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The downs and ups of FHA lending: The government mortgage roller coaster ride ☆

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Throughout the last decade, mortgage markets experienced both a considerable decline and a considerable increase in the share served by the FHA. Concerns have grown about the solvency of the program and about the access to credit of the borrowers served by the FHA market. These concerns are due, at least in part, to the evolving distribution of loans in the FHA portfolio and uncertainty about future patterns of lending. This paper attempts to explain FHA lending patterns over the past decade, particularly the dramatic downs and ups of FHA lending. We pay particular attention to the drivers of these changes, and the implications of these changes for FHA lending, mortgage markets, and associated public policy initiatives.

1. Introduction

Throughout the last decade, mortgage markets experienced first a considerable decline in the Federal Housing Administration ("FHA") market share and then a considerable increase in the FHA market share. This government-insured share of the mortgage market traditionally met the needs of particular subpopulations of borrowers that might not have been as well served by conventional, conforming markets. For example, FHA has offered low down payments, low closing costs, and, during some periods, easier credit qualification standards than other lenders serving borrowers in the conventional market. This meant that income or wealth constrained minorities and first time homebuyers found the FHA product appealing. As stated in the 2012 FHA Mutual Mortgage Insurance Fund ("MMI Fund") Summary,

> The FHA program is, and has been, a critical player in supporting homeownership, especially for minority and low-income populations, and for first-time homebuyers. A variety of FHA programs allows many homebuyers to find a program to suit their needs; MMI Fund's 203(b) is the largest FHA program, providing mortgage insurance for 400,000 to 1 million homebuyers a year for the past several years and over 1.6 million in fiscal year 2010. An important target group for increasing homeownership is first-time homebuyers. FHA loans are highly attractive to borrowers who are credit-worthy but have difficulty assembling a large down payment or securing conventional financing.

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> FHA insurance has played a key role in mitigating the effect of economic downturns on the real estate sector, as FHA does not withdraw from local markets or during periods of recession.[1]

While FHA market share has grown rapidly, concerns about the program have also grown. A major issue has been the continued solvency of the FHA program. Widespread public concerns were documented in *Inside FHA Lending*, September 14, 2012, "As of November 2011, the FHA's capital reserve fund for unexpected losses was estimated at 0.24 percent – far short of the 2.0 percent cushion required by law. The MMI Fund is not projected to meet its statutory minimum requirement until 2015." By November 2012, when the annual report to Congress on the MMI fund was released, Secretary Donovan noted that "as the findings of the new independent actuarial study remind us, the job of re-stabilizing our national housing market is not finished. According to those findings, the capital reserve ratio of the MMI Fund, which contains FHA's single family mortgage insurance programs, has fallen below zero, to *negative* 1.44 percent. Loans insured prior to 2010 continue to be the prime source of stress on the Fund, with fully $70 billion in future claim payments attributable to the 2007–2009 books of business alone."[2]

The House of Representatives approved the FHA Fiscal Emergency Solvency Act of 2012 (H.R. 4264) to help insure that the FHA remains solvent and does not require a taxpayer bailout.[3] On September 27, 2013, FHA requested a mandatory appropriation of about $1.7 billion to cover expected future losses as mandated by the Federal Credit Reform Act of 1990.[4]

Simultaneous concerns have grown about the expected or unexpected losses to the program and about the access to credit of the borrowers served by the FHA market. Several previous studies have detailed the tightening in underwriting standards in the wake of the subprime market collapse. To understand the current importance of the FHA segment of the market, as well as to understand which borrowers might be impacted by changes to FHA standards or curtailment of FHA programs, we provide here a micro level discussion of the changing tract shares of FHA over the past decade. Our focus in this paper is to explain FHA lending patterns, particularly the dramatic decrease and then increase in FHA share. We pay specific attention to the drivers of these changes, and the implications of these changes for FHA lending, the mortgage market, and associated public policy initiatives.

An important result of the changes in FHA lending patterns over the past decade has been a reduction in the tract-level concentration of FHA lending such that FHA lending is now more prevalent over a greater number of tracts. In particular, it was in the (formerly) high FHA share tracts that FHA lending declined the most from 2000 through 2006. In contrast, the increase in FHA lending volume in the last few years has been far more dispersed across the country. As a result, FHA lending is now a more broadly integrated part of the overall mortgage lending market.

Furthermore, mortgages with higher loan-to-value ("LTV") ratios and borrowers from lower-income and minority census tracts disproportionately gained FHA share over the decade. In part, this was driven by the lower cost of FHA insurance relative to private mortgage insurance. It was also driven, however, by the much tighter credit requirements of the conventional market. In this regard, the growth in FHA share is clearly counter-cyclical.

This provides an interesting lesson for Congress and policy makers as they consider how to craft the housing market for the future. Clearly FHA's increased market share helped to stabilize mortgage origination volumes, by providing an alternative loan product to replace the subprime sector originations characterized by more relaxed underwriting standards. Policy makers may be concerned about the high concentration of FHA lending in high (above 80 percent) LTV lending, but there is no doubt that the rising share of FHA lending allowed increased access to credit at a critical time, relative to what would have been available in the absence of FHA lending.

The public policy question often raised with respect to FHA concerns the tradeoff between the provision of mortgages through a fully insured government product with its attendant risks and costs and the increase in homeownership that may result from this market segment when borrowers are constrained from getting mortgages from the private mortgage markets. Historically, there were clear goals and targeting of particularly underserved segments of the population that were served by FHA. It is unclear whether those goals and targeting will persist in the next decade.

The remainder of the paper is organized as follows. Section II discusses the roles of the federal government and FHA in housing finance. Section III summarizes previous research focused on FHA lending and Section 4 presents the data used in our analyses. The empirical results are found in Section 5 with conclusions in Section 6.

2. Historical perspective

The structure of the current mortgage market stems historically from important changes that occurred during the Great Depression and in the years directly following that era. A concerted effort was made by the federal government to provide liquidity and stability to housing markets, following a slowdown in housing construction and widespread housing foreclosures. Some of the housing market conditions present during the Great Depression mirror those observed over the past few years.

In 1932, the Federal Home Loan Bank System was established to provide liquidity to housing markets. The

[1] http://portal.hud.gov/hudportal/documents/huddoc?id=FHA_Fund_MMI_Fund_2_2012.pdf, last accessed November 30, 2013, at B-4.

[2] http://portal.hud.gov/hudportal/HUD?src=/fhammifrpt, last accessed November 30, 2013.

[3] http://financialservices.house.gov/uploadedfiles/hrpt-112-hr4264.pdf, last accessed November 30, 2013.

[4] Washington Post, "FHA Needs $1.7 Billion Taxpayer Subsidy," September 27, 2013 available at http://articles.washingtonpost.com/2013-09-27/business/42443524_1_fha-commissioner-carol-galante-housing-market-loans, last accessed November 30, 2013. Higher than expected losses were attributed to the Home Equity Conversion Mortgage ("HECM") program and not to the 203(b) program.