

Housing Policy, Subprime Mortgage Policy, and the Federal Housing Administration

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Abstract

This paper analyzes federal programs providing insurance and credit guarantees for housing. We analyze activities managed by the Federal Housing Administration (FHA), the Veterans' Administration (VA), and the Government Sponsored Enterprises (GSEs). We review and quantify the public resources devoted to these programs – the market value of the federal insurance and credit guarantees provided. The review clearly establishes the quantitative importance of credit guarantees in the federal system of housing support.

We then consider the activities of the FHA in more detail, focusing on the historical development of its role as supplier and guarantor of credit. We consider the rationale for these activities in the light of current competition in the mortgage market, in particular, the rise of the subprime mortgage market. We suggest that a reinvigorated FHA mortgage program could provide a comparison and a benchmark for evaluating predatory lending in the primary housing and mortgage markets.

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I. Introduction

Federal policy affecting housing is dominated by indirect and off-budget activities directed towards homeowners -- tax expenditure policies and federal credit, insurance, and guarantee programs – rather than the direct provision of housing or the payment of housing allowances to deserving renter households. Recently, the implicit goal of increasing homeownership has been articulated by the Secretary of the Department of Housing and Urban Development (HUD), and the federal objective of “an ownership society” has been made quite explicit.¹ This paper provides a review of these indirect and off-budget activities supporting homeownership, with special emphasis on the mortgage insurance and guarantee programs undertaken by the Federal Housing Administration (FHA). We begin with a brief review of housing subsidy programs, concentrating on the activities of off-budget agencies such as the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), as well as the Veterans’ Administration (VA) and the FHA. We review the history and operations of these organizations, and we highlight current issues about the housing system and the broader economy. We then concentrate on changes in the role and influence of the FHA, and we propose an expanded role for FHA in the housing system. In particular, we suggest explicit FHA policies designed to protect potential home buyers better from unscrupulous “predatory” lenders. This changed emphasis would give a new leadership role to the federal agency which pioneered the long-term self-amortizing mortgage more than a half century ago.

¹ See, for example, “Statement of the Honorable Alphonso Jackson, Secretary, U.S. Department of Housing and Urban Development,” before the United States House of Representatives Committee on Financial Services, April 13, 2005.

II. Federal Housing Programs: Direct Expenditures

As noted above, Federal housing policy is dominated by off-budget programs supporting home ownership and providing subsidies for middle- and upper-income home owners and home purchasers. In contrast, direct Federal expenditures for housing programs, Congressional appropriations for housing in the annual budget, are concentrated upon programs for lower-income households and mostly for rental households.

Direct Federal expenditures on housing began with the Public Housing Act of 1937, a federally financed construction program which sought the “elimination of substandard and other inadequate housing.” Dwellings built under the program are financed by the Federal government, but are owned and operated by local housing authorities. Importantly, the rental terms for public housing specified by the Federal government ensure occupancy by low-income households, currently at rents no greater than thirty percent of their incomes.

This program of government construction of dwellings reserved for occupancy by low-income households was supplemented in the 1960s by a variety of programs inviting the participation of limited-dividend and nonprofit corporations. Section 8 of the Housing and Community Development Act of 1974 further increased the participation of private for-profit entities in the provision of housing for the poor. The act provided for federal funds for the “new construction or substantial rehabilitation” of dwellings for occupancy by low-income households. The Federal government entered into long-term contracts with private housing developers, guaranteeing a stream of payments of “fair market rents” for the dwellings. Low-income households paid twenty-five (now thirty) percent of

their incomes on rent, and the difference between tenant payments and the contractual rate was made up by direct Federal payments to the owners of the properties.

Crucial modifications to housing assistance policy were introduced in the Section 8 housing program. The restriction that subsidies be paid only to owners of new or rehabilitated dwellings was weakened and ultimately removed, and payments were permitted to landlords on behalf of a specific tenant (rather than by a long-term contract with the landlord). This tenant-based assistance program grew into the more flexible voucher program introduced in 1987. Households in possession of vouchers receive the difference between the “fair market rent” (FMR) in a locality (that is, the HUD-estimated median rent) and thirty percent of their incomes. Households in possession of a voucher may choose to pay more than the fair market rent for any particular dwelling, up to forty percent of their incomes, making up the difference themselves. They may also pocket the difference if they can rent a HUD-approved dwelling for less than the FMR.

In 1998, legislation made vouchers and certificates “portable,” thereby increasing household choice and facilitating movement among regions in response to employment opportunities. Local authorities were also permitted to vary their payment standards from 90 to 110 percent of FMR. The 1998 legislation renamed the program the “Housing Choice Voucher Program;” it currently serves about 1.9 million low-income households.

In addition to these programs providing rental assistance, direct appropriations through HUD also support a few small programs encouraging homeownership, for example, down payment assistance and sweat equity grants.

Direct appropriations under all these programs amounted to \$37.7 billion in 2007; since 1990 these low-income housing programs have grown hardly at all -- by only about 0.6 percent per year in real terms.

III. Tax Expenditures

A. The Federal Tax Code

The most widely distributed and notoriously expensive subsidy to housing is administered by the U.S. Internal Revenue Service (IRS). Under the tax code, investments in owner-occupied housing have always been treated differently from other investments. If taxpayers invest in other assets (such as equity shares), dividends accruing under the investment are taxed as ordinary income, and profits realized upon the sale of the asset are taxed as capital gains. At the same time, the costs of acquiring or maintaining the investment are deductible as ordinary business expenses in computing a taxpayer's net tax liability under the internal revenue code.

In contrast, if a taxpayer makes an equivalent investment in owner-occupied housing, the annual dividend (i.e., the value of housing services consumed in any year) is exempt from taxation. In addition, the first \$0.5 million (for married taxpayers) of capital gains realized on sale is exempt from taxation. Two important components of investment costs, mortgage interest payments (up to \$1.0 million for married taxpayers) and local property taxes, are considered to be deductible personal expenses. In contrast, depreciation, maintenance, and repair expenses are not deductible.

These benefits have been in effect since the enactment of the Internal Revenue Code. The budgetary costs of the program (i.e., the foregone income tax revenues resulting from these special provisions) are sensitive to monetary policy and tax policy.

When interest rates increase, the value of the deduction for interest payments increases. If Federal or local tax rates are reduced, the value of the homeowner deduction declines.

The Federal tax code also provides two other forms of housing subsidy, both directed to renters rather than homeowners: housing tax credits and tax-exempt bonds.

The Low-Income Housing Tax Credit (LIHTC) Program provides direct subsidies for the construction or acquisition of new or substantially rehabilitated rental housing for occupancy by low-income households. The LIHTC Program permits states to issue federal tax credits that can be used by developers or property owners to offset taxes on other income, or which can be sold to outside investors to raise initial development funds for a project. Rents for these dwellings are limited to thirty percent of tenant income, and qualification requires that these units be set aside for occupancy by low-income households for a period of thirty years.

Federal tax credit authority is transmitted to each state, on a per capita basis, for its subsequent distribution to the developers of qualified projects. The credits are provided annually for ten years, so a “dollar” of tax credit authority issued today has a present value of 6 to 8 dollars.

In addition, states have always been permitted to issue debt, and the interest payments made by states (and their local governments) on this debt have been exempt from Federal taxation. The Tax Reform Act of 1986 placed, for the first time, a limit on the volume of bonds which could be issued by states for private purposes. “Private purposes” include the financing of most tax-exempt facilities (e.g., airports), industrial development agencies, student loans, and housing (multifamily construction and homeowner subsidies). The allocation of private-purpose bond authority among these

activities is supervised by each state, and the priorities among states may vary substantially.

The subsidy provided by tax-exempt bonds, the net difference between the market interest rate and the rate for tax-exempt paper, varies with changes in federal tax rates and with macroeconomic policy. When interest rates are low and the spread between taxable and tax-exempt interest rates is small, state and local governments may not issue tax-exempt bonds, since the costs of issue (underwriting, bond counsel, etc.) are relatively high.

As indicated above, the magnitude of tax expenditures for housing is dominated by the large and open-ended subsidies provided to those homeowners who itemize their deductions or who sell their residences in any year. For 2007, it was estimated that the homeowners' exclusion of imputed rental income cost the Federal treasury \$32.5 billion in foregone revenue. This is almost as much as *all* direct Congressional appropriations for low-income housing programs. The deduction for homeowners' mortgage payments represents an additional \$78.1 billion in tax expenditures. The property-tax exclusion cost an additional \$15.0 billion, and the exclusion of capital gains on housing from Federal taxation represented another \$43.0 in foregone tax revenues. In contrast, the Low-Income Housing Tax Credit represented only \$4.1 billion in foregone revenues. The issuance of tax-exempt bonds cost about \$1.4 billion in Federal revenue. Overall, Federal tax expenditures for homeowners in 2007 were \$166.1 billion, or about seven times the tax expenditures for all other housing programs. (See Jaffee and Quigley, 2007, for a detailed discussion.)

B. Mortgage Credit

Federal support for housing credit began in the aftermath of the great depression, with the establishment of the Federal Home Loan Bank (FHLB) System in 1932. FHLBs were chartered by Congress to provide short-term loans to retail mortgage institutions to help stabilize mortgage lending in local credit markets. Interest rates on these advances were determined by the low rates at which this government agency, the FHLB Board, could borrow in the credit market. In 1938, the Federal National Mortgage Association (FNMA) was established as a government corporation to facilitate a secondary market for mortgages issued under the newly-established FHA mortgage program (described below). The willingness of the FNMA to buy these mortgages encouraged private lenders to make FHA, and later VA, loans.

In 1968, the Association was reconstituted as a Government Sponsored Enterprise (GSE), Fannie Mae. The change allowed Fannie Mae's financial activity to be excluded from the federal budget. Its existing portfolio of government-insured mortgages was transferred to a wholly-owned government corporation, the newly established Ginnie Mae. In contrast, ownership shares in Fannie Mae were sold and publicly traded. Fannie Mae continued the practice of issuing debt to buy and hold mortgages, but focused its operations on the purchase of conventional mortgages neither guaranteed nor insured by the federal government. Freddie Mac was chartered as a GSE two years later, in 1970, but its shares were not publicly traded until 1989. Originally, Freddie Mac chose not to hold purchased mortgages in its portfolio. Instead, mortgages were pooled, and interests in those pools, mortgage-backed securities (MBS), were sold to investors with the default risk guaranteed by Freddie Mac.

These mortgages, subject to specific balance limits and underwriting guidelines—referred to as “conforming conventional” mortgages—are securitized by Freddie Mac and Fannie Mae. These MBS are guaranteed against default risk by the GSEs themselves. The two mortgage GSEs, Fannie Mae and Freddie Mac, operate under congressionally conferred charters, which provide both benefits and obligations. Their foremost benefit is an implicit U.S. government guarantee of their debt and MBS obligations. Their Federal charters oblige the GSEs to support the secondary market for residential mortgages, to assist mortgage funding for low- and moderate-income families, and to consider the geographic distribution of mortgage funding, including mortgage finance for underserved parts of urban areas.

The GSEs carry out this mission through two distinct business lines: (i) they create and guarantee mortgage-backed securities; and (ii) they purchase and hold whole mortgages and MBS in their on-balance-sheet retained-mortgage portfolios. The GSEs claim that both business lines are required to meet their charter responsibilities to support the secondary mortgage market and to unify the geographic distribution of mortgage funding. Economists are quick to point out, however, that the unhedged interest-rate risk embedded in the retained-mortgage portfolios creates a large contingent liability for the U.S. Treasury and a systemic risk for U.S. capital markets. Since the GSEs issue MBS, it also seems clear that the retained-mortgage portfolios are not essential for the agencies to carry out their charter obligations.

The extent of the subsidy provided by Federal taxpayers is somewhat difficult to estimate, and the distribution of subsidies among recipients is a good bit more problematic. It is certainly clear that large public subsidies are provided to the GSEs. The

GSEs benefit from their federal charters, which allow them to be treated, for some purposes, as agencies of the federal government rather than as private profit-seeking firms.² Estimates by the Congressional Budget Office (CBO, 2004) of the value of this special treatment totaled about \$1.5 billion in 2003.

The more important public subsidy to the GSEs arises from the government's implicit guarantee of all their debt and all their MBS obligations. Other financial institutions would surely be willing to pay a significant fee to receive a comparable guarantee from the Federal government. This special treatment of the GSEs arises in part because the Federal government views the securities issued by these organizations as safe and sound – if not, the government would not have exempted the GSEs from the protective regulations governing other similarly situated private entities. Thus, despite an explicit statement in every prospectus disavowing a federal guarantee, the GSEs enjoy lower financing costs than those of similarly situated private firms.³

GSE debt obligations are classified as “agency securities,” and are issued at interest yields somewhere between AAA corporate debt and U.S. Treasury obligations. This is despite the fact that the firms themselves merit a somewhat lower credit rating.⁴ An estimate of the cost of this implicit federal subsidy for the debt issued by the GSEs

² For example, the GSEs are exempt from state and local income taxation and from Securities and Exchange Commission registration requirements and fees. The GSEs may use the Federal Reserve as their fiscal agent, and they are provided a \$2.25 billion line of credit at the U.S. Treasury. GSE debt is eligible for use as collateral for public deposits, for unlimited investment by federally chartered banks and thrifts, and for purchase by the Federal Reserve in open-market operations. GSE securities are also exempt from the provisions of many state investor-protection laws. These privileges provide direct monetary savings to the GSEs, and these privileges have not been granted to any other shareholder-owned companies.

³ This benefit can be measured either in terms of the subsidized cost of GSE borrowing or in terms of the expected costs that would be imposed on the government if it had to make restitution to GSE bondholders and MSB investors.

⁴ The Congressional Budget Office estimates that without GSE status the housing enterprises would have credit ratings between AA and A. See CBO, 2001.

can be derived from the spread between the interest rates paid by the GSEs for the debt they issue and the rates paid by comparable private institutions. This comparison, in turn, depends upon the credit ratings, maturities, and other features of the bonds issued, as well as market interest rates and credit conditions. Quigley (2006) provides a detailed review of estimates of this spread which have been reported in different studies using different methodologies. On the basis of this kind of evidence, the CBO (2001) has concluded that the overall funding advantage enjoyed by the GSEs is about 41 basis points. The total Federal subsidy provided to GSE debt, in 2006 dollars, was estimated by the CBO (2004) to be \$4.7 billion in 1995, and \$13.7 billion in 2003. In large part, the tripling of this subsidy reflects the rapid growth of Fannie Mae and Freddie Mac during this recent period.

The implicit federal guarantee provides an analogous advantage to GSE-issued MBS compared with MBS guaranteed by other private entities. The market requires a greater capital backing for a private guarantee than for a guarantee made by Fannie Mae or Freddie Mac, and the provision of this additional capital reserve is costly to private firms. The CBO has also estimated that the advantage enjoyed by the GSEs is thirty basis points. When this is applied to the MBS issued by the GSEs in 1995, the estimated subsidy is \$3.2 billion (in 2006 dollars). By 2003, the subsidy had grown to \$10.1 billion, again reflecting the rapid growth in Fannie Mae and Freddie Mac during the recent period.

The combined subsidies to the GSEs in 2003, the most recent available estimates, amounted to over \$25 billion in 2006 dollars. These subsidies could, in principle, either be passed through to mortgage borrowers in the form of lower mortgage rates, or be

retained as profits by the GSEs. If an equivalent subsidy were provided to a competitive industry, it could be presumed that most, if not all, of the subsidy would be passed through to final consumers. There is evidence, however, that Fannie Mae and Freddie exercise considerable market power. (See Hermalin and Jaffee, 1996). However, even duopolists have incentives to pass forward part of a subsidy, and there is evidence that a part—perhaps about half--of this subsidy is passed through by Fannie and Freddie to mortgage borrowers.⁵ The residual fraction of this benefit is retained by the shareholders of the GSEs. This residual arises from the competitive advantage of the GSEs over other financial institutions which is conferred by their federal charters.

As noted, estimates of the reduction in mortgage interest rates attributable to this subsidy have some range -- around, say, forty basis points. (See Quigley, 2006, Table 3.) If the conforming limit for GSE loans were set low enough, more of the benefits of this interest-rate reduction would accrue to moderate income households. But the limit has been set generously by the Federal Housing Finance Board; conforming mortgages can currently be written for an eighty percent loan on a property selling for \$521,250 (\$781,875 in Alaska and Hawaii).

IV. The FHA and VA Insurance and Guarantee Programs

A. The Great Depression Origins

Before the depression of the 1930s, home mortgage instruments were typically of short terms (3-10 years) with loan-to-value ratios of sixty percent or less. Mortgages were

⁵ Differing estimates of the reduction in mortgage rates created by the subsidy has resulted in a quite contentious literature. Perhaps the lowest estimate, 7 basis points, is provided by Federal Reserve economists in Passmore, Sherlund, and Burgess (2005). A much higher estimate is provided by Blinder, Flannery, and Kamihachi (2004), in a study funded and published by Fannie Mae.

non-amortizing, requiring a balloon payment at the expiration of the term. The onset of the Great Depression engendered a liquidity crisis beginning in 1930, precluding renewal of many outstanding contracts. Other borrowers were simply unable to make regular payments. The liquidity crisis affecting new mortgage loans, together with elevated default rates on existing loans, had catastrophic effects upon housing suppliers as well as housing consumers.

Despite voluntary forbearance on the part of some lending institutions and mandated forbearance enacted by many state legislatures, the system of mortgage lending which existed in the early 1930s continued to contract, and many lending institutions simply failed. The establishment of the Home Owners' Loan Corporation in 1933 within the Federal Home Loan Bank System (established a year earlier) provided stop-gap refinancing for a million mortgages. Passage of the National Housing Act of 1934 established the structure of home mortgage insurance and facilitated the growth of the modern system of mortgage finance in the U.S.

The 1934 Act established the Federal Housing Administration (FHA) to oversee a program of home mortgage insurance against default. Insurance was funded by the proceeds of a fixed premium charged on unpaid loan balances. These revenues were deposited in Treasury securities and managed as a mutual insurance fund. Significantly, default insurance was offered on "economically sound" self-amortizing mortgages with terms as long as twenty years and with loan-to-value ratios up to eighty percent.

Diffusion of this product across the country required national standardization of underwriting procedures. Appraisals were required, and borrowers' credit histories and

financial capacities were reported and evaluated systematically. The modern standardized mortgage was born.⁶

The Mutual Mortgage Insurance Fund, which was established to manage the reserve of annual premiums, was required to be actuarially sound. This was generally understood to involve very small redistributions from high-income to low-income FHA mortgagees. (See, for example, Aaron, 1972.) By its original design, the FHA was clearly intended to serve the vast majority of homeowners. Initial loan amounts were restricted to be no larger than \$16,000 at a time when the median house price was \$5,304.⁷

Near the end of World War II, it was widely feared that the peace time economy would return the housing market to its depression-era performance. Indeed, housing starts in 1944 were at about the same level as they had been a decade earlier. The VA loan program, passed as a part of the GI bill in 1944, rapidly evolved from a temporary “readjustment” program to a long-range housing program available to veterans for a decade or more after returning to civilian life. This transformation contributed to the boom in the residential construction industry which began in the late 1940s. Ultimately, a liberal program of veterans’ home loans was established in 1950 and subsequently extended. In contrast to the insurance provided by the FHA, the VA provided a federal guarantee for up to 60 percent of the face value of a mortgage loan made to an eligible veteran, subject to a legislated maximum. The VA program facilitated loans by private lenders on favorable terms with no down payments at moderate interest rates.

⁶ See Green and Wachter (2005) for an extensive discussion of this history.

⁷ The FHA ceiling was reduced to \$6,000 in 1938, but that level was still above the price of the median house at the time, \$5,804.

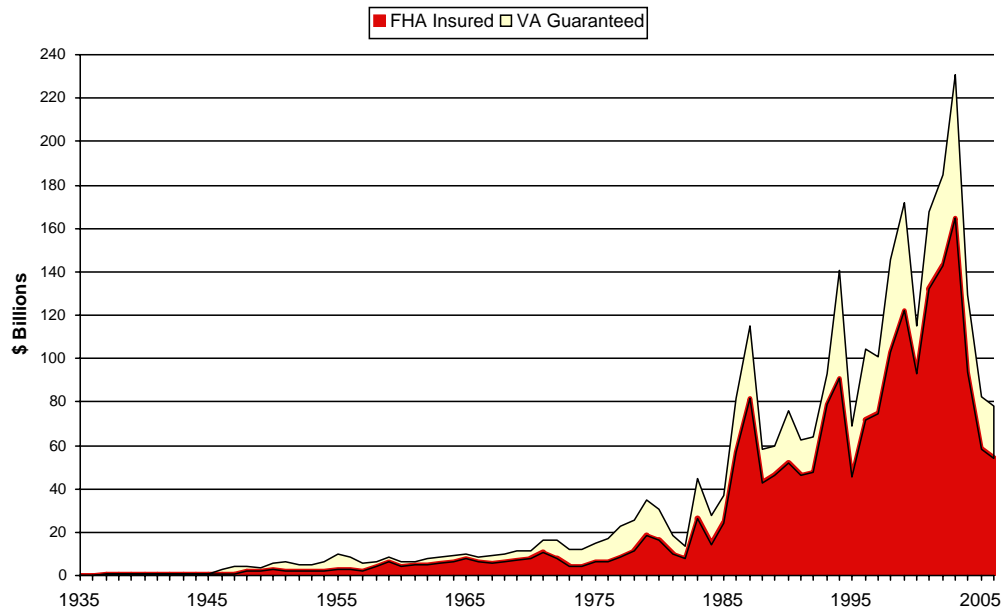
B. The FHA and VA Programs in the Post World War II Housing Market

The two programs, FHA and VA, providing government insurance and mortgage guarantees, brought homeownership opportunities to middle class American households in a short space of time. Since 1950, annual housing starts have rarely fallen below one million. Figure 1 shows the remarkable growth of mortgage originations attributable to these programs.⁸ In 1960 about \$5 billion in FHA insured mortgages and \$2 billion in VA guaranteed mortgages were issued. The programs reached their all-time peak volume in 2003, when the FHA insured about \$165 billion and the VA guaranteed about \$66 billion in mortgages. The year 2003 also marked the all-time peak in real terms. Since 2003, the volumes of mortgage originations in both programs have declined significantly, so that by 2006 the FHA insured under \$54 billion and the VA guaranteed under \$25 billion in mortgages, a decline of two thirds from their peak volumes recorded just three years earlier.

The fraction of total mortgage originations attributable to the FHA and VA has also declined systematically over time. Figure 2 reports that the FHA mortgage origination share (based on dollar volume) has declined from the peak share of about 25 percent in 1970 to under 2 percent in 2006. The VA guaranteed mortgage share has similarly declined from a peak share of almost 28 percent in 1947 to under one percent in 2006. Figure 3 shows the corresponding trend in FHA and VA mortgages outstanding as shares of the total one-to-four family mortgages outstanding.

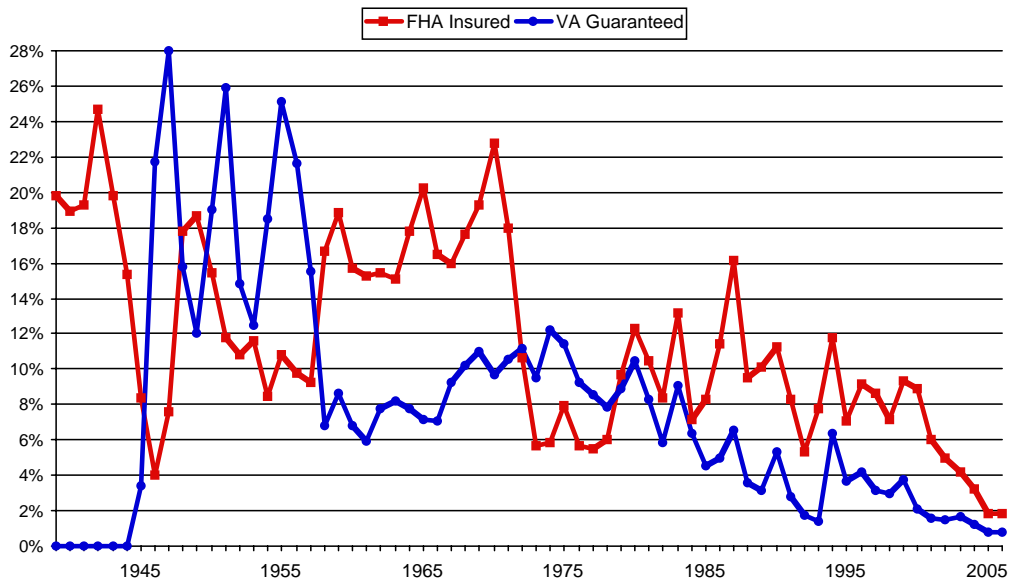
⁸ This figure and the subsequent discussion focus on the single-family insurance programs of the FHA and VA agencies. The original mission for the FHA also included multifamily housing, and starting in the 1960s the FHA multifamily programs became significant in size and scale. Indeed, the multifamily program became quite notorious for allegations of waste, fraud, and corruption; see Vandell (1995) and Quigley (2006). However, multifamily loans never exceeded 15 percent of the total FHA portfolio and today they are less than 10 percent. In this paper, we consider only the single-family program.

**Figure 1: Dollar Volume of FHA and VA Mortgage Originations
1935-2006**



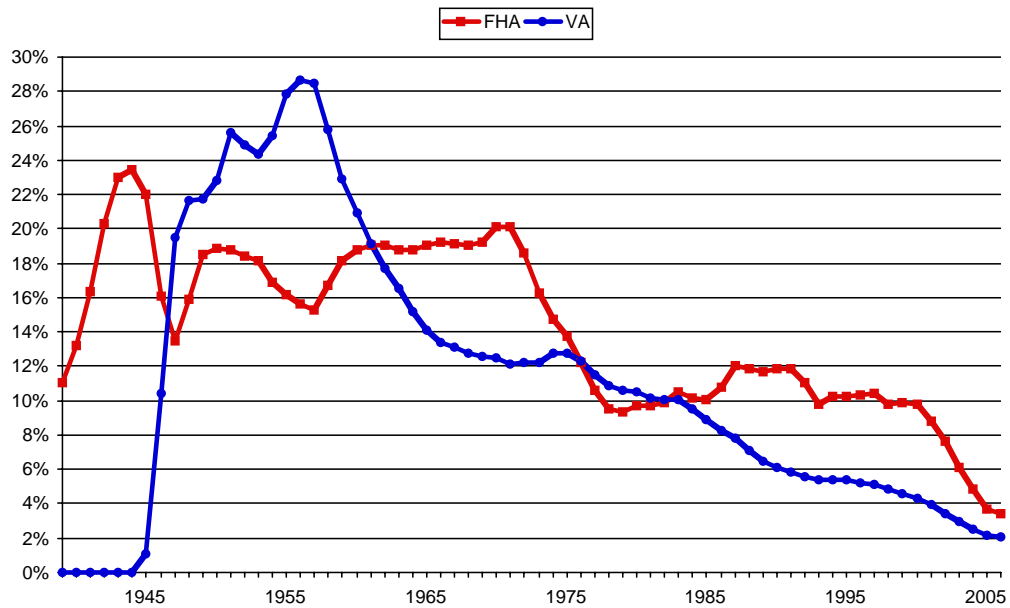
Sources: to 1990 – Historical Statistics of the United States Millennial Edition Online
<http://hsus.cambridge.org/SeriesDc903-1288>
 1990 to 2005: Office of Federal Housing Enterprise Oversight

**Figure 2: FHA and VA Mortgage Originations
Share of Total Originations
1939-2006**

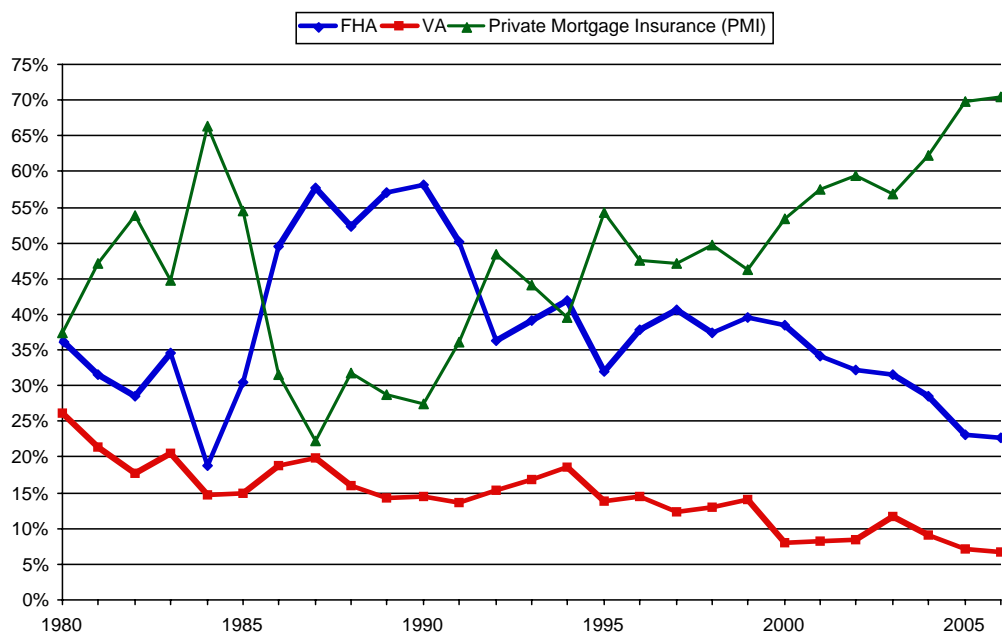


Sources: to 1990 – Historical Statistics of the United States Millennial Edition Online
<http://hsus.cambridge.org/SeriesDc903-1288>
 1990 to 2005: Office of Federal Housing Enterprise Oversight

**Figure 3: FHA and VA Mortgages Outstanding
Percent of All 1-4 Family Mortgages
1939-2006**



**Figure 4: Insured Mortgages by Insurance Share
1980-2006**



Source: U.S. Department of Housing and Urban Development, *U.S. Housing Market Conditions: 4th Quarter 2006*, February 2007. Historical data, pp. 65-94.
<http://www.huduser.org/periodicals/ushmc.html>

The secular decline in the market share of the two programs and the precipitous decline in both market shares and dollar volumes since 2003 raise serious policy issues concerning the future of the two programs. A reasoned policy response requires a sound understanding of the forces that have contributed to these absolute and relative declines in the program activity. We consider the forces creating these declines, analyzing first the long-term factors, and then the more recent and immediate contributors.

C. The Declining FHA and VA Market Shares: Long-Term Causes

The long-run decline in FHA and VA originations has arisen from two primary factors, both relating to the development of the private mortgage insurance (PMI) industry. A significant PMI industry was first developed in the U.S. during the housing boom of the 1920s. These insurance firms quickly went bankrupt in the early years of the Great Depression, and there were allegations of fraud and mismanagement as well. The recreation of a PMI industry began in 1957, aided by the evident success of the FHA and VA programs.⁹ Until the experience of FHA/VA mortgages was accumulated, it was not well known or widely appreciated just how safe home mortgages are from default. Balances in the FHA Mutual Mortgage Insurance Fund were easily observable to private actors. The development of the PMI industry was also abetted by the expansion of Fannie Mae and Freddie Mac, whose charters require that credit enhancement be provided on all mortgages they purchase or guarantee with loan-to-value ratios above eighty percent. PMI has been the dominant form of this credit enhancement.

Secondly, the rules governing FHA and VA coverage affect the government-insured market share as a proportion of the total insured market (that is, the market which

⁹ In 1957 MGIC became the first private mortgage guarantee firm established since the Great Depression.

includes PMI and other credit enhancements). In particular, fixed-dollar limitations on government insured mortgages significantly reduced the ability of the FHA and the VA programs to serve middle- and upper-middle-income households. Figure 4 reports the number of FHA and VA insured mortgages as a fraction of the number of all insured mortgages. As the figure shows, FHA/VA mortgages were almost eighty percent of all insured mortgages in 1987. This fraction, however, has steadily declined ever since, so that by 2006, the FHA and VA programs represented less than thirty percent of all insured mortgages.

D. The Recent Collapse in FHA and VA Program Activity

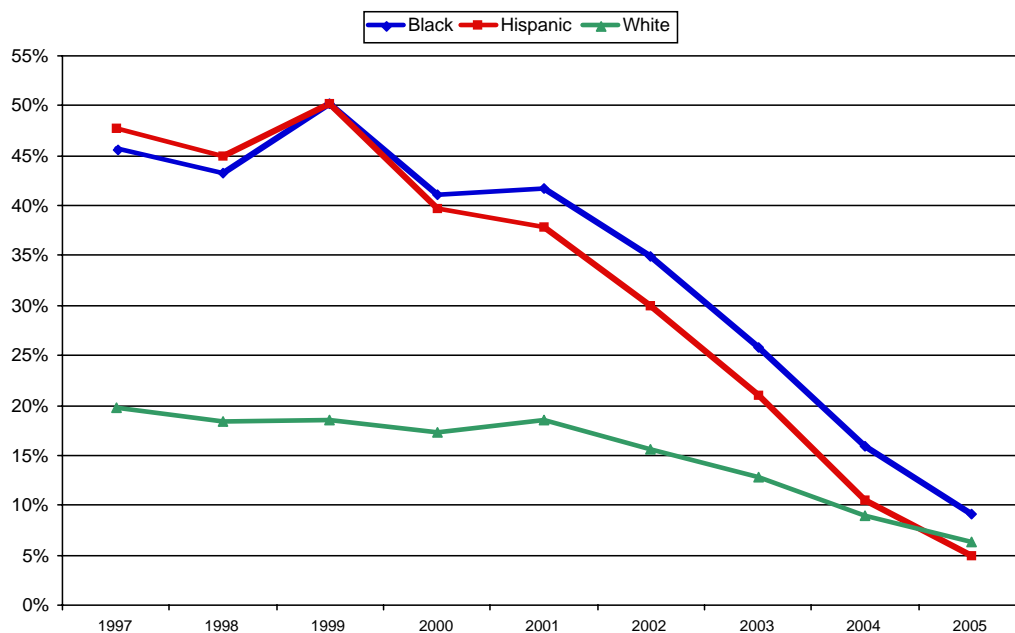
Although the FHA program was initially developed to support a large part of the mortgage market, for the past quarter century its focus has been on lower-income borrowers. Indeed, the Housing and Community Development Act of 1981 explicitly established specific targets for serving low-income borrowers. The availability of low-down-payment FHA mortgages and FHA mortgages for those with a less-than-perfect credit rating has meant that FHA's market share of originations has been larger for those traditionally disadvantaged in the home ownership market. As a result, the overwhelming fraction of FHA borrowers have obtained mortgages with loan-to-value (LTV) ratios of 95 to 98 percent or more, including a large number of borrowers with "nontraditional" credit histories or with imperfect credit records. The academic literature has documented these specific attributes of the FHA clientele. For example, Ambrose and Pennington-Cross (2000) find that FHA market shares are higher in cities with higher economic risk characteristics, while Ambrose, Pennington-Cross, and Yezer (2002) find that as local

economic conditions deteriorate, conventional lenders tend to withdraw mortgage finance, in effect making the government programs the only source of credit.

Data released under the Home Mortgage Disclosure Act (HMDA) include measures of the income and race of borrowers, as well as the census tracts in which they reside. By comparing insured and uninsured mortgage originations, it is possible to gauge how well the FHA succeeds in serving a lower-income clientele.¹⁰ Figure 5 presents estimates of the FHA plus VA share of total mortgage originations separately by race. In 1997, market shares for black, Hispanic, and white borrowers were 46, 48, and 20 percent respectively. By 2005, the combined FHA-VA market share for each borrower group had fallen precipitously, to between five and ten percent. The Hispanic borrower share (five percent) was actually below that of white borrowers (six percent). Figure 6 reports the combined FHA-VA market share by the income of the census tract in which the borrower resides. In 1997, the government programs had a 16 percent share of mortgages made in upper-income neighborhoods and close to a 35 percent share of originations in low- and moderate-income neighborhoods. By 2005, the FHA-VA share for all neighborhood categories had declined precipitously and converged to values about 5 percent. Figure 7 reports analogous FHA-VA market share information by the fraction of minorities living in the census tract of origination. By 2005, all these market shares had fallen rapidly to shares of about 5 percent.

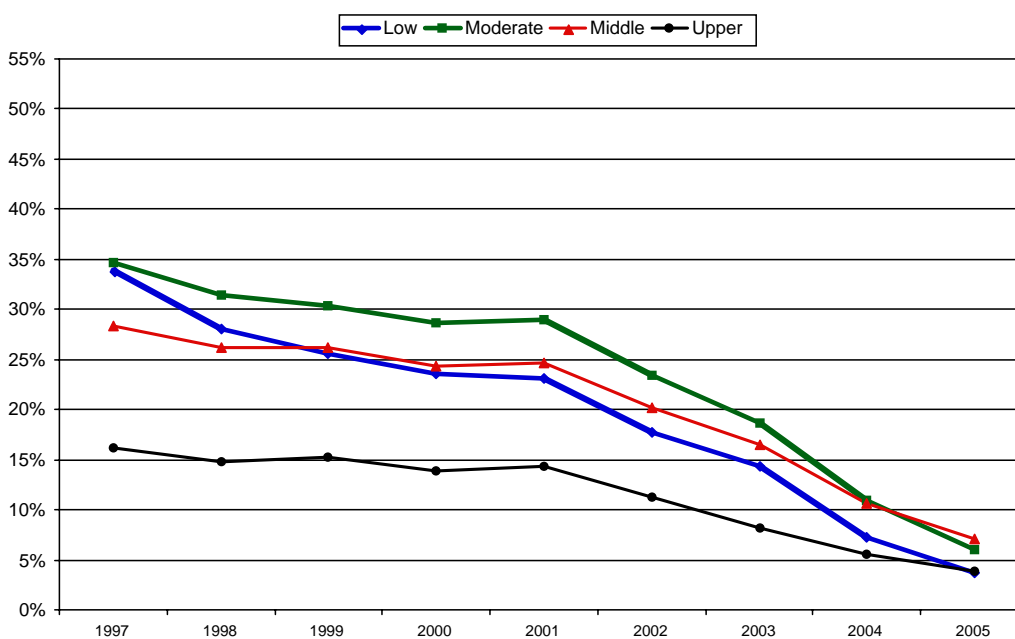
¹⁰ Quigley (2006) analyzed the same data for the period just before the sharp decline of the last three years. GAO (2007a), published after the first version of this paper had been circulated, also analyzes these data, but only during the 1996 - 2005 period.

**Figure 5: FHA+VA Share of Origination, by Borrower Race
1997-2006**



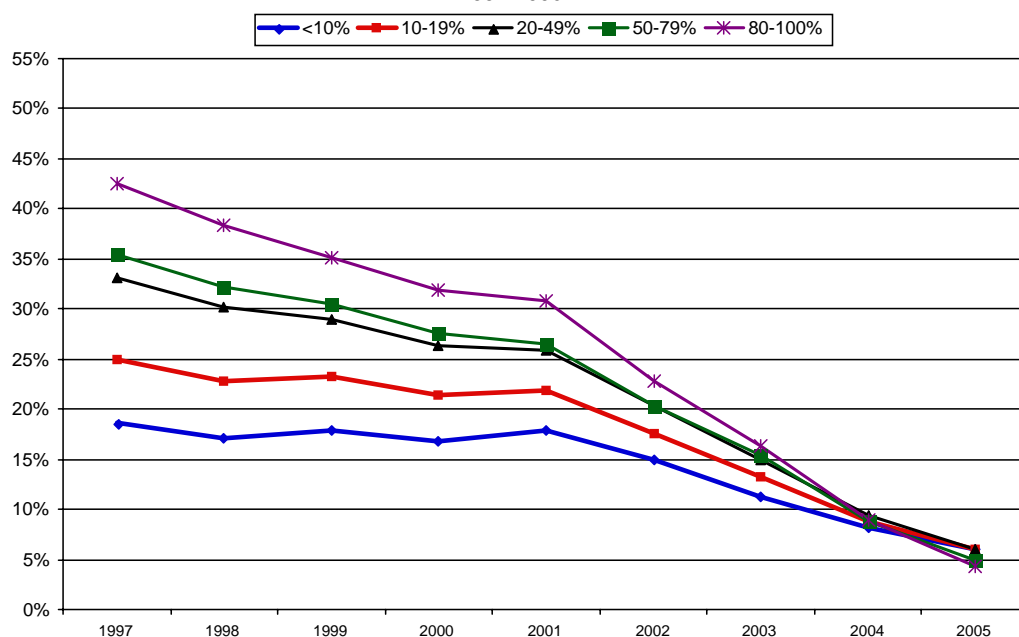
Source: Federal Financial Institutions Examination Council (FFIEC),
Home Mortgage Disclosure Act (HMDA) National Aggregate Report
<http://www.ffiec.gov/hmdaadwebreport/NatAggWelcome.aspx>

**Figure 6: FHA + VA Market Share by Census Tract Income
1997-2006**



Source: Federal Financial Institutions Examination Council (FFIEC),
Home Mortgage Disclosure Act (HMDA) National Aggregate Report
<http://www.ffiec.gov/hmdaadwebreport/NatAggWelcome.aspx>

**Figure 7: FHA + VA Share of Originations by Census Tract Percent Minority Population
1997-2006**

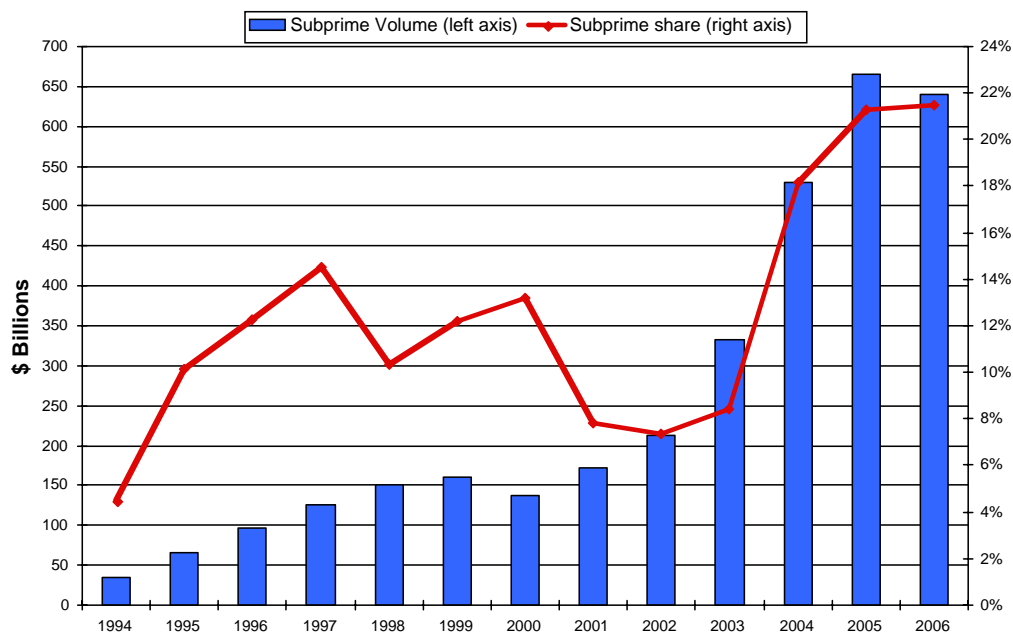


Source: Federal Financial Institutions Examination Council (FFIEC),
Home Mortgage Disclosure Act (HMDA) National Aggregate Report
<http://www.ffiec.gov/hmdaadwebreport/NatAggWelcome.aspx>

In summary, Figures 5 to 7 indicate that, however borrower characteristics are categorized, the government insured share had simply collapsed to about five percent by 2006. This reinforces the trends noted in Figures 1 to 3; FHA and VA shares have fallen precipitously, to less than two percent by 2006.¹¹ We now consider the factors responsible for this precipitous decline in FHA and VA originations since 2003. We identify four specific factors—subprime lending, predatory lending, GSE competition, and the failure of the FHA to innovate its mortgage contracts. We discuss each in turn.

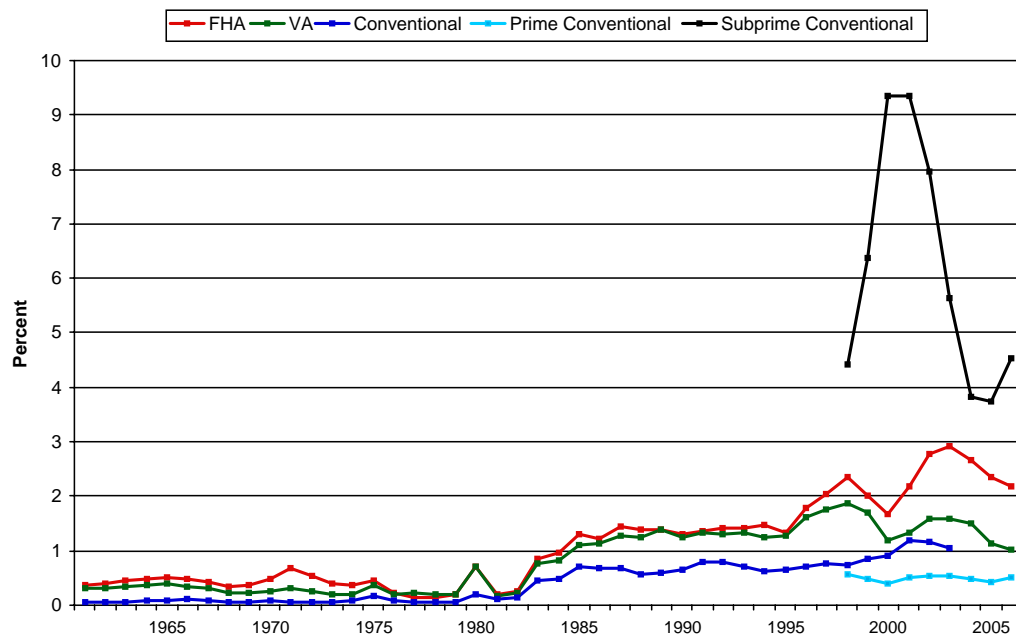
¹¹ The aggregate data use HUD's estimates of total mortgage originations and FHA and VA mortgage originations based on data reported by the agencies. The HMDA data, in contrast, are based on a sample of large, for-profit, and metropolitan lenders who are required to report their loan applications and loans made. The higher FHA+VA market share in the HMDA data would arise if the surveyed lenders have a higher share of government insured mortgages than the universe of all lenders.

**Figure 8: Subprime Lending and Total Mortgage Originations
1994-2006**



Source: Inside Mortgage Finance Publications, *Inside B&C Lending*, December 2006.
http://www.imfpubs.com/issues/imfpubs_ibcl/archives.html

**Figure 9: Foreclosure Rate, Year-End Inventory
1961-2006**



Source: Mortgage Bankers Association, National Delinquency Survey
<http://www.mortgagebankers.org/ResearchandForecasts/ProductsandSurveys/NationalDelinquencySurvey.htm>

1. Subprime Lending¹²

Figure 8 shows the dramatic inroads that conventional subprime lending has made as a share of total home mortgage originations. As recently as 2002, subprime lending represented only seven percent of total mortgage originations, but its market share rose to more than 21 percent by 2006. This 14 percentage point increase in market share coincides with the precipitous decline in FHA and VA lending. Correlation, of course, need not imply causation. But the subprime lenders and the government insured programs would seem to share a very similar clientele—focusing on borrowers with lower credit scores, offering lower down payments, and so on. So it seems highly plausible that the expansion of the subprime loan market is the source of some, and perhaps most, of the decline in the market share of the FHA and VA programs.

The recent financial distress of some subprime loans has made headline news and drawn some regulatory responses.¹³ Figure 9 compares the foreclosure rates on FHA, VA, and conventional mortgages over the past 30 years, based on data from the Mortgage Bankers' Association (MBA). The MBA series on conventional mortgage foreclosure rates was discontinued at the end of 2003, but it was replaced with separate series on prime conventional and subprime conventional loans, available beginning in 1998. Until 1997, the annual default rates for the available categories never reached as high as two percent. In contrast, the foreclosure rates on subprime loans, with data starting in 1998,

¹² See Murphy (2007) for a useful primer on subprime mortgages.

¹³ Starting in 1999, and expanding since then, the principal bank regulators—the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision -- have enforced stronger regulatory standards (described as “guidance”) for evaluating subprime lenders. Most recently, in March 2007, the Federal Financial Institutions Examination Council—representing the US banking regulators -- issued expanded guidance concerning alternative mortgage products, including a renewed focus on predatory lending practices.

are almost an order of magnitude higher, exceeding nine percent annually in 2000 and 2001; foreclosure rates are currently above four percent.¹⁴ In recent years, the FHA foreclosure rate has also remained relatively high, above two percent, while the VA foreclosure rate has remained above one percent, although in both cases their recent trend has been downward. The foreclosure rate on prime conventional loans has been very stable at about 0.5 percent in recent years.

The growth of the subprime loan market is certainly one source of the recent decline in the FHA and VA market shares. But this raises the deeper question of why the subprime market expanded so suddenly. What skills or techniques were subprime lenders able to adopt – quite suddenly it appears, in about 2000 – that were not evident earlier? This is a key question for the government-insured programs, since it may identify the missing skill or technique that could allow them to regain a reasonable share of the lower-income mortgage market. Given the relatively short history of the subprime market, and the uncertainty over how (or whether) it will survive its current crisis, answers are necessarily speculative. Nevertheless, three factors appear to be crucial:

a) Technology. Access to large bodies of information concerning current borrowers and past loan outcomes has been combined with computing power and statistical methods to extract new and useful information concerning likely default rates and loan costs, especially for lower-quality borrowers.

¹⁴ There are various possible explanations for the recent decline in subprime foreclosure rates., even when the headlines suggest the opposite. One explanation is that lenders and mortgage servicers rely less on formal foreclosures to close defaulting loans. An alternative explanation is that the recent bankruptcy of some mortgage lenders, which has created the headlines, actually reflects the cumulative effect of the previously high foreclosure rates, and current market conditions are more benign than the headlines suggest.

b) Contract Innovation. The mortgage markets have created new “alternative” mortgage contracts (including interest-only, optional-payment, and incomplete-document loans).¹⁵ They have also expanded the use of traditional formats (such as adjustable-rate and negative-amortization mortgages) as alternatives to the standard, fixed-rate, long-term mortgages offered by FHA and VA.

c) Securitization. Many of the lenders utilizing this new technology and sponsoring innovative contracts have a limited capacity to hold mortgages, so it has been essential they have access to the new and efficient techniques of mortgage-backed and asset-backed securitization for selling newly originated loans in the secondary market.

Although these factors creating the subprime mortgage boom are reasonably clear, it is very unclear at this time how prolonged and deep the current financial distress for subprime lending in the U.S. will be. Despite the current mortgage crisis, the U.S. subprime market does rest on sensible fundamentals—technology, contract design, and securitization—so it is likely that the market will continue to operate as a long-term and viable competitor for the FHA and VA government insurance programs. We will return to this issue when discussing policy options for the government insurance programs in Section V.

2. Predatory Lending

Headlines in the popular press as well as the business press have drawn attention to predatory lending practices as well as subprime mortgages. Predatory loans generally refer to loans which the borrower would have rejected with full knowledge and

¹⁵ See Piskorski and Tchisty (2007) for a discussion of the new alternative mortgages based on the concepts of security design.

understanding of their terms and those of available alternatives. In practice, predatory loans rely on a range of practices including deception, fraud, and manipulation that create loans with terms that are highly disadvantageous to the borrower, thus creating a high likelihood of default (to which the lender is generally immune.) (See Government Accountability Office, GAO, 2004; Morgan, 2007.)¹⁶ The two key features of predatory loans are: first, the borrower would not have agreed to the loan had he or she understood the terms and conditions; second, the lender earns an acceptable return even if the borrower defaults. These features contrast with a standard subprime loan, in which the borrower benefits from the loan, and in which the lender (or loan investor) suffers a loss if the borrower defaults.

Actions have been taken at the federal, state, and local levels to stop predatory lending. At the federal level, banking regulators, the Federal Trade Commission, the Department of Housing and Urban Development, and the Department of Justice all enforce rules and regulations against predatory lending activities. (See GAO, 2004, for the details and the applicable laws and statutes). At least thirty states have now passed anti-predatory lending statutes. North Carolina and New Jersey are examples of the strongest statutes. (See Ho and Pennington-Cross, 2006, and Holder and Manuel, 2007.) A number of cities, including Baltimore, Philadelphia, Oakland and Washington DC have also passed ordinances mandating ceilings on the points paid and the mortgage interest rates charged, usually stated in terms of the Annual Percentage Rate. (See Litan, 2001.)

¹⁶ Specific devices include loan flipping (repeated refinancing with excessive prepayment penalties), unexpected balloon payments, and mandatory arbitration.

The rigid regulation of lending terms, however, runs the risk that it will discourage appropriate and efficient subprime lending as well as predatory lending. One problem is that the proposed regulations generally focus on the easily quantifiable aspects of loans, such as defining a maximum spread for the contract rate relative to treasury rates or imposing fixed limits on the number of points. While limits such as these will no doubt stop some predatory loans, they will also discourage some, perhaps even more, sensible subprime loans.

One regulatory approach would be to impose a duty of “suitability” on mortgage lenders in the same way that the duty has been imposed upon stock brokers. Ever since 1938, the National Association of Securities Dealers (NASD) has required that brokerage firms be held responsible for recommending investments that are financially suitable to the economic circumstances of their customers (Rule 2310). Courts and arbitration panels routinely adjudicate claims of “unsuitability,” awarding damages to customers and imposing sanctions upon firms which have sold securities unsuitable to their clients. A large plaintiffs’ bar has arisen to police overly aggressive brokers. It is not hard to envision applying an analogous duty of suitability upon mortgage lenders.

Another useful regulatory approach would focus on disclosures and incentives that can mitigate the informational asymmetry, under which inexperienced borrowers are unaware of more beneficial alternative contracts for which they might also qualify. For example, it appears that mortgage brokers often receive their full commission soon after a loan is closed. If the loan subsequently defaults, there is no recourse to the broker for the commission already paid. Mortgage brokers thus have clear incentives to recommend loans to borrowers, even when they know that an early default is likely. An incentive-

compatible reform would impose a delay on the payment of origination fees and commissions to mortgage brokers, at least until the borrower creates a credible record of on-time payments. More generally, it would seem that the best way to mitigate asymmetric information is to create a standardized, non-predatory, subprime loan and require that all lenders making loans to lower-income borrowers disclose the availability of this loan. As noted below, we suggest that this be a primary function of an expanded FHA.

3. The Government Sponsored Enterprises Go “Down Market”

The expansion of the GSE mortgage portfolios into riskier mortgages is a third important factor which has reduced the market share of the FHA and VA government insurance programs. The GSE expansion is partly profit-motivated, since the GSEs require new markets if they are to expand beyond their traditional domain of prime conforming mortgages. But it is also regulatory-based, since the GSEs now face “affordable housing goals,” which require that they allocate specified shares of their lending activity to various classes of lower-income borrowers. (See Weicher, 2006, and Jaffee and Quigley, 2007, for detailed discussions of the goals).

The academic literature has confirmed the recent “down-market” expansion of the GSEs and has found it to have a measurable impact on the traditional domain of the government-insured programs. An and Bostic (2006) present quantitative evidence that the GSEs are increasingly targeting borrowers who would otherwise represent the higher-quality segment of FHA borrowers. Using HMDA data, they confirm the fact that as the GSE share of originations in an underserved neighborhood expands, the FHA share declines. Their theoretical model also predicts that in response to GSE competition the FHA will raise its underwriting standards, in order to control what is now a lower-quality

loan pool, on average. Most recently, An, *et al* (2007) have investigated the relationship between the GSE affordable housing goals and the FHA clientele. Using a sample of FHA loans, they confirm the decline in the quality of the FHA borrowing pool; they also find that FHA borrowers exercise their refinancing options less aggressively, consistent with other studies of lower income borrowers and those with lower credit ratings.

Analyses of the overlap in clientele are an alternative method to measure the possible substitution between GSE and FHA loans. HUD has commissioned several such studies, including a thorough analysis by Abt Associates (HUD, 2005). The analysts used micro data on loans to estimate two statistical models, one predicting FHA loans and the other GSE loans. If the 95 percent confidence interval for an individual loan did not include a probability of 0.0 or 1.0 for either the FHA or the GSE category, then the loan was designated to be an “overlap.” Based on data from 1998 to 2000, HUD (2005) found that 10 to 14 percent of the loans made by FHA fell in the “overlap” region. This result is consistent with the academic studies documenting substitution between the FHA and GSE loans. The quantitative estimate does indicate that no more than 14 percent of the FHA clients would also qualify for GSE loans. However, the HUD analysis was based on data from 1998 to 2000. It seems reasonable to conclude that, as the GSEs have lowered their underwriting standards since then, the degree of overlap has greatly expanded.

4. Failures in Contract Innovation and in Underwriting at the FHA

The previous sections indicate how subprime, predatory, and GSE lenders have greatly reduced the market share of FHA and VA loans in recent years. It is natural to ask why the government programs have not responded with innovative contracts and underwriting methods of their own, in order to protect their market share. Indeed, historically, the FHA was responsible for crucial innovations in the U.S. mortgage

market: the fixed-payment, long-term, fully-amortizing mortgage in the 1930s and the first mortgage-backed securitization program—Ginnie Mae—in the 1970s. In recent years, however, the FHA has shown a distinct disinclination to innovate.

In particular, the FHA has offered no response to the new alternative mortgages permeating the subprime market. One major handicap is the FHA's outdated credit scoring model, which suggests that the FHA cannot adequately judge the quality of borrowers or loans, nor can it implement risk-based pricing by charging higher insurance fees on demonstrably riskier mortgages. (See GAO 2006a). Given that most of the recent mortgage innovations have involved somewhat riskier contracts, it is essential that these risks be reflected in the insurance premiums (unless a subsidy to riskier borrowers is an explicit policy). To be sure, the FHA requires Congressional approval before it can carry out these and related innovations. Mobilizing Congress to act is, at the least, a time consuming friction, one that surely inhibits the innovative process. (See Weicher, 2006).

There is also a sense that the failure of the FHA to innovate reflects to some degree the agency's philosophy. This is suggested in the report commissioned by HUD in 1995, at a time when the FHA was facing an earlier crisis concerning its future. A major part of that report argues that the FHA clientele is "unique," with no significant overlap with either private mortgage insurance or the GSEs. The report dismisses what were the early signs that the conventional mortgage market was making headway in meeting the needs of underserved borrowers:

"Only FHA allows for a combination of credit histories, cash balances, downpayments and payment ratios, which provide mortgage credit opportunities to families with past credit problems and broken income streams. Because of this, private market initiatives will grow as they attract new homeowners, but they will not significantly diminish the core business of FHA." (HUD, 1995, p. 7-2)

A bit later, the report lists some “distinctive” FHA benefits:

- Up to full financing of up-front loan closing costs and insurance premiums;
- Lower downpayment requirements on both home purchase and refinancing loans;
- Higher allowances for seller-paid closing costs;
- Greater protections against foreclosure.

These FHA “benefits” are hardly distinctive and are certainly not unique.

The FHA has also resisted implementation of risk-based pricing for its insurance premiums. From its inception in 1934 through 1983, the FHA charged a flat annual insurance premium of 0.5 percent on the outstanding loan balance, very low by current standards. In 1983, the FHA switched to a 3.8 percent, one-time, up-front fee which was revenue neutral overall compared to the earlier system. As a result of worsening underwriting experience during the 1980s, the 1990 National Affordable Housing Act (NAHA) required an increase in the FHA premiums and, for the first time, imposed higher premiums on loans with higher loan-to-value ratios. However, in practice, this component of risk-based pricing was quantitatively minor; the major change mandated by NAHA was that FHA premiums were, for the first time, significantly higher than the PMI premiums a borrower would pay if she qualified for both insurance programs. Since rational borrowers who are eligible for both FHA and PMI loans would always choose the lower cost PMI option, the FHA argues that, at least in principle, there is no effective overlap between the FHA and PMI clientele.

In summary, it appears that two of the three forces that lead to the dramatic growth in subprime lending, technology and contract innovation are missing —

seemingly intentionally missing — from the current FHA strategic plan. Furthermore, even the third factor, securitization, for which the FHA was once the leader with its Ginnie Mae program, is at risk for the first time. The Ginnie Mae program will not be able to maintain a liquid market for its mortgage-backed securities if its supply of raw material, newly originated FHA and VA mortgages, continues at the currently low levels.

E. FHA Single Family Program Subsidies

The mortgage insurance fund for FHA's single family housing insurance program has remained solvent continuously, and, with the exception of a few brief intervals, the fund has remained actuarially sound as well. The FHA has also reported, under the budget accounting rules specified in the Federal Credit Reform Act of 1990 (FCRA), that the program provides a net surplus to the government; that is, the program is estimated to provide a *negative* subsidy to general taxpayers, as much as \$1.5 billion during fiscal year 2003. This is an important factor because the FHA is a "discretionary" program and otherwise would require an annual appropriation for any explicit subsidy costs.

The Congressional Budget Office, however, has challenged the FCRA method and contends that the Mutual Mortgage Insurance program actually requires a positive federal subsidy when the actuarial costs are computed appropriately. (See CBO 2003 and 2006). There are two main elements of contention. The first element is that the FCRA method excludes administrative expenses from the subsidy computation. Indeed, were administrative costs included, then the FCRA method indicates that the FHA received a modest subsidy from federal taxpayers in fiscal year 2007.

The second element is that expected future losses from insurance activity are computed as a single average present value under the FCRA method. This ignores the dispersion of possible losses, including the likelihood that the greatest losses will occur

when the economy is in a recession. The CBO contends that the covariation of potential realized losses and weak states of the overall economy requires that a “risk premium” be added to the computation. The CBO quantifies this risk premium as the difference between the insurance premiums charged by the private mortgage insurance (PMI) industry and the premiums charged by the FHA on comparable mortgages. Using this benchmark, the CBO estimates that the FHA program actually required a taxpayer subsidy of about \$2 billion for fiscal year 2007 (compared to the small surplus computed using the FCRA method).

The FHA disagrees with the principle behind the CBO’s risk premium adjustment. In the FHA view, the Federal guarantee that backs its insurance and the FHA’s privilege to borrow from the U.S. Treasury at risk-free interest rates are fundamental features of the program, which allow the FHA to operate with vastly lower capital ratios than its PMI competitors. The *quid pro quo* is that the FHA program serves a much riskier clientele. In the FHA view, an accurate actuarial computation of its expected losses relative to the premiums charged is the proper basis for determining the cost, if any, that the program imposes on the Federal budget.

The proper computation of the program’s subsidy is important if Congress is to make sensible appropriations for the FHA programs, in comparison with all other discretionary government expenditures and also in the evaluation of alternative means for subsidizing housing (for example in comparing HUD voucher programs and FHA mortgage insurance). A proper computation of the subsidy amount would also help to

avoid unexpected and quite unpleasant budgetary surprises, which may occur when any insurance program suddenly suffers losses that exceed its revenues.¹⁷

V. Policy Options for the FHA Single Family Insurance Program

The large decline in the volume of FHA and VA mortgage originations in the past few years raises fundamental questions about the future of the agencies. The plummeting share of FHA and VA in total originations may suggest that the agencies simply be closed. This action would recognize the great success of private mortgage insurance in insuring risky mortgages. It would also recognize the recent developments by private lenders in quantifying potential default risk among high-risk borrowers and in designing alternative mortgages that meet their special needs. Thus, while the FHA programs may have increased homeownership historically among the eligible population,¹⁸ the elimination of FHA might simply induce private lenders to be more aggressive in supplying credit to this segment of the market

A much different approach would allow the FHA to continue to function, but to require that it become much more aggressive in using technology to improve its underwriting policies for high-risk borrowers, to develop innovative mortgage contracts that will appeal to these borrowers, and to incorporate risk-based pricing in federal mortgage products. This would entail an expanded legislative mandate for the agency,

¹⁷ As a case in point, Congress recently had to appropriate more than \$20 billion to the Federal Flood Insurance (FFI) program to cover the unexpected losses created by hurricane Katrina, an amount equal to the total insurance premiums, net of administrative expenses, collected since that program's inception in 1968; see Government Accounting Office (2006b). In other words, the premiums charged over the program's 40 year history actually represented more than a 50 percent subsidy. This subsidy had gone unrecognized because the program had broken even on a cash flow basis over its entire history until the 2005 hurricane. But this represented only good luck —no previous flood had struck a major metropolitan center — hardly the basis for sensible actuarial budgeting.

¹⁸ See Quigley (2006) for a further discussion of the dramatic effect of the FHA program in expanding homeownership among its clientele households.

increasing loan limits, eliminating statutory down-payment requirements, and encouraging risk-based pricing of mortgage products. These directions have been endorsed by the various interest groups which would benefit from more robust and liquid housing markets.¹⁹ However, concerns have also been raised that the FHA will not have the expertise to manage a more creative underwriting program entailing more complicated and riskier loans, and that risk-based pricing will eliminate what some consider the current beneficial pattern of cross-subsidization of riskier borrowers by safer borrowers (See GAO 2007b and Inside Mortgage Finance 2007a and 2007b).

A Demonstrable FHA Alternative to Predatory Loans

We propose instead a third concept, namely an expansion of the role of the FHA - by focusing on its potential to mitigate predatory lending. As noted above, current regulatory actions to eliminate predatory lending often focus on quantitative restrictions, such as ceilings on loan rates, points, and prepayment penalties. These restrictions, if enforced, would no doubt reduce the extent of predatory lending, but it is equally clear that they would also reduce the incidence of subprime loans beneficial to borrowers. Indeed, with imperfect enforcement, it is quite plausible that the primary impact would be to reduce beneficial subprime loans.

A new predatory lending proposal, the Borrower's Protection Act of 2007, S. 1299, is also currently pending before the U.S. Senate. This bill has been criticized both for being vague in some of its prohibitions, and overly rigid in others; see Consumer Mortgage Coalition (2007). As an example of vague requirements, the bill requires that

¹⁹ Some of these measures have been introduced into legislation (e.g., the "Expanding American Homeownership Act," H.R. 1752, and H.R. 5121) and have been debated in the House of Representatives, but not in the Senate.

each mortgage originator shall “...(A) act with reasonable skill, care, and diligence; and (B) act in good faith with fair dealing in any transaction....” This could be interpreted as requiring a new federal suitability requirement for mortgage loans. As examples of rigid requirements, the bill requires that borrowers be qualified for loans based on the fully-indexed mortgage rate and that lenders consider only the borrower’s own financial resources. While these restrictions would rule out certain predatory loans, they would also rule out some, perhaps a great many, advantageous subprime loans.

Of course, the operation of a “fully competitive” market should itself protect less informed market participants. That is, if a segment of borrowers were accepting contracts that provided excess returns to “predatory” lenders, other lenders could enter the market offering superior terms to these borrowers. However, the wide range of consumer protection legislation enacted in the U.S. suggests that policy makers are frequently not confident that competitive markets can be depended on to perform this role. Even within the financial markets, the U.S. government has systematically taken action to protect consumers. For example, in stock market trading, the SEC regulates brokers and mutual funds, requiring them to obtain “best execution” for their customers, even though, at least in principle, “perfect competition” would achieve the same end. Similarly, as noted above, brokers are held to a “suitability” standard in mediating retail stock transactions. Government intervention in these ways no doubt reflects some paternalism, but, as Sunstein and Thaler (2003) recently argue, financial decisions by consumers often reflect framing and other behavioral factors, with the result that an element of low-cost paternalism might be judged to be highly beneficial overall.

Consumer protection has also long been a rationale for housing and mortgage market legislation (See U.S. Treasury 2000). For example, the Truth in Lending Act (TILA, Regulation Z of the Federal Reserve Act), specifies very precisely how the terms of installment loans, including mortgage loans, must be disclosed to borrowers. For another example, the Real Estate Settlement Procedures Act (RESPA) regulates the behavior of the parties to a home purchase transaction and specifies in detail the disclosures required by lenders to borrowers. Finally, the Home Owner and Equity Protection Act (HOEPA) requires special disclosures concerning prepayment penalties, balloon payments, and negative amortization on certain refinancings and home equity loans.

These detailed regulations illustrate the fact that Congress has not been shy to take a paternalistic stance when it felt poorly informed borrowers were disadvantaged. While it has been suggested that current disclosure regulations are sufficient, or that they could simply be expanded to provide protection to borrowers against predatory lending, (e.g., General Accounting Office, 2004), it appears that the details of modern mortgage contracts are sufficiently technical and specialized that it is more efficient to regulate predatory lending with separate legislation. Consider, for example, the following list of loan features associated with both subprime and predatory loans:

- “Teaser rates” on adjustable rate mortgages, after which borrowers may face a large and possibly unexpected jump in their required monthly payments;
- Low- or no-documentation loans, often made on the expectation of house price appreciation; if house price appreciation is not realized, the borrower may be unable to meet contractual payments;

- Features that virtually require the borrower to refinance the loan, often combined with large prepayment penalties;
- Failure to enforce normal protections such as escrow accounts for insurance and property taxes.

An Alternative FHA Loan to Deter Predatory Lending

We suggest that an aggressive and innovative loan demonstration by the FHA can be an efficient and effective means to reverse the inroads that predatory lenders have achieved as a result of the inherently complex nature of the new mortgage contracts. Suppose, for example, legislation enabled the FHA to offer risk-based pricing, teaser rate mortgages, adjustable rate mortgages, and so forth, and at the same time, the FHA was directed to develop new alternative mortgage contracts that would offer competitive terms to those currently eligible for FHA financing, but who were being attracted to the private subprime market, at least in some instances by predatory lenders.

Disclosures concerning these new alternative FHA mortgages could be of potential value in deterring predatory lending to lower-income home purchasers. Comparable actions by government entities can be found in other markets. Perhaps the most relevant comparison is the student loan market, where the Direct Loan Programs provided through the U.S. Department of Education compete with loans offered by banks and other private lenders.²⁰ Also at the federal level, the United States Postal Service

²⁰ The federal student loan programs operate in two forms. The Direct Loan programs use government funds and the loans are originated and serviced by the U.S. Department of Education. The Federal Family Education Loan (FFEL) program use funds provided by a bank or other participating lender, but the loans are government guaranteed and the key loan terms, including the interest rate, are identical to the Direct Loan programs. Both of these programs compete with fully private market loans that are available from banks and other lenders. Private market student loans, in turn, come in different version, including those where the student is “certified” by his or her university versus loans that do not require such certification.

provides mailing services that compete with private suppliers such as Federal Express and the United Parcel Service. And at the state level, the Departments of Insurance in a number of states provide comprehensive information on the auto insurance and homeowner insurance options available to consumers based on the rate filings of their registered insurers.²¹

To apply this technique to the subprime mortgage market, the FHA would have to offer a borrower one or more alternative mortgages for consideration several days before a scheduled house closing. To allow the FHA to prepare these loan offers, information about borrower credit worthiness, assets, home appraisal, etc. would have to be transmitted to the FHA in advance of a contemplated mortgage transaction by any lender about to make a loan to a household eligible for FHA financing. The concept of requiring subprime lenders to make unique disclosures prior to a loan is already a core component of the Homeowner and Equity Protection Act (HOEPA). The FHA would be directed to use this information to produce one or more specific loans for consideration by the contracting household. These terms would be transmitted to the household in a side-by-side comparison with those offered by the subprime lender. Mortgage contracts would not be enforceable unless the contracting household had explicitly declined the terms of an FHA mortgage in favor of the private market subprime loan. This requirement, together with the suitability rules, described earlier, patterned after those of the NASD, could provide powerful deterrents to predatory lending.

²¹ For example, in California auto insurance premiums are regularly published by the state government. See <http://interactive.web.insurance.ca.gov/survey/survey?type=autoSurvey&event=autoSearch> . For Berkeley California, for example, the highest rates reported for standard coverage are more than double the lowest rates.

The disclosure requirements envisioned here would provide the borrower with an explicit alternative in the form of an available FHA loan, as well as the full set of information suggested by the Congress:

“This new disclosure should include a table clearly displaying a full payment schedule over the life of the loan, all fees associated with the loan, an explanation of the “alternative features” of the loan (i.e. negative amortization) and a full explanation of the risks associating with taking advantage of those features, including the timeframe in which borrowers were likely to feel the negative effects of those risks.” (Joint Economic Committee, 2007)

This proposal would require FHA-eligible households to consider and reject the terms of competitive FHA mortgages before contracting for private market subprime mortgage finance. In making this decision, borrowers would have the full set of mortgage information, and they would have a specific alternative to consider. If, after consideration of the terms proffered, a household chose subprime mortgage finance, it would not be on the basis of incomplete information or the misrepresentation of alternatives. This is probably the best one can hope for in guiding the choices of others in a market economy.

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