The Complex History of the Federal Housing Administration: Building Wealth, Promoting Segregation, and Rescuing the U.S. Housing Market and the Economy

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Introduction
The Federal Housing Administration (FHA) has been one of the most important US housing policy institutions of the 20th and 21st centuries. Its mortgages were the first guaranteed mortgages in the US, backed by the full faith and credit of the US government, and were a major contributor to both the post-World War II housing boom, particularly in the suburbs, and accelerated home ownership. For example, with the assistance of the FHA, the US homeownership rate increased from 47.8 percent in 1930, to 43.6 percent in 1940, to 55 percent in 1950, 61.9 percent in 1960, 62.9 percent in 1970, 64.4 percent in 1980, 64.2 percent in 1990, and 66.2 percent in 2000.

Over the past eight decades, the FHA has insured 40 million mortgages, providing three main benefits to the US housing market.

1. The agency provides regional and countercyclical stabilization.
2. The FHA provides mortgage credit to borrowers, especially to first-time homebuyers, and, later, neighborhoods underserved by the private mortgage market.
3. The agency tests and standardizes new types of mortgages.

This article examines the historic role of the FHA related to homeownership, the agency’s products and services, and the evolution of the FHA’s beneficiaries.

This article focuses on borrowers of mortgages for single-family homes in its Section 203(b) program for single-family residences, financed through the Mutual Mortgage Insurance Fund (MMIF).

The FHA’s history is complex and can be examined in three distinct eras. First, from 1934 to the early to the mid-1960s the FHA almost exclusively benefitted non-Hispanic White borrowers. During that era, the segregationist policies of the agency’s administrators accelerated the abandonment of older industrial cities by non-Hispanic White households and contributed greatly to the economic decline of those cities. Second, from the early to mid-1960s to 2007 the FHA continued to benefit non-Hispanic White borrowers but also increasingly served borrowers of color, frequently accompanied by discriminatory, abusive, and fraudulent practices by independent mortgage brokers. Third, since 2007 the FHA arguably played a more important counter-cyclical role since its establishment and has increasingly addressed reckless lending practices while insuring and refinancing conventional mortgages disproportionately held by borrowers of color.

First Era of FHA Activities (1934 to early to mid-1960s)
The FHA was established through the National Housing Act of 1934. A year earlier, in 1933, the Home Owners’ Loan Corporation (HOLC) was established to help refinance delinquent or defaulted single-family home mortgages during the Great Depression. Four years later, in 1938, President Franklin D. Roosevelt established the Federal National Mortgage Association, called Fannie Mae. While the HOLC refinanced mortgages near or in foreclosure until 1936, both the FHA and Fannie Mae have facilitated the flow of credit to homebuyers, homebuilders, and financial institutions up to the present day.
Prior to the FHA, downpayment requirements were large, often more than 50 percent; repayment schedules were short, typically five years; and balloon payments at the end of a loan term also were large. The FHA designed a long-term 20- to 30-year, low interest, fixed-rate amortizing mortgage for single-family homes, along with layout, construction, and mortgage underwriting standards, with a relatively low downpayment in which the borrower pays an insurance premium in proportion to the outstanding loan amount to the FHA to protect the HUD-approved mortgage lender (i.e., if the borrower defaults on the mortgage, the FHA pays the lender and possesses the home).

From 1934 to the early to mid-1960s the FHA almost exclusively benefited non-Hispanic White borrowers who bought new single-family detached homes in non-Hispanic White communities, occasionally with racial covenants and typically in the suburbs, that had not changed in their racial and social composition and were not predicted to do so in the future. In other words, “[t]he FHA [...] redlined the cities, speeding the migration of the white middle class out of the older central cities, contributing to residential racial and ethnic segregation.

At the same time the FHA had a negative impact on many Blacks/African Americans, who, on the basis of their race, were not eligible for FHA-insured loans. FHA’s practices were based on historic mortgage underwriting ratios and risk-rating systems adopted from the HOLC, which had previously adopted them from the real estate industry based on biased attitudes and predictions about the trajectory of property values in communities on the basis of the race and ethnicity of their residents. The FHA also initially enforced racially biased restrictive covenants that enabled owners to preclude the sale of homes in White neighborhoods to Black and other races or ethnicities.

The non-Hispanic White migration to the suburbs was especially pronounced in the North, where central cities were filled with predominantly African American migrants from the South. The FHA, when combined with the 1956 Highway Act, helped trigger US urban decline by spurring the outmigration of non-Hispanic White households and ultimately businesses from central cities, denying opportunities for people of color to take advantage of the new housing and job opportunities, and denying homeownership opportunities to Blacks who remained in the cities.

Although the US Supreme Court ruled in 1948 in Shelly v. Kraemer that state courts were prohibited from enforcing racial covenants, and although the FHA revised its underwriting manual in 1950, factoring in Shelly v. Kraemer, the FHA nevertheless continued to favor racial segregation and to refrain from challenging racial steering and redlining for many years, creating racial ghettos. In the mid-1950s, the FHA began to soften its exclusionary stance and made substantial investments toward expanding FHA insurance to Black/African Americans.

**Second Era of FHA Activities (mid-1960s to 2007)**

From the early to mid-1960s to 2007, the FHA continued to disproportionately benefit non-Hispanic White borrowers but also increasingly assisted borrowers of color. Much of the FHA’s lending to African Americans, however, was marred by reckless, fraudulent, discriminatory, predatory, and unsustainable financial practices. Starting in the 1960s,

Lenders found that they could join local real estate agents in exploiting racial fears and fomenting racial change in order to create a huge volume of sales in certain areas. Their motivation was to make as many loans as possible to minorities, not to exclude them. In fact, the financial incentives were so great that scores of real estate agents, lenders, and even FHA officials engaged in fraud, in order to make sales to unqualified and unsuspecting minority homebuyers [...].

In the 1950s and 1960s, many alternative home buying practices were common for those excluded from the conventional homeownership market, including land-installment practices and double sales schemes. In regard to the former, a speculator would purchase a house and then add costly purchase and sales commissions, various financing charges, and overhead costs. Next, the speculator would make largely cosmetic renovations to the property, also at a large profit margin. Finally, the speculator would sell the house for an inflated price often as high as double the investor’s purchase price. Before the purchase the speculator...
would take out two loans, one for the amount of the appraised value of the property and another for the difference between the appraised value and the sale price. These two loans would be packaged for the buyer. The speculator would retain the title to the property but permit the buyer immediate possession of the property until the second loan that covered the difference between the appraised value and the sale price was paid off. Then, a new conventional mortgage at the appraised value would be taken out, at which time the purchaser would retain the title to the property. In regard to the latter, a property would pass through the hands of two or more speculative-investors, increasing in price between transactions and finally being sold through Section 221(d)(2), FHA's low income/no downpayment program, introduced in 1968. The impact of all of these layered fees and inflated prices was that buyers were effectively in negative equity at the time of purchase, thereby limiting if not precluding them from ever building any equity from their home purchases. Most disturbing about these complex and fraudulent transactions was that they were no secret within the housing industry; FHA administrators were fully aware of these types of discriminatory transactions but took little if any action to excise them from the market.

In the 1960s and 1970s, discrimination on the basis of race, color, religion, national origin, gender, disability, and the presence of children in the household was officially outlawed through Executive Order #11063 in 1962, which banned racial discrimination in federally assisted housing; the Fair Housing Act of 1968, subsequently amended in 1988; the Home Mortgage Disclosure Act (HMDA) of 1975; and the Community Reinvestment Act (CRA) of 1977. The implementation and enforcement of these laws was weak, however, partly due to inadequate enforcement provisions in those laws and partly to insufficient funding. One of the consequences of this situation was that rather than ending discrimination, these legislative efforts simply caused a shift in the form of housing discrimination from open and overt to discriminatory actions that are subtle and more difficult to challenge.

**Third Era of FHA Activities (2007 to present)**

Since 2007, the FHA has increasingly insured and refinanced conventional mortgages disproportionately held by borrowers of color. For example, in 2009 about 60 percent of Black/African American and Hispanic/Latino borrowers, respectively, obtained an FHA-insured mortgage, compared to about 35 percent of non-Hispanic White borrowers.

Also, as the housing market began its rapid deterioration in 2008, the FHA’s share grew rapidly. As shown in Figure 1, the FHA proportion of all mortgages was at 1.8 percent in 2005 and 2006, 3.3 percent in 2007, 16.9 percent in 2008, 20.4 percent in 2009, 18.3 percent in 2010, 13.7 percent in 2011, and 11.5 percent in 2012.

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**Figure 1: FHA Proportion of US Mortgage Market, 1935 to 2013**

Source: Authors, based on Golding, Szymanski, and Lee (2014)
The decrease of the FHA’s market share in the early 2000s illustrates the crowding out of the FHA by the private mortgage market, with its many poorly underwritten and unsustainable, high-cost loans, and its many aggressive independent mortgage brokers. During that time, FHA insurance almost sank into oblivion. In turn, the increase of the FHA’s market share in the late 2000s after the private mortgage market had largely retrenched from lending has reminded many of the FHA’s core mission and importance. In sum, “[w]hen conventional lending falters, the FHA picks up the slack.”

In fact, the FHA not only bailed out the US housing market but also the US economy during the Great Recession. According to Moody’s Analytics, in the absence of FHA-insured mortgages during the Great Recession, property values would have declined an additional 25 percent, resulting in more than $3 trillion in lost housing equity, three million additional lost jobs, an unemployment rate of 12 percent, and a loss of half a trillion dollars in economic output.

The dramatic increase in market share for the FHA was accompanied by major enhancements to the quality of loans underwritten by the agency. Although the FHA’s mutual mortgage insurance fund required a draw on the Treasury for the first time in its history, the massive losses experienced by the FHA during the collapse of the housing market were principally due to two programs and the dramatic decline in home prices nationally.

One program was the seller-funded downpayment assistance in which nonprofit groups funded primarily by home builders provided borrowers with downpayment assistance. This program performed poorly during the financial crisis and contributed heavily to the FHA’s losses. Congress finally discontinued this program effective June 30, 2009. Second was the reverse mortgage program, which was often used in connection with fraudulent or inappropriate financial products.

Since 2008 this program has been overhauled and improved. Other changes that have improved the FHA’s book of business are the insuring of loans with higher average credit scores, higher downpayments for borrowers with credit scores below 580, and manual underwriting for any borrower with a credit score under 620 and a debt-to-income ratio of more than 43 percent. Other changes have been an increased annual fee and upfront insurance fees and the requirement that premia need to be paid for the life of the loan rather than being cancellable when the loan reaches a 78 percent loan-to-value ratio.

Although these strategies benefit the FHA’s book of business, they make access to homeownership more difficult—a trend that has been ongoing for several years, regardless of whether the mortgage is insured by the FHA. Goodman et al. (2015) have estimated that an additional 1.25 million mortgages could have been made in 2013 had the cautious lending standards of 2001, instead of the severe lending standards of 2013, been applied. Differentiating by race and ethnicity, these could have been 30.8 percent additional mortgages for non-Hispanic Whites, 50.4 percent additional mortgages for Blacks/African Americans, and 37.9 percent additional mortgages for Hispanics/Latinos.

The four main reasons for the current tight credit box are the repurchase risk, the reliance on outdated credit scoring models, the high costs of servicing delinquent loans, and fears of litigation by the US Department of Justice, the Inspector General of the US Department of Housing and Urban Development, or state attorneys general.

Lenders face a repurchase risk if there is a mistake in the underwriting of those mortgages that were bundled into securities and guaranteed by the US government, either explicitly (i.e., in case of securities issued by the Government National Mortgage Association (also called Ginnie Mae), which contain mortgages from the FHA, the US Department of Veterans Affairs, and the US Department of Agriculture’s Rural Development Program) or implicitly (i.e., in case of securities issued by Fannie Mae and the Federal Home Loan Mortgage Corporation (Freddie Mac)). About 80 percent of mortgages originated in the past few years face a potential repurchase risk, translating into much uncertainty for lenders and thus their reluctance to originate mortgages.

The FHA relies on credit scoring models that were developed more than a decade ago and do not predict as well as recent and improved credit scoring models. Alternative credit scoring models could include new
entrants or consumers with thin credit files, that is, files that do not contain information on recent activity but do have information on infrequent activity or information on collections or public records. Future credit scoring models could also include expanded utility or rent payments. Fears of litigation are a concern of many lenders as the FHA requires lenders to certify that the submission materials are completely correct and that the loan meets all FHA requirements. "Any manufacturing defects in the loan production create potential violations of this certification and make the lender subject to a range of consequences, including liability under the False Claims Act." Recently, the FHA published a taxonomy of defects, in which different defects have different causes and impacts, and different consequences for lenders. Thus, a "[...] more targeted certification would focus enforcement on defects that pose the greatest risk to the insurance fund and borrowers, and also focus on lenders with deficient underwriting and quality systems." This discussion is currently underway.

Currently, several strategies have been suggested and are being implemented by the FHA to explicitly increase access to homeownership:

- Incentivizing housing counseling for borrowers of FHA-insured mortgages through the recently suggested four-year pilot program Homeowners Armed with Knowledge (HAWK) initiative. Congress prohibited FHA from implementing this program for the time being. But it is an initiative that, if pursued, could enhance sustainable mortgage lending at FHA. Homeowners who complete housing counseling before signing a home purchase contract would receive a 50-basis-point reduction in the upfront FHA mortgage insurance premium (MIP) and a 10-basis-point reduction in the annual FHA MIP. Homeowners who complete housing counseling after signing a home purchase contract and who do not have serious delinquencies for the first 24 months would receive an additional 15-basis-point reduction in annual MIP. However, Congress prohibited HUD from implementing the HAWK initiative through the Fiscal Year 2015 spending bill.
- Establishing clear quality assurance policies for lenders of FHA-insured mortgages by, for example, redesigning the FHA Handbook to avoid credit overlays by lenders who fear back-end enforcement actions of the FHA; developing a new methodology for evaluating underwriting defects; and establishing a new Supplimental Performance Metric that will compare the lender's default rate to an FHA target rate instead of the mortgage lender's peers.

These strategies are laudable but might not reach far enough in assisting an otherwise creditworthy borrower "who doesn’t have pristine credit these days” to obtain a mortgage, and "reinventing FHA as a first-class financial institution.” Additional implications for the FHA have been suggested in several past major proposals to revamp the US housing market. In February 2011, for example, the US Department of the Treasury and the US Department of Housing and Urban Development published Reforming America’s Housing Finance Market: A Report to Congress.

The authors presented three options for the future housing finance market:

1. A privatized system of housing finance with the government insurance role limited to FHA, US Department of Agriculture (USDA), and US Department of Veterans Affairs assistance for narrowly targeted groups of borrowers;
2. A privatized system of housing finance with assistance from the FHA, USDA, and Department of Veterans Affairs for narrowly targeted groups of borrowers and a guarantee mechanism that scales up during times of crisis; and
3. A privatized system of housing finance with FHA, USDA, and Department of Veterans Affairs assistance for low- and moderate-income borrowers and catastrophic reinsurance behind significant private capital. In sum, all three options foresaw a limited yet targeted, reformed, and strengthened role for the FHA.

Similarly, in February 2013 the Housing Commission of the Bipartisan Policy Center released Housing America’s Future: New Directions for National Policy. Acknowledging the FHA’s countercyclical role, the authors suggested a continued traditional mission of primarily serving first-time homebuyers and borrowers.
with low wealth or home equity. However, they also suggested a more targeted role for the FHA, achieved by lower mortgage limits and increased insurance premiums “to help reduce the size of government involvement in the single-family mortgage market.”

In July 2013 House Financial Services Committee Chairman Jeb Hensarling (R-Texas) released The Protecting American Taxpayers and Homeowners (PATH) Act (H.R. 2767), which suggested making the FHA an independent agency outside of HUD yet regulated by the Federal Housing Finance Agency (FHFA). PATH also suggested FHA reforms that would limit its market role and shift the risk to the private sector.

The PATH Act proposes to limit the amount of risk the FHA can assume (i.e., reducing FHA insurance from 100 to 50 percent of the original principal balance); increasing the amount of capital that it is required to hold (i.e., increasing the amount of additional capital that it must hold in reserve to pay for any additional, unanticipated future losses beyond its expected losses from the current 2 percent to 4 percent of its outstanding insurance obligations); tightening certain mortgage standards (i.e., requiring a minimum annual premium of 0.55% and premiums based on risk); and narrowing the FHA’s role in the mortgage market to first-time homebuyers (who would need to provide a 3.5 percent down payment) and low- and moderate-income borrowers (who would need to provide a 5 percent down payment). The FHA would be permitted to guarantee more types of mortgages in periods of market stress and in areas affected by disasters. Lenders could be required to reimburse the FHA for defaulted mortgages that did not meet its standard in certain circumstances and would need to agree to repurchase mortgages that default soon after the mortgages were originated.

In May 2014 the US Senate Banking Committee approved legislation to reform the nation’s housing finance system with the help of a bipartisan proposal, the FHA Solvency Act of 2013 (S. 1376), drafted by Senate Banking Committee Chairman Senator Tim Johnson (D-S.D.) and Ranking Senate Banking Committee Member Senator Mike Crapo (R-Idaho). This proposal aimed at ensuring that the FHA’s single-family programs are financially sound. More specifically, the Johnson-Crapo proposal would require the FHA to evaluate its underwriting standards for its mortgages and revise them so that they are similar to the standards for qualified mortgages.

The proposal would require the FHA to set its minimum annual premium to 0.55 percent and increase the maximum premiums, subject to annual revaluations. The FHA’s capital ratio would be increased from 2 to 3 percent within 10 years, and the FHA would be required to undergo stress-testing, similar to the stress-test model issued by the Federal Reserve for banks. Also, lenders could be required to reimburse FHA for defaulted mortgages that did not meet its standards in certain circumstances.

**Conclusion**

The FHA provided the financial system infrastructure for the enormous wealth creation for the typical non-Hispanic White American family in the decades following World War II and into the 1980s. During that time, FHA’s policies also undermined the economic vitality of cities across the nation and were largely responsible for the significant wealth gap that was created during those years between non-Hispanic White households and households of color.

Since 2007, the FHA has significantly expanded its backing of loans to African Americans and Latinos while also improving its underwriting practices and purging reckless lending practices. Although additional reforms remain to be accomplished, the agency appears now to be on the road to providing mortgage insurance in a manner in which all communities will receive high quality, affordable mortgage credit. At the same time, proposals to restructure the larger US housing finance system could have significant and profound implications for the FHA that cannot be predicted at this time.

**Notes**


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