With an eye toward changes that will likely take place in the current Congress, the Report evaluates FHA residential mortgage activity and examines steps the agency is taking, or may consider, to ensure its long-term viability while fulfilling its historical goals. The series takes a closer look at some of the difficult questions facing Congress and FHA. Future pieces will discuss a number of FHA reforms intended to limit the government’s exposure and reduce taxpayer risk, including:

- FHA loan limits
- Low downpayment loans
- Other underwriting guidelines and policies

This second report focuses on current proposals by the Administration to reduce FHA loan limits.
FIRST EDITION FINDINGS

The first report, released in February 2011, analyzed the FHA’s current policies, particularly its loan limits, historical mission, and growing market share. The main conclusion from that report was that FHA served the market well during the recession, and FHA mortgages, while continuing to have higher default rates than conventional loans (and charging a fee to cover the costs), did not experience as large a surge in defaults as did conventional and other (e.g., subprime) mortgage types. However, FHA has moved into risky territory as its market share and focus on higher balance mortgages have increased sharply over the last few years.

Specifically, our analysis found that the 2008 expansion of FHA's loan limits gave the program, which previously had focused on low-to-moderate income and first-time homebuyers, the ability to insure nearly 97 percent of the available low downpayment market for home purchase. As a result, FHA’s share of the home purchase market increased from 6 percent in 2007 to more than 56 percent in 2009. Additionally, we found that FHA-insured loans that were more than $350,000 had default rates that were approximately 20 percent worse than those on smaller loans. Thus, it is not clear that enlarging FHA market share by maintaining high loan limits is a good way to recapitalize the insurance fund; nor is it clear that FHA is flexible enough to operate for long periods of time with a large market share.

We congratulated the FHA for its timely expansion to serve as a lender of last resort, slowing the collapse of housing markets. Moreover, we pointed out that FHA was able to serve this role, in part because its market share of total originations going into the crisis was only about 2.5 percent in 2006, largely due to the surge in subprime and Alt-A lending by conventional lenders. Indeed, this small market share protected FHA from large losses and was a major factor in the relative stability of its default rates. Now, FHA’s market share of total originations has risen to nearly 30 percent. However, as conventional lending has expanded, the need for FHA to be a lender of last resort is fading. As a result, our policy recommendation was that over time the FHA should revert to its previous role: helping first-time and low- to moderate-income homebuyers purchase homes, allowing the private sector to shoulder more of the risk associated with insuring larger loans. This will lead to a reduction in its market share.

CURRENT POLICY CLIMATE

Shortly after the publication of the initial FHA Assessment Report, the Obama Administration released a white paper on “Reforming America’s Housing Finance Market” that recommended, among other proposals, allowing the highest FHA loan limits to lapse to lower levels. The Administration’s stated goal was to slowly scale back the government’s role in the mortgage market. The paper, issued by the Department of the Treasury, underscored the Administration’s commitment to “reducing government support for housing finance” and to “reduce the risk to FHA and the taxpayer.” Specifically, the Administration proposed reducing taxpayer risk by ensuring that FHA return to its pre-crisis role as “a targeted provider of mortgage credit access for low- and moderate-income Americans and first-time homebuyers.”

Administration’s desire to return FHA market share to its historic range of 10–15 percent.

The Administration and Congress have proposed allowing FHA’s current maximum loan limits to expire in October 2011. For the most expensive markets, this would allow the maximum loan limit to drop from $729,750 to $625,500. If the limits lapse in October, new values will be determined according to the provisions of the Housing and Economic Recovery Act (HERA) of 2008. According to a 2011 U.S. Department of Housing and Urban Development (HUD) Market Analysis, the impact of this change will be small. Specifically, there will be no effect in 2,665 counties or county equivalents that are currently eligible for FHA insurance. The effects on the remaining 669 areas are generally modest. The market brief concludes that, for the United States as a whole, approximately 3 percent of loans, by count, endorsed in calendar year 2010 (only 2 percent for those endorsed thus far in 2011) would be affected by the lower loan amounts. In sum, the effect of the return to the HERA loan limits will have a small effect on FHA volume or market share.

In order to affect FHA’s book of business significantly, the maximum loan limit needs to be reduced further than what is proposed. At the other end of the loan size spectrum, FHA’s minimum loan limit, which sets the maximum loan size in low-cost areas (currently $271,050), is very important in this process. It increased sharply during the run-up before the recent crash, but because it was not decreased when market prices fell, it is at levels significantly above the current market. Reducing both of these limits is consistent with FHA serving its traditional clientele.

**WHAT LOAN LIMITS ARE NEEDED TO SERVE LOW-INCOME AND MINORITY BORROWERS?**

Market share *per se* is not an appropriate goal for FHA or a metric for determining whether loan limits are adequate to meet the goal of serving first-time, low-income, and/or minority homebuyers. But share and serving are related. Here we look more closely at the relationship between FHA share and how it serves its “traditional” clientele. The Home Mortgage Disclosure Act (HMDA) dataset provides the information needed to determine loan amounts necessary to serve such borrowers. HMDA has data on virtually all FHA-insured mortgages, in addition to borrower characteristics, income, and loan amount. These are the very pieces of information needed to determine the types of mortgage loans being used by low-income and minority homebuyers, the groups that form the basis for FHA’s mission in normal mortgage markets.

Given that current lending conditions and housing demand are unusual, we have decided to examine the mortgage demand by lower income and minority homebuyers during the more conventional year of 2004. Of course, national house prices were approximately 15 percent higher (in nominal terms) at that time, and mortgage demand by low-income and minority borrowers was also very high. Accordingly, we have selected 2004 to represent an upper bound year for both the number of low-income and minority borrowers and for their required and desired mortgage amount.

Figure 1 (next page) reflects tabulations from the 2004 HMDA data of all mortgages issued to Hispanic and African American borrowers whose income was less than or equal to area median income for the areas in which they reside. Clearly, mortgage demand for these borrowers could be almost completely satisfied with a loan limit equaling $350,000. Moreover, a loan limit of $300,000 would satisfy 95 percent of these borrowers.
Figure 2 shows the distribution of 2004 first lien mortgages by amount for Hispanic and African American borrowers with income of less than or equal to area median income, for a selection of the nation’s highest cost Metropolitan Statistical Areas (MSAs). As might be imagined, the largest mortgages in Figure 1 were concentrated in these areas, and loan amounts of $300,000 to perhaps $350,000 are justified to serve this group of borrowers.

The distribution of loan amounts for low-cost MSAs is displayed in Figure 3. As might be expected, the distribution of loan amounts is shifted dramatically to the left, and it is evident that a loan limit of $200,000 is adequate to serve Hispanic and African American homebuyers with incomes at or below the median in these low housing cost cities.

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5 High-cost MSAs included Los Angeles-Long Beach-Santa Ana, CA; Washington-Arlington-Alexandria, DC-VA; Boston-Cambridge-Quincy, MA-NH; Chicago, IL.

6 Low-cost MSAs included Kansas City, MO-KS; Dallas-Fort Worth-Arlington, TX.
In normal housing markets, FHA’s mission to ensure access for low-income and minority homebuyers implies mortgage limits that are easily measured and updated based on readily available HMDA data. In low-cost cities, a maximum mortgage amount of $200,000 is appropriate. In high-cost cities, this may range as high as $350,000. There are a few exceptional cases, such as Honolulu, which traditionally require separate analysis, but HMDA-based methods can be applied in these areas also.

Under the proposed October 1, 2011 limits, the maximum FHA mortgage ranges from $271,050 in low-cost MSAs to $625,500 in high-cost areas. These limits were justified on a temporary basis to enhance the flow of credit to mortgage markets, particularly in a time when the Federal Reserve is substantially reducing mortgage holdings. However, it is clear from the above that these loan limits are much higher than required for FHA to serve its role of promoting homeownership among low-income and minority households.

Hence, HMDA data suggest that FHA can fulfill its mission with relatively low balance loans. This has implications for FHA’s market share. To determine the implication for market share, we reviewed different data sets that allow us to observe high loan-to-value (HLTV) ratio loans (HMDA does not have that information), which are what FHA insures, along with borrower information. This allows us to estimate the share of the market that is HLTV and goes to low- to moderate-income borrowers and first-time buyers.

First, data from McDash, a collector of data on mortgage markets, the percentage of loans that have a high loan-to-value ratio, meaning purchases made with less than a 20 percent borrower downpayment, was approximately 34 percent of all loans made from 1990–2010. However, in 2010, the number of HLTV loans was unusually high, totaling 41 percent. Hence, we consider a mission-related market share range of 34–41 percent of total originations.

Second, we use a separate data set from CoreLogic HLTV loans (a sample of 386,100 loans), which indicates that 60–72 percent of low- to moderate-income borrowers (incomes less than or equal to 100 percent of area median) are within the HLTV cohort. Hence, the share of low- to moderate-income borrowers that have HLTV loans ranges from 20.4 percent
(.34x.60x100 percent) to 29.5 percent (.41x.72x100 percent). However, this does not take into account FHA's focus on first-time buyers. To adjust for this, we look at the share of loans given to first-time homebuyers. Data released by HUD indicate that FHA insured 882,000 loans for first-time homebuyers in fiscal year 2010. This was about 53 percent of total FHA lending activity (compared to 1.66 million total FHA loans — not including Home Equity Conversion Mortgages).

FHA tends to have a higher than average share of first-time buyers. We have an alternative estimate from the 2010 National Association of Realtors Profile of Home Buyers and Sellers, which shows an overall U.S. market percentage of first-time homebuyers of 50 percent in 2010 (inflated by the discontinued first-time home buyer tax credit) and 45 percent over the period 2007 to 2010.

We use a range of 45–53 percent of first-time homebuyers. From this, we determine that for FHA to focus on low-income first-time HLTV borrowers requires a market share range from 9.2 (.34x.60x.45x100) to 15.6 percent (.41x.72x.53x100), which is consistent with the Administration's proposed target market share for FHA.

These are, of course, approximate ranges. On the one hand, FHA will do more than just first-time borrowers; on the other hand, it is unlikely to do 100 percent of the business for which it is eligible. Nonetheless, the calculations give a basic idea that 9 to 15 percent market share is consistent with FHA's mission.
Recent research on problems that have arisen in mortgage markets since 2007 and resulted in the failure of, among other institutions, Fannie Mae and Freddie Mac, has increasingly focused on a scenario in which lending criteria were relaxed in the hope of expanding opportunities for home purchase and/or making a fast buck from originating low-quality loans and selling them. These efforts appeared successful at first but later resulted in high loss rates due, in part, to fraudulent behavior. For example, loss rates on stated income loans initially were lower than those on comparable mortgages where income was verified, but over time this relation reversed, and stated income loans began to perform very badly indeed. There were similar experiences with other loan products. In some cases, it was determined that the problem was that underwriters were not aware that second liens were having a major effect on owners’ equity. While it is clear that low-income lending was not the prime cause of the recent surge in defaults, it is the case that instruments that appeared to be successful in opening home purchase and refinance opportunities to creditworthy homeowners resulted in higher and higher loss rates later on. Apparently good ideas went bad.

This has all happened before. Section 101 of the Housing and Urban Development Act of 1968 created the Section 235 homeownership program. This new section of the National Housing Act was motivated by a number of apparently sound principles.

First, the Kaiser Commission Report emphasized the growing demand for housing. Second, FHA programs had been focused on new housing that could meet design and inspection criteria that had limited the use of the program in central cities. Third, minority homeownership had been identified as important as a social goal in the wake of urban riots. Fourth, some FHA underwriting criteria, including those related to neighborhood characteristics, had been rejected as both discriminatory and economically unsound. Fifth, there had been some success with limited scale programs such as 221(h), which assisted in the sale of rehabilitated housing to low-income buyers with mortgages below market interest rates (BMIR).

The Section 235 program replaced the “economic soundness” criterion with one of “acceptable risk,” and allowed FHA to relax its property inspection criteria, as well as consideration of neighborhood characteristics, in mortgage underwriting. In addition to changed underwriting criteria, Section 235 was a BMIR program with mortgage payments capped at 20 percent of income (or one percent interest, whichever was larger). The program was targeted at households with income less than 135 percent of the maximum level eligible for public housing. As household income increased, the amount of mortgage payment subsidy decreased until households exited smoothly from the BMIR component of the program. FHA insurance was provided by a special risk insurance fund. For further details, see the discussion in Schafer and Field.

As noted in the report of the Financial Crisis Inquiry Commission (2011), the fact that these mortgages were financed with highly leveraged positions certainly amplified the crisis, but the initial wave of losses on the underlying mortgage assets was certainly very high.

The Commission Report set an ambitious goal of 26 million new or rehabilitated units over the next decade.

The Section 235 program was one of the major reasons for the moratorium on subsidized housing programs declared in 1973. By that time, 400,000 new or rehabilitated units had been financed with FHA guaranteed mortgages under the program. There were many documented cases of abuse in which substandard units were given cosmetic rehabilitation and sold to households who simply could not maintain the units when their flaws became evident. As Benston (1997) noted:

Some of the new owners defaulted on their mortgages, in part because they were advised that they could live “free,” since the bank could not repossess the property for several years. In addition, HUD would not pay off FHA loans until the properties were taken over and, if not sold, boarded up. Thus “FHAing” a neighborhood came to be a pejorative term.  

Indeed, community concern over the tendency of FHA lending to displace commercial mortgage credit in neighborhoods with the consequent problems of foreclosure and abandonment led to passage of the Home Mortgage Disclosure Act in 1975.

By 1979 approximately 18 percent of the Section 235 mortgages insured over the 1968 to 1973 period had been foreclosed or assigned. Losses were substantial, and many neighborhoods complained that they were now burdened with the abandoned units.

Another goal of Section 235 was to allow African American homebuyers to purchase housing and promote racial integration. The Kerner Commission Report on urban problems that led to civil unrest recommended a homeownership strategy to give low income households a stake in society. However, Gotham analyzed both the spatial pattern and new versus rehabilitated housing purchased by race and concluded that:

Findings indicate that while the housing subsidy program allowed a vast majority of participating white families to purchase “new” housing in suburban areas, most participating African American families purchased “existing” homes located in racially transitional neighborhoods in the inner city.  

In a general analysis of effects of fair housing legislation during the 1960–1970 period, Collins found little evidence that the legislation promoted integration.

In keeping with the Hegelian theme regarding learning nothing from history, let us fast-forward to the American Dream Downpayment Act of 2003, which provided up to $10,000 (or 10 percent of value, whichever was smaller) in downpayment assistance to first-time homebuyers who otherwise would not qualify for mortgages. The similarities between this and the Section 235 program were pointed out at the time that it was implemented. Subsequently it proved approximately as long-lived as the Section 235 program, i.e., it was terminated in 2007.

Perhaps even more disturbing than the experience of the American Dream Downpayment Act, where mortgage performance was not significantly different from other FHA business endorsed at the same time, was the policy of allowing special downpayment assistance. Who can argue against allowing sellers to assist borrowers who have no savings to provide a downpayment? In the late 1990s, FHA began to allow nonprofits to facilitate sales. Non-

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profit 501(c)(3) entities were allowed to “facilitate” purchases by providing downpayment assistance that sellers were contractually obligated to return to the nonprofit (plus an additional fee). Of course, sellers would elevate the price of homes sold under this arrangement because they knew that they would not be allowed to retain the downpayment. These FHA mortgages defaulted at rates as much as three times greater than other FHA loan products.

What is even more revealing is the difficulty that FHA had in shutting down this program, despite the large losses. In 2006, the Internal Revenue Service published a notice to remove 501(c)(3) status from organizations whose primary purpose was to facilitate these transactions. Then in May 2007, FHA published a Proposed Rule that would disallow the practice. Subsequently, the U.S. District Court in the District of Columbia blocked the implementation of the rule. Finally, in July 2008, H.R. 322, containing a provision that blocked the practice, was signed into law.

History having repeated itself both in terms of Section 235 and the American Dream Downpayment Act, as well as the general experience with “creative” underwriting of the 2000–2007 period, what might we conclude as FHA moves forward in 2011? In a careful discussion of the Section 235 experience, Carliner notes that FHA was ill-prepared to administer the initial program thrust upon it. The 235 program was resumed in 1976 with a higher interest rate and larger downpayment. It was limited to new housing and functioned without scandal for a period of time.

However, it did not reach the same disadvantaged groups whose plight prompted the initial legislation. Accordingly, the lesson that we should take away from this experience is that FHA, as currently organized, should not be used as an experimental program to encourage homeownership. The subsequent experience with seller-financed downpayment assistance reveals that there are powerful political forces willing to push FHA to allow very unsound lending practices. The experiments in high-risk lending have been performed, and encouraging first-time homeowners with no savings for downpayment or repairs to take on homeownership is not sound public policy, particularly in a world where foreclosure has consequences for housing stock and neighborhoods. Furthermore, the classic role of FHA property appraisal and inspection to protect and inform first-time homebuyers is particularly valuable for low-income and minority buyers. Unfortunately, the experience with downpayment assistance reveals that even the classic function of FHA as a provider of sound, market-based appraisals can come under political assault.
SUMMARY AND POLICY OPTIONS

Then what are the dials that need to be changed? The Administration has stated its intention to “coordinate program changes at FHA to ensure that the private market — not FHA — picks up that new market share.” To accomplish this, the Administration has recommended the following:

- Decrease the maximum loan size that can qualify for FHA insurance — first by allowing the present increase in those limits to expire as scheduled on October 1, 2011, and then by reviewing whether those limits should be decreased further moving forward
- To enhance solvency of the program, increase the price of FHA mortgage insurance, putting in place another 25 basis point increase in the annual mortgage insurance premium, as detailed in the President’s 2012 Budget
- Coordinate reforms of Fannie Mae and Freddie Mac with changes at FHA “to help ensure the private market, not FHA, fills the opportunities created by reform” 14

As FHA transitions from one mission, lender of last resort, to its other mission, serving first-time, low-income and minority homebuyers, the operating parameters of the program and its market share will change. FHA can ensure that its program guidelines serve those within its historical mission while keeping market share low as the current housing crisis subsides, and preparing the agency to perform its market stabilization role during the next economic downturn.

The Administration’s policy recommendations still are higher than necessary for FHA to serve its traditional market, and probably are insufficient to reach its goal of a 10–15 percent FHA market share. Getting closer to serving that market can be done through the following steps:

- Reductions in both the high and low end of the FHA’s loan limits:
  - First, reducing the FHA’s minimum loan limit from the current $271,050 to $200,000 — 48 percent of the current GSE limit, which was FHA’s traditional basis for its loan minimum, or “floor”
  - Second, returning the FHA loan limit “ceiling” to 87% of the GSE limit — the traditional formula for determining the ceiling levels — bringing the maximum loan amount FHA could insure from $729,750 to $363,000
- Returning to use of the current area median home price in calculating the local loan maximum, moving away from the 2008 median home price estimate
- Reversing the current policy that allows FHA to guarantee loans of up to 125 percent of the median home price in high-cost markets

Our analysis suggests that the planned reduction of FHA’s high-end loan limit is a good first step in returning the agency to its historical mission focus, but additional action is necessary to limit FHA to its traditional clientele. This will have an effect on FHA’s market share. A commitment to returning FHA to its historical intent will ensure its long-term strength and viability, both because higher balance loans probably will be riskier, and because FHA does not have the flexibility to operate well in a large market.

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