis (during fiscal years [FY] 2004 through 2006) and their cumulative claim (foreclosure) rates, which provide a partial measure of the relative performance of each group of loans insured. Exhibit IV-6 (which follows exhibit IV-5) shows a detailed breakout similar to that in exhibit IV-5 but showing FHA's response to the crisis in FY 2007 through 2009. The tables clearly show the volumes of poor-performing loans with high-risk downpayment gifts that FHA had been trying to end declined rapidly after the legislative relief of 2008, and volume of new home purchase business, conventional-to-FHA refinances, and FHA-to-FHA refinances rose rapidly after 2006.

FHA Enabled Refinances

Not widely known is the fact that FHA provided support for the refinance segment of the housing market during the crisis. Beginning in 2007, FHA stepped in to enable growing numbers of homeowners facing large interest rate resets from expiring teaser rates on conventional ARMs to avoid large payment shocks. These conventional-to-FHA "product refinances" helped hundreds of thousands of borrowers who met FHA's standard underwriting criteria to convert conventional mortgages facing (or which already had received) monthly payment increases into far more sustainable FHA loans. Cagan (2007), who examined more than 8 million conventional ARMs originated between 2004 and 2006, found that given interest rate levels prevailing as of the time of his analysis, 39 percent would face a payment increase of between 25 and 50 percent on initial reset, 10 percent would face a payment increase of 51 to 99 percent, and 15 percent would face a payment increase of 100 percent or more (Cagan, 2007). If the borrower had sufficient equity and credit quality to qualify for an FHA loan, he/she could have refinanced into a fixed-rate FHA loan at a much lower payment than the fully indexed ARM rate. This advantage was somewhat negated after 2007 as policies by the Federal Reserve and other factors brought mortgage rates down to historic lows, reducing the potential for large payment shocks for conventional ARMs. Nevertheless, during 2007-2009 in particular, conventional-to-FHA refinance volumes rose rapidly. Because these loans were fully underwritten to FHA standards, their early performance has not been materially different than FHA's other fully underwritten loans in the same years (see exhibits IV-5 and IV-6 later in this section).

The FHA's countercyclical support enabled borrowers with unsustainable conventional mortgages to refinance into fixed-rate FHA mortgages.

In addition to providing help to homeowners with unsustainable conventional loans, FHA also enabled borrowers with existing FHA loans to refinance through its streamlined FHA-to-FHA refinance programs. Streamline refinancing, which was an option for FHA borrowers that existed before the crisis, became increasingly important during the crisis as a way for FHA borrowers who might not otherwise qualify to take advantage of lower interest rates to reduce monthly payment burdens. The idea underlying a streamline refinance is that FHA, which already held the default risk on the loan, would not be taking on new risk if it insured a *rate or term* refinance of the loan (with no cash out other than to cover closing costs), even if the loan were underwater, or if the borrower's credit history had deteriorated. A rate or term refinance involves either a reduction in the mortgage rate (to reduce monthly payment) or a change of the loan term (for example, from 30-year to 15-year—provided the new monthly payment does not exceed previous monthly payment) without the borrower taking any cash away from the

[39] Mortgagee Letter 10-29 restricted maximum financing to borrowers with a credit score of 580 or higher, maximum financing equal to 90 percent loan-to-value ratio for borrowers with a credit score of 500 to 579, and made borrowers with a credit score below 500 ineligible for FHA insurance. According to Fair Isaac, from 2005 to 2011 Americans with credit scores of less than 500 represented 6.3 to 7.3 percent of the U.S. population. Thus, after tightening its underwriting guidelines, FHA financing remained available for approximately 93 percent of the U.S. population. Mortgagee Letter 10-29 reaffirmed that applicants with nontraditional credit history or insufficient credit (either of which could cause the applicant to have no credit score available) remain eligible for maximum financing if they meet the underwriting guidance in HUD Handbook 4155.1 4.C.3. Mortgagee letters can be accessed at http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/letters/mortgagee.

transaction. As such, the original loan would not be required to be reunderwritten to approve the new streamline refinance loan.[40]

As explained previously, FHA's enabling of refinances was pivotal in arresting the self-perpetuating home price and default spiral shown in exhibit IV-3. The volumes of conventional-to-FHA refinances ranged from a low of 33,581 in 2005 and increased in each of the next 4 years, reaching 468,644 refinances in 2009.[41] FHA-to-FHA refinances, including streamline refinances, also increased during this period from 124,902 in 2005 to 367,802 in 2009.

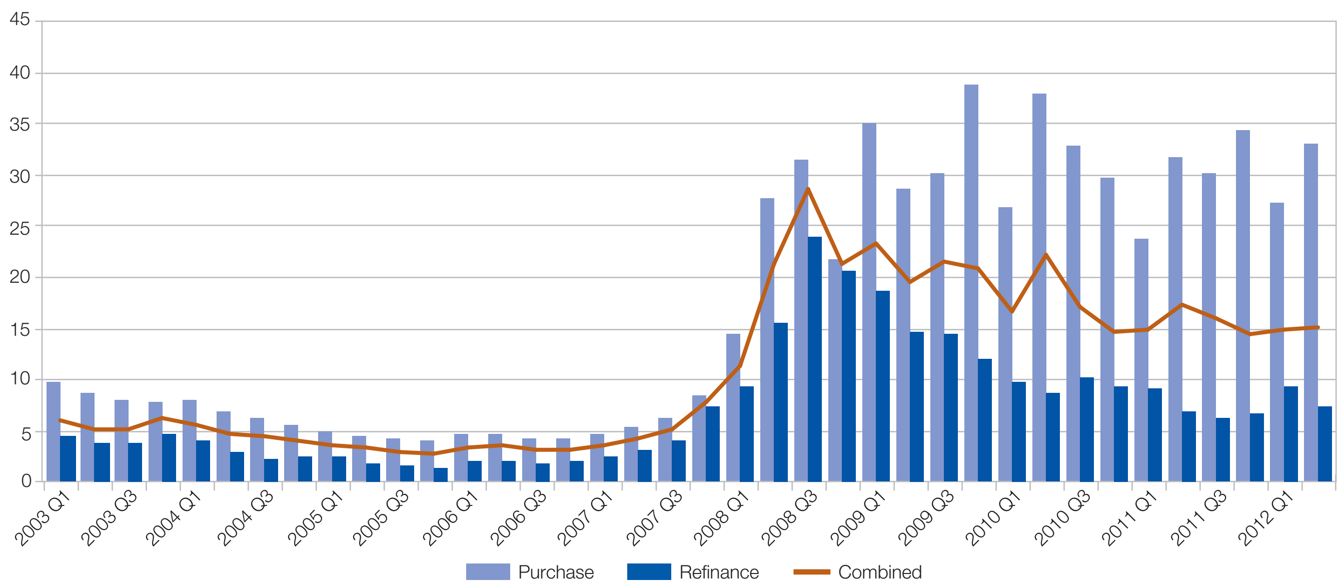
Although overall market origination volumes declined in 2007 and 2008, the total number of FHA originations increased by more than 29 percent in 2007 and 166 percent in 2008. Exhibit IV-4 shows FHA quarterly market shares (in terms of loan count) and clearly shows the ramping up of FHA market shares for both purchase and refinance mortgages, with FHA purchase loan shares being especially high after 2007 compared with the years preceding the peak of home prices. The graph also shows that FHA's market share of refinances increased sharply after Q3 2007, reflecting the ramp up in conventional-to-FHA refinances that FHA offered in its countercyclical role. As noted previously, in "normal" times, borrowers prefer conventional refinances but because conventional refinances were not available to many borrowers owing to tight underwriting standards, these borrowers turned to FHA refinances.

FHA Enabled Home Purchases

As discussed above, FHA maintained its traditional role of helping finance home purchases, especially to first-time homebuyers. Home Mortgage Disclosure Act (HMDA) data show that with the decline in home purchase demand from 2005 to 2011 (with 2011 home purchase lending being 67 percent below 2005 levels; see Avery et al., 2012), the count of HMDA reporting institutions also declined such that in 2011 there were fewer reporting institutions than in any of the previous 10 years. This decline, along with the tighter underwriting conditions (explained subsequently in this section) meant that many households were unable to qualify for conventional home purchase loans. As a result, FHA home purchase share rose dramatically as shown in exhibit IV-4.

Exhibit IV-4. FHA Is Known To Have Ramped Up Its Support for Home Purchases; Less Well Known Is Its Support for Refinances During Crisis

FHA as Share of Quarterly Mortgage Originations by Type (percent)



Sources: Mortgage Bankers Association and U.S. Department of Housing and Urban Development

[40] In some streamline refinance cases for which financed closing costs bring the new loan balance above a stated threshold (with no other cash out), a new appraisal would be required. Thus, exhibits IV-6 and IV-7 (which appear later in this section) show breakouts for streamline refinances with or without new appraisals. In either case, new mortgage credit underwriting is not involved.

[41] To date, these conventional to FHA refinances over the period from 2007 to 2009 have performed better than standard and streamline FHA refinances.

Several laws temporarily expanded FHA loan limits along with those of the GSEs up to a high cost ceiling of $729,750. In October 2011, the high cost ceiling was rolled back to $625,500, but in November 2011, the FHA ceiling was restored to $729,750, making it higher than that of the GSEs.

The increase in FHA's home purchase market starting in 2008 is due both to the withdrawal of private credit and to the increase in FHA's loan limits. Loan limits have risen rapidly in recent years: in 2006, FHA could insure loans up to $200,160 in all markets and up to $363,790 in high-cost markets. Several laws addressing economic recovery (EESA, HERA, and ARRA) temporarily expanded FHA loan limits along with those of the GSEs based on percentages of local median home price up to a high cost ceiling of $729,750. In October 2011, the high cost ceiling was rolled back to $625,500, but in November 2011, FHA ceiling was restored to $729,750, making it higher than that of the GSEs. Thus, in 2012 FHA can insure loans up to $271,050 in all markets and up to $729,750 in high-cost areas whereas the GSEs are now limited to $417,000 in most markets and $625,500 in high-cost areas. HERA also directed the Federal Housing Finance Agency to move the GSEs to a county-based system of loan limits like FHA while raising the standard (outside areas at the floor or ceiling) from 95 percent of median house prices to 115 percent. Thus, starting in 2008 FHA began insuring single-family mortgages of up to $729,750 and supporting broader segments of the housing market (including jumbo conforming) and reminiscent of the early days of FHA in the midst of the Great Depression when the loan limit was set at $16,000 at a time when average the home price was in the neighborhood of $5,000.[42]

With this raising of loan limits, a greater percentage of FHA loans endorsed since 2007 have been above the 2007 loan limits—that is, in the "jumbo conforming space." For instance, whereas 7.7 percent of FHA's endorsements in 2008 were above the old 2007 limits, this share increased to 12.8 percent in 2009 and 14.0 percent in 2011. Increased loan limits at a time of falling house prices has meant that FHA's market share of originations had increased to 29.8 percent of purchase originations in 2011:[43] a measure perhaps of the countercyclical role that it has played in the ongoing housing crisis.

Exhibits IV-5 and IV-6 are illustrative of FHA's ability to respond to the market in a relatively short time with the help of Congress. Exhibit IV-5 shows that going into the crisis FHA was at low volumes, and had large portions of its business in high-risk downpayment gift loans that were performing very poorly. Exhibit IV-6, however, shows that after the crisis began, FHA succeeded in eliminating the high-risk gift loans, increased its overall volume (purchase and refinance), and enabled product refinances (conventional to FHA) with the latter performing no worse than FHA's ordinary refinance business. This illustration provides another example of FHA's ability to address market challenges, which was also discussed in a historical context in section III.

FHA Helps Homeowners Keep Their Homes

Although FHA's expansion of mortgage credit was critical to housing markets, the FHA's support for the market extends beyond extension of credit to new FHA loans: FHA is the direct policy lever available to policymakers and has been used to test out policy programs to address the crisis. Although not as widely recognized as the U.S. Treasury's Home Affordable Modification Program (HAMP) for conventional loans, FHA has actually extended loss mitigation aid to more than 1.4 million distressed homeowners with existing FHA loans since the second quarter of 2009 (see exhibit IV-7).

FHA's loss mitigation actions include, amongst other actions, the FHA Home Affordable Modification Program (FHA-HAMP), which is not to be confused with the Treasury's HAMP for conventional loans. FHA-HAMP is available to existing FHA-insured borrowers who meet eligibility requirements to avoid foreclosure by permanently reducing their monthly mortgage payment through the use of a partial claim, which in effect writes down the principal on the first lien, and establishes a silent second lien for the amount of the partial claim. The Helping Families Save Their Homes Act of 2009 provided FHA the authority to pay a partial claim of up to 30 percent of the unpaid principal balance as of the date of default in combination with a loan modification. In addition to FHA-HAMP, FHA has encouraged its approved servicing lenders to make greater use of its existing loss mitigation programs, which have ramped up in volume considerably since the crisis. These

[42] On November 18, 2011, President Obama signed into law the Consolidated and Further Continuing Appropriations Act, PL-112-55, which extended FHA's authorization to insure loans of up to $271,050 in all markets and up to $729,750 in high-cost areas through December 31, 2013.

[43] See exhibit IV-11.

Table IV-5. FHA Single-Family Insurance Program: Entering the Crisis

FHA Had Low Volumes and Was Seeking To Stop Insuring Purchase Loans With High-Risk, Seller-Funded Downpayment Assistance (Gifts From Nonprofits), Data as of July 2012

Type of FHA Mortgage	Downpayment Gift Source	FY 2004			FY 2005			FY 2006		
		Total Insured Case Count	Percent of FY Insured Cases	Claim Rate to Date (percent)	Total Insured Case Count	Percent of FY Insured Cases	Claim Rate to Date (percent)	Total Insured Case Count	Percent of FY Insured Cases	Claim Rate to Date (percent)
First-time buyer	No gift	234,430	24.4	6.8	127,744	24.9	9.1	113,220	26.6	10.6
	Nonprofit/government	128,571	13.4	19.4	96,507	18.8	21.4	85,435	20.1	21.7
	Relative/employer	91,241	9.5	8.6	55,831	10.9	11.3	50,229	11.8	12.6
	Subtotal	*454,242*	*47.3*	*10.7*	*280,082*	*54.7*	*13.8*	*248,884*	*58.5*	*14.8*
Other home purchase	No gift	81,911	8.5	5.7	43,643	8.5	8.0	39,803	9.4	10.0
	Nonprofit/government	31,517	3.3	15.6	20,998	4.1	17.6	17,895	4.2	18.7
	Relative/employer	18,440	1.9	8.4	9,121	1.8	10.4	7,416	1.7	12.8
	Subtotal	*131,868*	*13.7*	*8.4*	*73,762*	*14.4*	*11.0*	*65,114*	*15.3*	*12.7*
Conventional-to-FHA refinance*	No gift	56,351	5.9	6.6	33,247	6.5	8.5	60,114	14.1	11.3
	Nonprofit/government	138	0.0	41.3	164	0.0	29.3	99	0.0	25.5
	Relative/employer	206	0.0	13.1	170	0.0	18.8	184	0.0	12.5
	Subtotal	*56,695*	*5.9*	*6.7*	*33,581*	*6.6*	*8.7*	*60,397*	*14.2*	*11.3*
FHA-to-FHA refinance (nonstreamline)*	No gift	26,104	2.7	4.4	11,825	2.3	6.9	14,696	3.5	12.2
	Nonprofit/government	1	0.0	0.0	0	0.0	0.0	2	0.0	50.0
	Relative/employer	41	0.0	0.0	15	0.0	0.0	24	0.0	12.5
	Subtotal	*26,146*	*2.7*	*4.4*	*11,840*	*2.3*	*6.8*	*14,722*	*3.5*	*12.2*
Streamline refinance (no appriasal)	N/A	221,275	23.0	5.5	90,663	17.7	8.0	26,014	6.1	9.7
Streamline refinance (with appriasal)	N/A	70,208	7.3	7.8	22,399	4.4	12.3	10,360	2.4	14.8
	Subtotal	*291,483*	*30.3*	*6.0*	*113,062*	*22.1*	*8.9*	*36,374*	*8.5*	*11.2*
Total insured cases		**960,434**	**100.0**	**8.6**	**512,327**	**100.0**	**11.8**	**425,491**	**100.0**	**13.6**

* Some nonstreamiline refinances require a cash contribution to pay closing costs, buy out the ownership interest of another party (such as a divorce situation), or pay off the old first- and second-lien mortgage balances, which may come from a gift.

Note: Fiscal years begin on October 1 of previous calendar year and run through September 30.

Source: U.S. Department of Housing and Urban Development

Table IV-6. FHA Single-Family Insurance Program: Response to the Crisis

FHA Volume Rises (Countercyclical Role), High-Risk Loans With Nonprofit Gifts Become Ineligible in 2008, and Homeowners Refinance out of High-Risk Conventional Loan Products Into FHA, Data as of July 2012

Type of FHA Mortgage	Downpayment Gift Source	FY 2007			FY 2008			FY 2009		
		Total Insured Case Count	Percent of FY Insured Cases	Claim Rate to Date (percent)	Total Insured Case Count	Percent of FY Insured Cases	Claim Rate to Date (percent)	Total Insured Case Count	Percent of FY Insured Cases	Claim Rate to Date (percent)
First-time buyer	No gift	98,302	23.1	10.1	240,999	22.2	5.7	548,034	29.9	1.7
	Nonprofit/government	81,495	19.2	19.6	170,575	15.7	12.2	45,773	2.5	7.1
	Relative/employer	41,673	9.8	11.8	80,711	7.4	7.0	187,872	10.3	2.2
	Subtotal	*221,470*	*52.1*	*13.9*	*492,285*	*45.3*	*8.2*	*781,679*	*42.7*	*2.2*
Other home purchase	No gift	33,995	8.0	8.7	87,474	8.0	5.7	174,202	9.5	1.9
	Nonprofit/government	16,534	3.9	18.2	37,142	3.4	11.7	9,916	0.5	7.8
	Relative/employer	6,395	1.5	12.1	14,753	1.4	7.3	29,754	1.6	2.4
	Subtotal	*56,924*	*13.4*	*11.8*	*139,369*	*12.8*	*7.4*	*213,872*	*11.7*	*2.3*
Conventional-to-FHA refinance*	No gift	107,403	25.3	11.1	356,512	32.8	8.2	466,590	25.5	2.9
	Nonprofit/government	60	0.0	0.0	54	0.0	16.7	24	0.0	4.2
	Relative/employer	276	0.1	15.9	914	0.1	11.5	2,030	0.1	3.7
	Subtotal	*107,739*	*25.4*	*11.1*	*357,480*	*32.9*	*8.2*	*468,644*	*25.6*	*2.9*
FHA-to-FHA refinance (Nonstreamline)*	No gift	16,483	3.9	11.5	31,438	2.9	7.4	38,231	2.1	3.0
	Nonprofit/government	0	0.0	28.6	3	0.0	0.0	1	0.0	0.0
	Relative/employer	21	0.0	0.0	45	0.0	16.7	133	0.0	2.3
	Subtotal	*16,504*	*3.9*	*11.5*	*31,486*	*2.9*	*7.4*	*38,365*	*2.1*	*3.0*
Streamline refinance	N/A	14,905	3.5	12.5	51,482	4.7	10.9	280,265	15.3	5.1
(no appriasal)	N/A	7,182	1.7	14.4	15,290	1.4	10.2	49,172	2.7	4.1
Streamline refinance	*Subtotal*	*22,087*	*5.2*	*13.1*	*66,772*	*6.1*	*10.7*	*329,437*	*18.0*	*5.0*
(with appriasal)										
Total insured cases		**424,724**	**100.0**	**12.8**	**1,087,392**	**100.0**	**8.2**	**1,831,997**	**100.0**	**2.9**

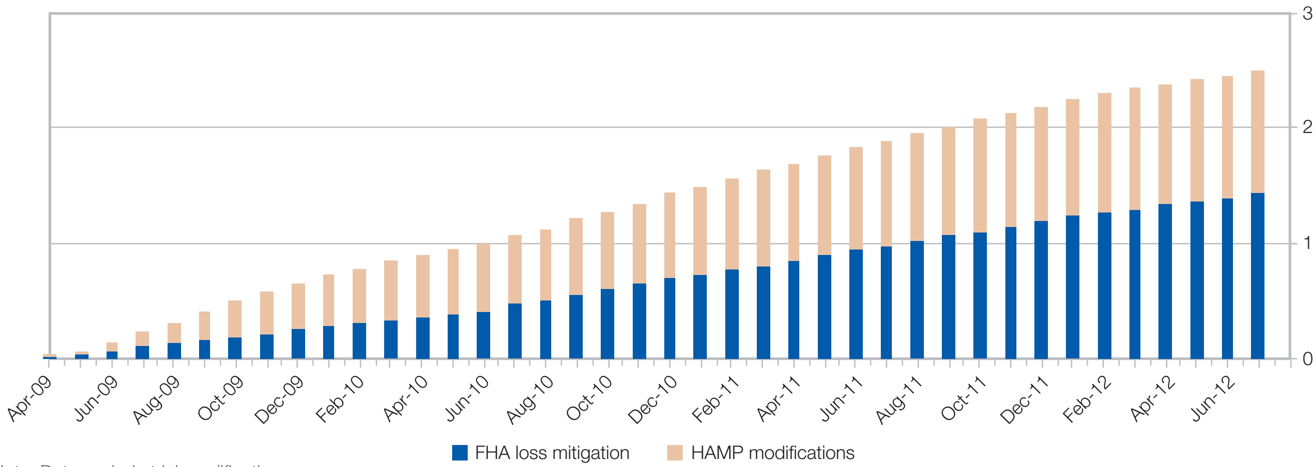
* Some nonstreamiline refinances require a cash contribution to pay closing costs, buy out the ownership interest of another party (such as a divorce situation), or pay off the old first- and second-lien mortgage balances, which may come from a gift.

Note: Fiscal years begin on October 1 of previous calendar year and run through September 30.

Source: U.S. Department of Housing and Urban Development

Exhibit IV-7. FHA Has Role in Helping Distressed Homeowners

Cumulative Mortgages Receiving Aid Since April 1, 2009 (millions)



Note: Data exclude trial modifications.
Sources: U.S. Department of the Treasury and U.S. Department of Housing and Urban Development

loss-mitigation programs include special forbearance, partial claim (intended to bring loan arrearages current and limited to 1 year of principal and interest payments), and loan modifications (non-HAMP).[44]

A promising recent FHA initiative is the expanded use of distressed note sales through FHA's *Distressed Asset Sales Program* beginning in 2010. This initiative includes a new pilot started in 2012, the *Neighborhood Stabilization Loan Sales* initiative, for which Departmental policies around future sales are still being refined. Under FHA's distressed asset sale programs, seriously delinquent loans (notes) are sold competitively to investors (either for-profit or nonprofit) at a market-determined price generally below the outstanding principal balance. FHA processes an insurance claim, removes the FHA insurance, and transfers the note to the investor. For some note sales, the investors are not restricted in how they resolve the loan default. In others, including the Neighborhood Stabilization initiative, restrictions are placed on the investor. Restrictions, when applied, generally have included a prohibition on starting foreclosure on any properties for a minimum of 6 months, giving the new loan servicer time to work through loan retention options. Because the loans are sold for less than the unpaid balance, the investor has the ability to reduce the loan principal, or otherwise modify the loan terms while still being able to earn a reasonable return on the initial investment. The Neighborhood Stabilization Loan Sales initiative is designed to help stem the flow of distressed properties hitting distressed markets and therefore requires that no more than 50 percent of the loans in the pool be sold as vacant REO properties, which provides an incentive for the investor to offer some REO properties in the pool for rent when home retention was not possible.

FHA Disproportionately Serves Racial and Ethnic Minority Borrowers

Historically, FHA endorsements have been provided to minority and low-income households that struggled to secure conventional market financing. At the home price peak in 2006, many subprime lenders targeted racial and ethnic minority communities and, accordingly, FHA's minority market share declined. As home prices declined and defaults rose, however, FHA reemerged as a critical source of financing for minorities seeking homeownership. As shown graphically in exhibit III-4, and with additional detail in exhibit IV-8, FHA's 2006 home purchase market share was 5.3 percent overall and among Black and Hispanic borrowers was 8.0 percent, and 5.1 percent, respectively. In 2009, FHA's home purchase market share overall reached a high of 37.3 percent and in 2010 FHA's home purchase market share to Black and Hispanic borrowers, reached 59.6 and 59.3 percent, respectively. Although minority households were disproportionately hurt by the foreclosure crisis and minority

[44] In addition to the listed loss mitigation programs which help FHA borrowers remain in their homes, FHA also has other loss mitigation programs—preforeclosure sale, and deed-in-lieu of foreclosure—which help borrowers who are unable to retain their homes through one of the other options.

Exhibit IV-8. FHA Home Purchase Mortgage Originations as Share of All Home Purchase Originations by Race/Ethnicity

Year	Count		Percent		
	Black	Hispanic	Black	Hispanic	Total
2011	64,658	117,402	53.5	54.0	30.7
2010	83,743	134,745	59.6	59.3	36.2
2009	87,203	145,337	58.8	58.4	37.3
2008	83,846	107,857	46.2	39.7	25.5
2007	40,113	36,084	13.5	8.8	7.0
2006	35,648	35,155	8.0	5.1	5.3

homeownership rates declined, the losses would have been far worse without the support provided by the FHA through its home purchase, refinance, loss mitigation, and other activities.

Since 2009 to date, nearly 60 percent of homes purchased by Black and Hispanic buyers were financed with FHA loans.

FHA Kept Low-Downpayment Loans Available

FHA has also traditionally played a large role in low-downpayment, high loan-to-value ratio (LTV) mortgage lending for home purchases. As house prices declined and mortgage losses rose, FHA was pressured to restrict low downpayment homeownership programs. The FHA resisted this pressure and continued to provide support for qualified creditworthy households seeking homeownership but lacking the significant assets often required for downpayments on conventional loans. Whereas the FHA chose to maintain its low downpayment loan programs for creditworthy borrowers, it sought to shore up its finances and to protect the MMI Fund by adjusting mortgage insurance premiums and downpayment requirements for higher risk, low-FICO borrowers. Mortgagee Letter 10-29 restricted maximum financing to borrowers with a credit score of 580 or higher, maximum financing equal to 90 percent LTV for borrowers with a credit score of 500 to 579, and made borrowers with a credit score below 500 ineligible for FHA insurance.[45]

Exhibit IV-9 shows that leading up to the home price peak, FHA's market share of borrowers making a downpayment of 4 percent or less declined from 71 percent in 2001 to 26 percent in 2007. Yet by 2009 at the height of the credit contraction, the FHA endorsed nearly 79 percent of mortgage loans with a downpayment of 4 percent or less. The graph also shows that FHA's support for the market was not limited to low-downpayment borrowers as FHA's purchase share of the formerly prime 5- to 19-percent downpayment market segments were also more than 50 percent in 2009 and 2010. Without FHA's continued commitment to low-downpayment home purchase lending, the pool of qualified borrowers would have shrunk, further reducing demand for homes, further depressing home prices, and putting additional stress on housing markets nationwide.

Without FHA's continued commitment to low-downpayment home purchase lending, the pool of qualified borrowers would have shrunk, further reducing demand for homes.

FHA's Role in Recent Years

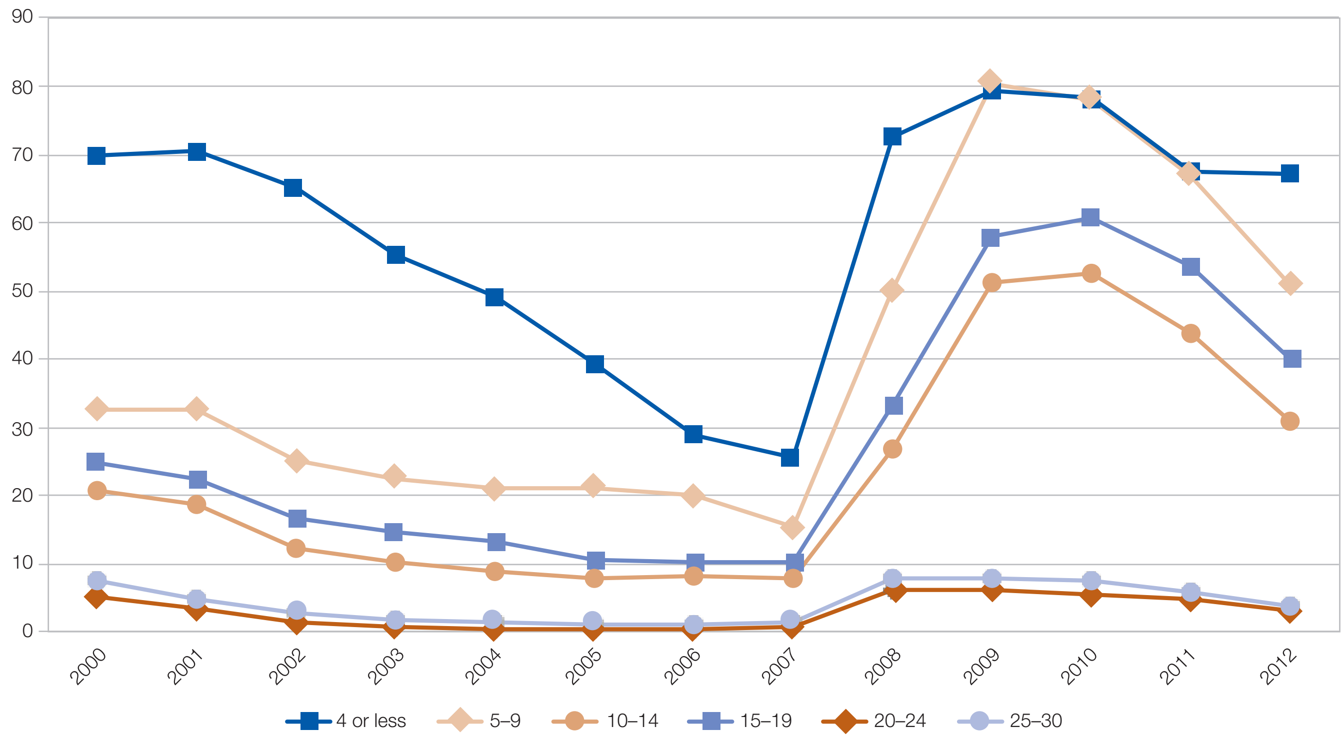
During 2004–2007, the PLS sector of the market grew in share and became the preferred conduit for securitizing loans made to "weak borrowers" or those with lower FICO, high LTV and additional risk layers, such as IO and low or no documentation. These years saw the proliferation of subprime and Alt-A loans. Exhibit IV-10 (taken from Goodman et al., 2012) shows the "loosening" of underwriting standards between 2004 and 2007 and the subsequent tightening of these underwriting standards in the market.[46] Between 2004 and 2007, whereas underwriting standards loosened considerably in the PLS sector, they loosened only slightly in FHA/U.S. Department of Veterans Affairs (VA) or in the GSE space. Exhibit IV-11 shows the origination volume by year, holder of risk and key loan characteristics.

[45] http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/letters/mortgagee.

[46] In exhibit IV-11, tighter standards are associated with higher average origination FICO credit scores, lower average LTV ratios, lower share of originations with ARMs, and lower share of originations with IO features.

Exhibit IV-9. FHA Purchase Origination Market Share by Downpayment Percentage and Vintage Year

Percent of Market Originations in Category



Source: LPS Applied Analytics

In additional to the individual risk characteristics such as those illustrated in exhibit IV-11, another symptom of loose underwriting is the layering of risk. For instance, many loan products originated during the housing bubble had multiple risk features: many borrowers obtained low/no documentation loans that also had high LTVs or second liens attached. Other risk layering features included the presence of IO options wherein the loan is essentially nonamortizing and the most risky of these loan products were the IO ARMs with a short initial period of 2 or three years after which interest rates rose sharply. Note that exhibit IV-10 does not reflect the favorable pricing in the nonagency sector for risk-layered loans (including low/no documentation, Alt A and stated income/stated assets) which were the mainstay of the PLS sector. The PLS sector priced these risk-layered loans very favorably and such loans proliferated during the peak of the housing bubble.

Underwriting standards remained roughly constant in FHA/VA/USDA programs through the housing boom and the bust unlike the pro-cyclical trend in the PLS market.

With the collapse of the PLS sector, some of these risk-layered loans did make their way into the GSEs in 2007 but this trend was reversed by the tightening of underwriting standards at the GSEs: origination FICOs dipped for the GSEs and originating LTVs inched up (the origination LTV at FHA/VA actually dipped and origination FICOs declined in 2007). The share of Refinances increased sharply in 2007 as some of the borrowers of these risk-layered PLS loans sought refinances into loans with the FHA/VA and the GSEs. This increase in FHA refinance share is evident in exhibit IV-5 under "Conventional to FHA Refinances" and represents one of the countercyclical roles played by FHA (and the GSEs) during the credit crisis—that is, product refinances which typically benefited consumers who were faced with large rate resets after the expiration of teaser rates. Through most of 2007, as the PLS sector dried up in terms of market share, it was the GSEs that gained most of the market share. By the end of 2007, however, the GSEs had tightened their credit underwriting requirements after realizing that their gain in market share was coming in the form of risk layered loans that would ultimately have higher loss severity. Thus, from 2008 onwards, the Ginnie Mae (that is combined FHA/VA/U.S. Department of Agriculture) share

Exhibit IV-10. Origination Volumes by Year, Holder of Risk, and Selected Loan Characteristics

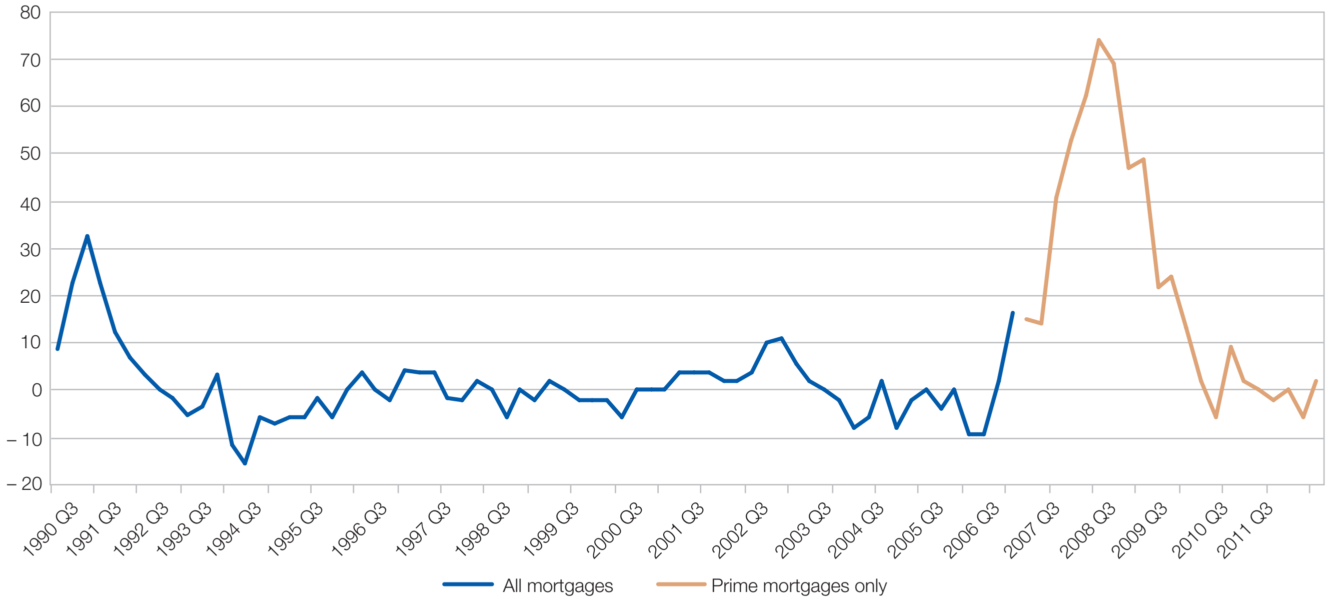
Issue Year	Balance ($ M)					Orig. FICO					Orig. LTV				
	Portfolio	FHA/VA	PLS	FHLMC	FNMA	Portfolio	FHA/VA	PLS	FHLMC	FNMA	Portfolio	FHA/VA	PLS	FHLMC	FNMA
2001	8,027	237,472	237,663	140,193	195,791	698	656	690	714	708	73.7	95.7	73.6	74	74.3
2002	17,476	258,643	351,107	350,103	483,890	722	655	690	721	715	68.3	95.8	72.6	70.8	71.5
2003	55,387	315,345	545,060	679,158	1,139,018	729	658	686	730	723	68.5	95	73.3	68.1	68.4
2004	70,613	174,183	809,647	349,172	510,354	725	650	677	721	718	72.2	95.8	76.6	71.2	71.2
2005	117,146	126,043	1,101,897	373,965	483,878	725	653	680	725	721	72.9	96	77	71.5	71.7
2006	183,366	112,430	1,000,064	346,611	468,775	720	654	679	725	720	73.6	96.1	77.7	72.6	72.9
2007	218,094	136,728	357,809	427,708	606,776	720	643	703	723	718	75	95.3	75.5	74.3	75.2
2008	105,208	380,911	1,352	339,015	530,635	741	667	736	740	737	70	95.3	71.3	71.4	72.3
2009	56,206	603,455	362	458,641	774,847	753	696	764	761	756	67.3	95.6	56.1	67.1	67.4
2010	74,407	484,259	414	372,725	594,935	765	707	773	760	762	65.4	95.6	58.9	69.5	68.4
2011	76,519	359,915	836	297,591	550,008	766	709	770	761	761	66.3	95.1	64	69.9	69.4

Issue Year	% Refi					% ARM					% IO				
	Portfolio	FHA/VA	PLS	FHLMC	FNMA	Portfolio	FHA/VA	PLS	FHLMC	FNMA	Portfolio	FHA/VA	PLS	FHLMC	FNMA
2001	67	25	64	63.8	63.3	29	3.4	37	5.9	5.1	2.8	0.1	4	0	0.1
2002	70.6	32.5	68	74.6	70.1	28.5	7.2	49	8.4	9.5	1.8	0.1	12	0	0.4
2003	70	49.4	68	81.3	78.1	30.9	5.7	55	7.6	10.2	6.8	0	17	0	1
2004	46.3	35	55	60.4	58.2	59.1	11.9	73	14.4	21.9	27.9	0	32	0.2	5.1
2005	44.2	31	52	56	54.2	63.3	7.2	73	16.2	22	36.6	0	38	7	10.3
2006	46.5	30.6	54	47.2	49.1	33	3.2	68	19.9	16.7	26.3	0.1	34	16.6	15.7
2007	48.6	36.6	60	51.3	50.6	34.9	2	57	18.1	10.3	30	0.6	45	22.6	15
2008	57.2	39.5	56	59.1	58.8	44.3	2.1	63	8.6	7.9	26.1	0	60	7.1	5.5
2009	65.8	47.7	80	80.2	77.5	34	2.3	87	0.8	2.9	18.6	0	69	0.2	0.9
2010	73.1	42.4	64	78.9	77.2	27.4	6.2	17	4.4	6.3	8.9	0	17	0.4	1.3
2011	68.5	41.5	55	78.4	76.5	26.8	8.2	14	8.6	6.6	10.7	0	14	0.1	0.7

Source: Case-Shiller®, 1010 data, Amherst Securities as reported in *Amherst Mortgage Insight*, May 30, 2012

Exhibit IV-11. Senior Loan Officers Reporting Tighter Underwriting Conditions

Net Change in Percent



Source: Federal Reserve Board

of market securitization rose from 4.7 percent of originations to 19.6 percent in 2008 to 21.8 percent in 2011. As noted in the May 30, 2012 Amherst Mortgage Insight, "However, in government lending programs, lending standards remained roughly constant, and much more activity has gravitated to these programs" (Goodman et al. 2012: 4).

These lending standards were consciously kept at a near-constant level to serve the market even in times of market turmoil and were crucial to the countercyclical role played by the government agencies. Another critical component that helped this role was the raising of the conforming loan limit in 2008 for FHA and GSEs, as noted previously in this section.

Tighter Credit Underwriting After 2008

As seen in exhibit IV-10, originating FICOs have been rising for all sectors after 2008 with the originating LTVs falling for the GSEs and portfolio loans indicating the tightening of their underwriting. Through these years, the originating LTV for FHA/VA stayed steady in the 95-percent range indicating that it has now effectively become the sole source of high LTV loans and for borrowers with low credit scores.

This tightening of credit standards is evident in other data as well. The Federal Reserve survey of senior loan officers shows that banks tightened underwriting standards every quarter from late 2006 through mid-2010 with very little easing since then. Exhibit IV-10 shows the dramatic tightening of credit in 2007 and 2008, which peaked with 74 percent of senior loan officers reporting tighter underwriting conditions on prime mortgages.[47] Although underwriting conditions have not become tighter since then, they nevertheless remain tight: The July 2012 survey reports that "lending standards for most categories of loans remained at least somewhat tighter, on balance, than the middle of their respective ranges since 2005."[48] Thus, in 2012, the housing market is faced with historically low interest rates and high housing affordability (as measured

[47] The "net change" represented in exhibit IV-11 is the fraction of banks that tightened standards minus the fraction that reported having eased standards. Thus, negative net changes imply that more banks reported having eased standards than tightened standards.

[48] The July 2012 Senior Loan Officer Opinion Survey on Bank Lending Practices, accessed on 9/28/2012 from http://www.federalreserve.gov/boarddocs/snloansurvey/201208/fullreport.pdf, p.7: "With respect to loans to households, a majority of the banks reported that lending standards for all five categories of residential mortgage loans included in the survey (prime conforming mortgages, prime jumbo mortgages, subprime mortgages, nontraditional mortgages, and HELOCs) were at least somewhat tighter than the middle of the range that those standards have occupied since 2005, whereas smaller but still significant fractions of domestic banks also reported that standards were tighter than the midpoint for prime credit card, subprime credit card, auto, and other consumer loans."

by the NAR's housing affordability index) and yet remains anemic as evidenced by housing market activity (sales and prices). Policymakers and legislators are faced with the daunting task of healing housing markets while reforming them. The White Paper on Reforming America's Housing Finance Market that was released by Treasury and the U.S. Department of Housing and Urban Development in February 2011 endorsed "returning FHA to its traditional role as targeted lender of affordable mortgages" (U.S. Treasury and HUD, 2011: 14). The White Paper recommends "a reformed and strengthened FHA" that will ensure that "creditworthy first-time home borrowers and families with modest income can access a mortgage" (U.S. Treasury and HUD, 2011: 19).

Finally, any discussion of FHA's countercyclical role during the current crisis should consider the costs incurred by FHA in performing this role. Loans FHA insured during the 2005 to 2009 period are likely to suffer the most (in terms of lifetime performance) from the recent national housing recession. These loan vintages contained high shares of seller-funded downpayment gifts, which historically have performed much worse than other FHA loans. These vintages also were underwritten when home prices were near or at their peak in mid-2006, with the subsequent 33-consecutive-month declines in national price levels creating the most potential for negative equity. FHA's relatively low market shares during these high-loss boom years, however, has helped mitigate the effect of these loan vintages on FHA. In certain states like California, for which falling home prices were especially severe, FHA had even more limited exposure because of lower precrisis loan limits that restricted origination volumes. In addition to precrisis loan vintages, the surviving FHA mortgages originated between 2009 and 2012 will enter their peak default periods during 2013 through 2017. As FHA stepped up its countercyclical role, and the relatively high volumes of FHA originations in the 2009-2012 period, which has resulted in about 78 percent of the entire MMI Fund concentrated in mortgages in these loan vintages as of 2012, the MMI Fund is expected to realize high claim losses in the next several years.

Appendix. Key Questions on Future Role of FHA

The authors hope that this paper serves as a useful foundation for considering the Federal Housing Administration's (FHA's) future role in housing finance as both institutional and regulatory reforms are debated. FHA's history has shown that the public policy debate after FHA's financial crisis of the 1980s was driven by balancing the dual objectives of carrying out FHA's purpose and mission and maintaining and improving its financial soundness. In the current environment, FHA is still engaged in helping to mend the ailing housing market. Looking forward to a time when that objective will have been substantially accomplished, numerous policy questions remain to be addressed. Some questions involve balancing the costs and benefits of FHA assuming a countercyclical role when future market distress may occur at the same time it is meeting the other aspects of its mission. This and other questions about FHA's institutional role are integral to the policy debate framed by the White Paper on Reforming America's Housing Finance Market that was jointly released by the Departments of Treasury and Housing and Urban Development in February 2011 (U.S. Treasury and HUD, 2011).

FHA is a valuable direct policy lever and has been used to address credit market imperfections, market failures and to provide countercyclical support. It has helped address market imperfections by providing increased homeownership opportunities to creditworthy low- and moderate-income families, minority households and first-time homebuyers that the conventional market was unable to serve. FHA has also expanded access to credit in all regional markets and smoothed regional variations that might have surfaced otherwise. FHA has demonstrated innovative processes in mortgage finance such as underwriting borrowers with nontraditional credit that have since become more mainstream practices. As, the paper has detailed in sections III and IV, FHA has provided significant countercyclical support with regional recessions (such the oil patch recession of the 1980s) and the national housing bubble in recent years. (Regional recessions have been more common than national ones and FHA has been a valuable policy instrument in mitigating them). Furthermore, FHA has applied the lessons it has learned in the past to the actions it has taken in dealing with the current crisis: both to protect its fiscal health and also to support its dual mission of bolstering the housing market during tough times and providing access to homeownership for underserved populations. Although the final accounting for the cost of actions taken to deal with the current crisis is still to be determined, FHA and policymakers will likely seek answers to the following questions.

- What is the cost of the current level of countercyclical support being provided? Is it appropriate given the benefits secured?
- In the future, are other institutional structures possible that will support/augment/replace this role? Should FHA's countercyclical role be confined to segments of the market such as the underserved populations? How might FHA interact with private mortgage insurance (PMI) companies and other institutions in the future: should operations overlap considerably as in the past or very little? Is this overlap to be addressed via regulation or through pricing?
- Will FHA need to become active in developing standards, innovating new guidelines, and providing information on loan performance to the industry, such as identifying creditworthy borrowers among households whose credit was impaired during the crisis?
- How will regulatory reform affect these discussions? What is the appropriate "credit box" for Qualified Mortgages (QMs) that balances the responsible lending standards (in terms of taking ability to repay into consideration) with availability of credit? How will the market react to the cumulative effect of these reforms?
- How will demographic trends affect FHA's role and market share? Demographic trends such as slowing down in the rate of household formation may reduce the demand from first time buyers who have traditionally relied heavily on FHA financing. The State of the Nation's Housing Report from the Joint Center for Housing Studies at Harvard University notes "a sharp slowdown in average annual household growth in 2007-2011 to 568,000 in 2011 which is less than half the pace in the first half of the 2000s or even the 1.15 million average in the late 1990s" (Joint Center for Housing Studies of Harvard University, 2012: 6). The Report notes that two causative factors: a decline in the rate at which individuals (especially those younger than age 35) form households (or headship rates) and a sharp drop in immigration which could contribute to a decrease in first-time homebuyers, a traditional FHA constituency.

As the Treasury/HUD White Paper has pointed out, the current housing crisis has exposed deep flaws in our housing finance system. The White Paper does not rule out a dramatic transformation in the role of government in the housing market as it offers three options for the housing finance system. These options offer widely different degrees of government support and along with different associated costs and benefits.

Option 1: A privatized system of housing finance with the government insurance role limited to the FHA, U.S. Department of Agriculture (USDA), and U.S. Department of Veterans Affairs (VA) assistance to narrowly targeted groups of borrowers.

Option 2: A privatized system of housing finance with assistance from the FHA, USDA and VA for narrowly targeted groups of borrowers and a guarantee mechanism to scale up during times of crisis.

Option 3: A privatized system of housing finance with FHA, USDA and VA assistance for low- and moderate-income borrowers and catastrophic reinsurance behind significant private capital.

As policymakers debate and choose among these options, they will be making difficult trade-offs between providing broad access to mortgages for all households with risks to taxpayers and market stability and resiliency. Another set of difficult trade-offs will be involved in the phasing of these reforms: ensuring housing market recovery will need to be balanced with long-term reform of the entire housing finance structure.

In addition, questions emerge related to regulatory reforms that are under consideration which are likely to affect FHA's role going forward. These reforms are detailed in the Qualified Residential Mortgage (QRM) proposed rule, the QM proposed rule, and Basel III capital proposed rules for financial institutions. The outcomes of these rulemakings could affect how and at what price the conventional market will be able to serve future homebuyers of varying credit risk profiles. If FHA continues to perform its traditional role of serving those creditworthy, lower wealth households not well served by the conventional market, these rules could affect the size of the potential FHA market.

All three proposals are expected to be finalized in the near future and the final provisions of each rule may be quite different from those contained in the proposed rules. This appendix will discuss the challenges, concerns and reactions to the proposed rules because the final rules have not yet been published. It is likely (and hoped) that the concerns raised here will be addressed in the final rules.

QRM or "Skin in the Game" Rules

The Dodd-Frank Act requires issuers to retain 5 percent of the credit risk on loans they securitize (that is, they retain some "skin in the game") unless the loan is a QRM in which case those loans are exempt from the 5-percent requirement. FHA/VA/USDA loans and government-sponsored enterprise (GSE) loans while the GSEs are in conservatorship are exempt from the 5-percent requirement.[49] Six federal agencies that have been charged with jointly issuing the QRM rule (the Federal Deposit Insurance Corporation [FDIC], Federal Housing Finance Agency [FHFA], the Federal Reserve Board, the U.S. Department of Housing and Urban Development, the Office of the Comptroller of Currency and the Securities and Exchange Commission) issued their proposed QRM rule in 2011, have received comments and have not yet announced plans to issue the final rule.[50] The consensus is that the regulators will likely finalize the QRM after the final Qualified Mortgage or QM rule is issued.

The proposed QRM definition is a closed-end loan with the following characteristics.

- A maximum loan-to-value ratio (LTV) of 80 percent for purchase loans, 75 percent for rate and term refinances, and 70 percent for cash out refinances.
- A maximum front-end and back-end Debt-to-Income or DTI ratio of 28 and 36, respectively.
- On any debt, the borrower cannot be 30 days past due, never 60 days past due in the past 24 months, or have any bankruptcy, repossession, foreclosure, deed-in-lieu, short sale or judicial judgment on any debt in the past 3 years.
- Points and fees on QRM cannot exceed 3 percent of the loan amount.
- The loan cannot have negative amortization, a balloon term, term longer than 30 years and in the case of an adjustable-rate mortgage (ARM), rate increases are capped at 2 percentage points per year and 6 percentage points over the life of the loan.

[49] Note that GSE loans could continue to be exempt from risk retention requirements should regulators decide so.

[50] See "Credit Risk Retention, Proposed Rule." 76 *Federal Register* 24090-24186.29. April 2011.

These rules, as proposed would restrict a large share of the recent mortgage market from QRM designation. An FHFA study showed that only 19.8 percent of GSE loans made from 1997 to 2009 would have been QRM-eligible (Federal Housing Finance Agency, 2011). Only 30.5 percent of GSE loans made in 2009 (a year of very tight credit underwriting at the GSEs) would have been QRM-eligible. One argument in favor of a restrictive QRM designation is to require nearly all securitizations to involve retained risk by the issuer (that is, for most to retain "skin in the game") with only a small fraction of securities involving very safe mortgages being exempt. Many have suggested preference for a less restrictive QRM definition, however, expanding LTVs to 90 or even 95 percent to capture more of the market (Moody's Analytics, 2011). Consumer advocates such as the Center for Responsible Lending have pointed out that even allowing LTVs to expand to 90 percent (with PMI) will still adversely affect borrowers, especially low- and moderate-income and minority households (Center for Responsible Learning, 2012b).

Many industry participants, consumer advocates (including the Coalition for Sensible Housing Policy) and trade groups have argued that instead of the 10-15 basis point increase anticipated in the analysis of the proposed QRM rule, interest rates would actual increase by 80-185 basis points for non-QRM loans. If the higher estimates of effect on mortgage rates are correct, a narrow definition of QRM may severely restrict the securitization of nongovernment mortgage loans.

Proposed Regulatory Change: QM[51]

When a lender originates a QM loan under the requirements set forth in the proposed QM rule,[52] they are making a reasonable and good-faith determination, based on verified and documented information, that at the time the loan is closed, the consumer has a reasonable ability to repay it according to its terms, including all applicable taxes, insurance (including mortgage insurance) and assessments. The QM provisions apply to nearly all mortgage loans[53]—whether securitized or held in portfolio, whether held by private entities or by government or government sponsored entities.

Under the proposed QM rule, lenders can comply with the ability-to-repay requirement in four ways.

1. By originating a mortgage loan after considering and verifying eight factors.[54]
2. By originating a QM loan: The proposed rule offers two alternative approaches to protecting lenders from liability when they originate a QM loan—"a legal safe harbor" and a "rebuttable presumption" from liability for QM loans.[55] The CFPB is expected to adopt one of these approaches in the final rule. Under the legal safe harbor approach, legal safe harbor would be available only for a mortgage that met certain specific conditions.[56] Under the rebuttable presumption of compliance, in addition to the requirements listed for safe harbor, the lender is also required to consider and verify the borrower's employment status, monthly payment for any simultaneous mortgage(s), borrower's current debt obligations, monthly DTI ratio or residual income and borrower's credit history.
3. By originating a "balloon payment QM" for small lenders operating predominantly in rural or underserved areas that will be holding the loan in portfolio.
4. By refinancing a "nonstandard" mortgage into a "standard mortgage" with certain restrictions.

[51] The regulatory landscape discussion here relies heavily on the detailed discussion provided in Canfield Press L.L.C. (2012).

[52] See Regulation Z, Truth in Lending, Proposed Rule, 76 *Federal Register* 91. pp. 27390-27506.

[53] The proposed rule excludes HELOCs, time shares, and reverse loans. Subordinate closed-end loans are covered.

[54] The eight factors are (1) the borrower's current or reasonably expected income or assets, other than the value of dwelling that secures the loan; (2) the borrower's current employment status if current income from employment is used to determine ability to repay the loan; (3) the loan payment based on the fully indexed-rate and on fully amortizing payments that are substantially equal; (4) the borrower's monthly payment on any simultaneous mortgage loan that the lender knows—or has reason to know—will be made, and for HELOCs, the payment is based on the amount of credit drawn at the closing of the QM loan; (5) the borrower's monthly payment for mortgage-related obligations; (6) the borrower's current debt obligations; (7) the borrower's monthly debt-to-income ratio or residual income; and (8) the borrower's credit history.

[55] By definition, "the safe harbor approach" ensures that the lenders face minimal putback or litigation risk if the loan is originated per QM rule. The rebuttable presumption approach on the other hand has some built-in litigation risk but provides the basis with which the lender can defend their decision.

[56] (1) Does not include negative amortization, interest-only payments, or balloon payments or have a loan term exceeding 30 years; (2) total points and fees that generally do not exceed 3 percent of the loan amount (with alternative thresholds proposed for smaller loans); (3) lender considered and verified borrower income or assets; and (4) where the underwriting is based on the maximum interest rate in the first 5 years, takes all mortgage-related obligations into account (including taxes and insurance) and that uses a payment schedule that fully amortizes the loan over its term.

The Dodd-Frank Act provides for "enhanced damages" for violation of the ability-to-pay requirements by expanding the statute of limitations from 1 to 3 years and permits borrowers to assert the ability-to-pay violations as a defense to foreclosures even after the 3-year limit.

Although both legal-safe-harbor and the rebuttable-presumption approach provide the borrower the opportunity for judicial review of a claim that the ability-to-repay standard was not satisfied, a significant difference exists between the two. As industry experts have pointed out, within a litigation context, only the stated standard or factors of safe harbor can be applied by the court, and only this approach would minimize litigation risk and put-back risk (whereby the loan originator may be required to repurchase a defaulted loan previously removed from its balance sheet and put into a mortgage-backed security pool) to the lender/originator. By definition, the rebuttable presumption inherently has some litigation and put-back risk built into it and is viewed less favorably by industry and trade groups. On the other hand, some consumer advocates have argued that adopting a safe-harbor provision is contrary to the spirit of the Dodd-Frank Act and that the absence of legal consequences for creditors would provide for the same conditions that led to the financial crisis in the first place.

Additionally, industry and trade groups[57] have pointed out that an undefined or vaguely defined rebuttable-presumption standard could have a significant effect on the cost and availability of credit as the costs of defending against future litigation or of carrying a put-back loan on balance sheet are likely to be passed on to borrowers in the form of higher rates and fees and of additional disclosures.[58] Furthermore, these sources say lenders are likely to reduce their exposure to such risks by tightening credit standards to stay well inside of those established by the QM rule and thus will face reduced incentives to originate non-QM loans.

In March 2012, a coalition including the Center for Responsible Lending, the Consumer Federation of America, the Leadership Council on Civil Rights and Human Rights and The Clearinghouse Association jointly presented a "term sheet" to the CFPB in an effort to forge a compromise that defined the terms under which the borrower could rebut the presumption compliance with QM rules (The Clearing House, 2012). Despite this attempt at compromise, a comment letter (American Bankers Association, 2012) from 23 industry and trade groups has stated that establishing a rebuttable presumption of compliance would "force lenders to retreat to far more conservative lending standards" and called for the inclusion of a legal safe harbor.

Consumer advocates such as the Center for Responsible Lending, the Consumer Federation of America and the Leadership Council on Civil Rights and Human Right have explained why their position on the proposed QM has changed: their comment letter from July 29, 2012 contains extensive analysis of data from various sources that shows that "low-wealth, low-income and minority consumers will be at greater risk of being excluded from the QM market unless creditors can apply a bright line standard which is easily measured, understood, and can be applied at scale across underwriting platforms and organizations" (Center for Responsible Lending, 2012a: 3).

The CFPB is set to issue its final rule at the end of 2012. Whether that rule is based on safe harbor or as a rebuttable presumption, it is very likely that non-QM loans, which by definition are also non-QRM (QRM is a subset of QM), are *unlikely to be originated* because they will face significantly higher capital retention requirements. If non-QM loans are originated by some lenders, the loans would likely involve premium pricing because of their higher litigation and put-back risks. Establishing the appropriate "credit box" for QM is important.[59] Without such definition, lenders will likely use the *more* restrictive QRM definition as the *de facto* QM definition. The current QRM proposal is quite narrow requiring for instance, a 20-percent downpayment for purchase loans and would exclude large segments of the current mortgage market. Additionally, unless this box is wide and broad, critical market segments (likely low-income, low-wealth and minority borrowers) will be either excluded or will be able to get a mortgage only at much higher interest rates and costs than might otherwise be possible.

Proposed Basel III Capital Standards

Regulatory capital requirements such as those under the Basel III Accord are intended to ensure that banks retain a sufficient cushion to absorb losses during times of economic stress. Regulators determine the amount of capital required for different

[57] See the ABA's comments, for instance, at http://www.aba.com/aba/documents/news/QMletter41312.pdf.

[58] Goodman et al. (2012) estimate that each violation of the "ability to repay" statute could cost the lender $70,000–$100,000.

[59] The term "credit box" refers to a graphic representation of the range of risk levels over multiple credit risk factors, often depicted as a rectangular "box." One example would be a credit box showing acceptable ranges of LTV on one dimension and debt-to-income ratio on the other.

types of assets using a risk-weighting scheme, with low-risk assets (such as government securities) having little or zero capital requirements, whereas assets that represent greater risk require a larger capital cushion. Thus, these risk weights also provide a policy lever by which regulators indirectly influence the type of activities banks elect to engage in.

In 1988, the Basel Committee developed a new capital framework (Basel I) that was designed to make minimum capital requirements uniform across member countries and to take the riskiness of the bank's portfolio into account in setting capital requirements. A minimum capital requirement of 8 percent was established in all member countries (including the United States) and bank assets were divided into broad categories with a risk weight for each asset category. For instance, in the United States, commercial loans are risk weighted at 100 percent risk, residential mortgages at 50 percent, GSE backed securities at 20 percent and government obligations (such as Ginnie Mae securities) are given a 0-percent weight.

In 2004, the Basel Committee agreed to a new capital framework, (Basel II), but before Basel II was actually used by any U.S. banking institutions, the financial crisis hit and the Basel Committee determined that refinements were needed. Basel III rules were released in December 2010 and implementation of Basel III in the United States requires the three Federal Banking agencies to issue proposed regulation. The OCC, the FDIC and the Federal Reserve Board began the process by issuing proposed regulations in the summer of 2012 that both community and regional banking organizations and the very largest international banks will be required to adopt. In general, the proposed rules will increase the capital needed for residential mortgage finance. Although a complete analysis of the proposal is beyond the scope of this paper, consider the following examples where the proposed rules directly affect mortgage financing and—[60]

- Increase the risk weight for residential mortgages held in portfolio.
- Increase the risk weight assigned to mortgage servicing rights.
- Double the capital required to be held against undrawn home equity lines of credit (unless banks retain the right to cancel the line at any time).
- Increase the regulatory burden on banking institutions for holding private-label securities relative to other types of securities.

Consider the risk weight for residential mortgages held in portfolio. Currently, prudently underwritten residential mortgages are assigned a risk weight of 50 percent, implying that the bank has to hold only one-half the capital for such a residential mortgage as for a commercial loan. Under the proposed Basel III rules, all mortgages belong in one of two categories and are further subdivided based on LTV. Category 1 mortgages have lower capital charges than Category 2 loans.[61]

The table in this appendix summarizes the proposed risk weights and the significant increase in risk weights for Category 2 loans.

Proposed Risk Weights for Residential Mortgage Exposures[a]

Loan-to-Value Ratio (%)	Category 1 Residential Mortgage Risk Weight (%)	Category 2 Residential Mortgage Risk Weight (%)
≤ 60	35	100
>60 and ≤80	50	100
>80 and ≤90	75	150
≥90	100	200

[a] See page 33, Table 5 in the news release at http://www.occ.treas.gov/news-issuances/news-releases/2012/nr-ia-2012-88b.pdf.

[60] See Natter (2012) and K&L Gates (2012).

[61] Category 1 loans must be a first mortgage, must have a term not exceeding 30 years, cannot have a balloon payment or a negative amortization feature, cannot allow for deferment of principal payments, and must be underwritten using documented and verified income and after considering all the borrower's obligations (including taxes, insurance, and assessments). Furthermore, the creditor must have made a reasonable determination that the borrower can repay the loan using the maximum allowable interest rate in the first 5 years and if the loan is an ARM, the interest-rate adjustments are capped at 2 percent per year and no more than 6 percent over the life of the loan. Category 2 is a catchall category for all mortgage loans that are not Category 1 loans. Moreover, PMI does not count when determining LTV because PMI providers have varying financial strengths.

According to the proposed rule, the current risk based capital treatment for residential mortgage exposure that is unconditionally guaranteed by the U.S. government or its agencies will be maintained. That is, residential mortgages unconditionally guaranteed by the U.S. government would retain their risk weighting of zero and conditionally guaranteed loans (such as those guaranteed by the GSEs) will retain a risk rating of 20 percent. This treatment means that under the new proposed rules, the capital requirements on a loan with nongovernment mortgage insurance will become much higher. In certain market segments such as high-LTV lending, this treatment may have the consequence of raising the cost of loans with PMI (as banks/originators pass on the extra cost of holding capital on to borrowers) and therefore leaving FHA with a higher share of these loans. Further, some industry experts have cautioned that the effect of these rules (if enacted in current form) in conjunction with regulations to be issued under the Dodd-Frank Act could adversely affect the origination of loans by private capital and its subsequent securitization in certain market segments such as high-LTV segments.

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