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# Credit Rationing in the U.S. Mortgage Market: Evidence from Variation in FHA Market Shares[1]

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This paper examines the nature of mortgage credit rationing across geographic markets and time. Particular attention is paid to the response of conventional mortgage supply to higher risk conditions associated with regional recessions. We develop a series of four indirect tests based on the spatial variation of the FHA share of mortgages, both endorsements and applications, as well as FHA and conventional rejection rates. Results of these four tests indicate that conventional mortgage underwriting criteria do not become more flexible and may even become more demanding when local economic conditions deteriorate. This result indicates the use of non-price credit rationing in the mortgage market

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and suggests a special role for FHA-insured mortgages as a mechanism for maintaining mortgage credit supply in declining housing markets. © 2001 Elsevier Science (USA)

## 1. INTRODUCTION

In this paper, we test the nature and existence of non-price credit rationing in single-family residential mortgage markets in the United States by exploiting the institutional fact that conventional lenders, including private mortgage insurers (PMIs), are free to vary conventional underwriting criteria across spatial markets (but not within markets), whereas the Federal Housing Administration (FHA) imposes spatially uniform underwriting standards for all FHA-insured mortgages.[2] Thus, in originating FHA and conventional mortgages, lenders in spatially defined mortgage markets across the United States are free to alter conventional mortgage underwriting criteria to reflect changing economic conditions while also offering FHA-insured mortgages with uniform underwriting criteria.

In areas experiencing an economic downturn, the risk of mortgage lending increases and the percentage of low-risk mortgage applicants falls. The resulting decline in demand for lower-risk conventional mortgages means that conventional lenders must cut prices if they are to maintain their market share in declining areas. Cutting price explicitly, in the form of lower mortgage rates or insurance fees, is inconsistent with observed price invariance over space.[3] Thus, if conventional lenders attempt to maintain their market share in declining (higher risk) areas, they must do so by relaxing underwriting criteria. Alternatively, conventional lenders may maintain underwriting standards and allow their market share to fall as fewer applicants are able to qualify. We develop a number of indirect tests for non-price rationing by conventional lenders in response to local differences in economic conditions, based on the implications of that behavior for the relative shares of FHA and conventional mortgage activity.

Recently expanded Home Mortgage Disclosure Act (HMDA) reporting requirements covering virtually all mortgage banking firms allow for the observation of spatial variation in patterns of applications, endorsements, and rejections for both conventional and FHA mortgages. Supplementing HMDA data with FHA internal records allows us to characterize the risk structure of

[2]The GAO [18] notes that, under FHA program guidelines, FHA mortgage underwriting criteria and premium structure do not deviate across geographic locations. Although conventional lenders and PMI maintain spatially uniform pricing structures (Duca and Rosenthal [8]), they may vary underwriting criteria spatially. The FHA may vary underwriting guidelines to a limited extent in response to Presidential decrees following natural disasters; however, these variations are highly localized.

[3]For a recent theoretical treatment that predicts a mortgage market equilibrium characterized by non-price rationing, see Brueckner [2]. Furthermore, Duca and Rosenthal [8] note that Fair Lending Laws make it difficult for lenders to differentially price applicants based on applicant risk.

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