AEI's International Center on Housing Risk

FHA from 1934 to 1938: Lessons for Wealth Building

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Background: Thought leaders of the 1st half of the 20th Century

- **Richard Ely** (1854-1943)
- **Richard M. Hurd** (1865-1941)
- **Frederick Babcock** (1897-1983)*
- **Ernest Fisher** (1893-1981)*
- **Homer Hoyt** (1895-1984)*
- **Richard Ratcliff** (1906-1980)*
- **Arthur Weimer** (1909-1987)*

*Joined FHA in 1934

Background: Ely's Colleagues Lay Foundation for the FHA's Lending Practices

- 1932: **Frederick Babcock** writes *The Valuation of Real Estate* (considered to be the most significant appraisal book since Hurd's in 1903). **Ernest Fisher** helped Babcock with this second book as both were at the University of Michigan in the early 1930s.
- 1933: **Homer Hoyt** receives PhD (U. of Chicago), publishes his dissertation, *100 Years of Land Values in Chicago* (influenced by Chicago-based research done by Institute members). Writes *The Structure and Growth of Residential Neighborhoods in American Cities* (1939) with **Ernest Fisher** and *Principles of Urban Real Estate* with **Arthur Weimar** (1939).
- Early-1930s: **Richard Ratcliff**, student of **Richard Ely** and **Ernest Fisher**. Writes *Urban Land Economics (1949)*.
- 1934: **Arthur Weimer** receives PhD (U. of Chicago). Writes *Principles of Urban Real Estate* with **Hoyt** (1939).
- **Fisher** (Chief Economist), **Babcock** (Chief Underwriter), **Hoyt** (chief housing economist), **Ratcliff** (economist), and **Weimer** (economist) all join FHA in 1934.

1934: the State of Housing[1]

- In 1934 the federal government conducted a 64 city survey of 1.945 million structures (79%: 1-unit single family) with 2.63 million dwelling units (58%: 1-unit single family) in 100,770 blocks
  - 62% needed minor or major repairs or were unfit for use
    - Minor repairs - 44.4%
    - Major repairs – 15.7%
    - Unfit for use – 2.3%
  - Of dwelling units:
    - 73% had 4 rooms or less
    - 6.2% had 2 or more toilets
    - 3% had 2 baths or more
    - 43% used heating stoves
    - 83% used ice or no refrigeration
    - 68% and 12% used coal or wood respectively
  - Of owner-occupied single-family dwellings:
    - 71% had a value of under $5000
  - Of tenant-occupied dwelling units:
    - 79% rented for less than $30/month

[1]FHA, The Structure and Growth of Residential Neighborhoods in American Cities, 1939 (available in bibliography of historically significant valuation and mortgage risk documents (Bibliography)

1934: the State of Housing Segregation[1]

- Racial segregation was a reality when the FHA was established in 1934
  - Of the 100,770 blocks surveyed:
    - 85,478 or 84.8% were occupied exclusively by whites
    - 5,004 or 4.9% were occupied exclusively by nonwhite persons
    - The remaining 10,288 or 10.3% were of mixed occupancy
  - "Of the 11,891,143 Negroes in the United States in 1930, 75.0 percent were in the South, 24.0 percent were in the North, and only 1.0 percent were in the Pacific and Mountain States"
  - Nonwhite occupancy in two cities by enumeration district (ED)
    - In Chicago 90.4% of nonwhites lived in EDs that were 50% of more nonwhite
      - Constituted 6.7% of total population
    - In Jacksonville 89.6% of nonwhites lived in EDs that were 50% of more nonwhite
      - Constituted 38.1% of total population

[1]FHA, The Structure and Growth of Residential Neighborhoods in American Cities, 1939 (available in Bibliography)

Racial and ethnic covenants, lending and FHA

- FHA has been rightly criticized for condoning segregation based on race and national origin and enforcing local customs and practices including racial and ethnic covenants through its underwriting practices
  - It was wrong to condone long outdated segregation attitudes and policies
  - Yet a total of 1 ¼ pages of its five hundred page Underwriting Manual consisted of references to racial and ethnic customs and practices[1]
- Sustainable underwriting led to the virtual elimination of foreclosures and loss severity was in the single digits[2]
  - Over its first 20 years, the FHA paid only 5,712 claims out of 2.9 million insured mortgages, for a cumulative claims rate of 0.2 percent
  - FHA's claim loss severity was 9 percent of the original insured mortgage balance, or a total of $3 million lost on 5,712 claims
  - Private foreclosure rates were about 40 percent of FHA's in the 1950s[3]
- By the late-1950s many sensible guidelines began to be discarded, negatively impacting low-income and minority borrowers in particular
  - The numerical mortgage rating grid was abandoned in 1964[4]
  - By 1966 FHA's foreclosure rate was six times higher than just 10 years before[3]
  - For the period 1977-2013, 1 in 8 FHA borrowers experienced a foreclosure, a total of 3.4 million foreclosures[5]

[1] FHA Underwriting Manual, February 1938 revision (available in Bibliography)

[2] John P. Herzog and James S. Earley, *Home Mortgage Delinquency and Foreclosure*, 1970 (available in Bibliography)

[3] http://www.fdic.gov/bank/analytical/working/98-2.pdf

[4] Thomas N. Herzog, *A Brief History of Mortgage Finance with an Emphasis on Mortgage Insurance*, Society of Actuaries, 2009, www.soa.org/library/monographs/finance/housing-wealth/2009/september/mono-2009-mfi09-herzog-history-comments.pdf

[5]Compiled by author from various FHA Actuarial Studies

1940-1960: progress in sustainable homeownership

- The national homeownership rate reached 61.9% in 1960, similar to today's rate of 62.2% (current rate of 63.9% adjusted for borrowers >=90 days delinquent or in foreclosure):
  - 8.36 million more homeowners in 1950 than in 1940—a gain of 55%, the largest proportionate increase recorded by the Census up to that date[1]
  - At least 3 million owner-occupied units in 1950 were formerly renter-occupied in 1940[2]
  - Non-farm homeownership rate: 61.0% in 1960,[2] up from 53.4%, 41.1%, 46%, and 40.9% in 1950, 1940, 1930, and 1920 respectively [2]—up **19.9 ppts. (48%)** from 1940 to 1960
    - "The rise in the level of income in 1940s and 1950s, the high rate of new construction, liberalized financing terms were among the factors which contributed to the sharp rise to 55% in 1950, then to 62% [overall rate, not just non-farm]" [2]
  - While still substantially below the non-farm ownership rate, the nonwhite rate increased to 38.4% in 1960[2] up from 35.2%, 23.9%, 27.1%, and not available in 1950, 1940, 1930, and 1920 respectively[1]—up **14.5 ppts. (61%)** from 1940 to 1960
    - During the 1940s, "nonwhite owners increased at a more rapid rate than white owners, reflecting in part the improved economic status of the nonwhites[1]

[1]US Census Bureau, Census of Housing: 1950, vol. 1, part 1, table L, 1953 (available in Bibliography)
[2]US Census Bureau, Census of Housing: 1960, vol. 1, part 1, tables G, W, and X (available in Bibliography)

Informing FHA's Valuation and Underwriting Theory

- Babcock in his *The Valuation of Real Estate* (1932)[1] establishes the concept of warranted value.
  - "Fair market value would then be the price which a buyer were warranted in paying in view of the potential utility of the property. The fact that several hundred purchasers have been found who were willing to buy certain undesirable subdivision lots at exorbitant prices would in no way be presentable as evidence of market value."
  - "Value will be used to designate the concept in which the thoroughly informed buyer is present and market price will be used to designate the prices which properties actually do bring in the real estate market."

[1]Available in Bibliography

1934: National Housing Act (NHA)[1]

- The 1934 NHA established the Federal Housing Administration (the FHA)
- The NHA consisted of four main titles:
  - Title I: Housing Renovation and Modernization
  - Title II: Mutual Mortgage Insurance
  - Title III: National Mortgage Associations
  - Title IV: Insurance of Savings and Loan Accounts

[1]National Housing Act, Public—No. 479—73d Congress—H.R. 9620 (available in Bibliography)

1934: FHA mortgage insurance provisions

- Title II provided:
  - Sec. 203: Insurance of Mortgages—a mortgage shall:
    - "Contain complete amortization provisions requiring periodic payments by the mortgagor not in excess of his reasonable ability to pay (ATP)"
      - ATP implemented with housing debt-to-income, payment shock relative to current rent payment vs. housing expense-to-income; and review of budget
    - "Contain such terms and conditions with respect to…additional and secondary liens…as the administrator may in his discretion allow."
  - Sec. 205: Classification of Mortgages and Reinsurance Fund
    - "Mortgages…shall be so classified into groups that the mortgages in any group shall involve substantially similar risk characteristics and have similar maturity dates"
    - Mutuality achieved by paying excess premium balances refunded based on mortgagor risk groupings

1935: How You Can Build, Buy, or Refinance Your Home[1]

- "Home ownership has been preached for many years.[2] But the ways and means to home ownership provided for the public at large have been largely based upon many unsound principles and faulty theories."
- "It was generally not taken into account that your income, your salary—your wages—are paid on a monthly basis."
- "Your initial investment in the property may be as little as 20 percent of its appraised value."
- "You may take up to 20 years to pay. You may pay in 12 or 15 years if you like."
- "The easiest way for you to pay for a home is to pay for it as you pay rent….It's very much like buying a house and renting it to yourself."

[1]FHA, How You Can Build, Buy, or Refinance Your Home, 1935, (Rev. 9-3-35) (available in Bibliography)
[2]See: Republican Campaign Text-Book 1920, Better Homes in America, Plan Book, letter by secretary to President Warren G. Harding, forward by Vice President Calvin Coolidge, 1922, and US Commerce Department, How to Own Your Home, 1923 and 1931 (all available in Bibliography)

1935: Open this door to Farm Property Improvement[1]

- "…to return the unemployed to useful occupation… to raise the standards of good living…and to produce tangible, useful wealth." Franklin D. Roosevelt
- *"Is the Better Housing Program designed to foster borrowing?* No. The plan is to stimulate the making of necessary desirable improvements."
- *"May I take the maximum time allowed to pay back any size loan?* No careful banker or prudent borrower will want the maximum time if is not necessary—nor will they approve a time arrangement that bears too heavily on the farm owner's income."

[1]FHA, Open this door to Farm Property Improvement, 1935 (available in Bibliography)

1936: How to Have the Home You Want[1]

- To many people, 'Mortgage' became just another word for trouble—an epitaph on the tombstone of their aspirations for home ownership."
- "[t]his new mortgage system provides a straight, broad highway to debt-free ownership."
- "Up to 80 percent of the appraised value of the home (including house and lot) may be borrowed on *just one mortgage*."
- "…it is always considered desirable to pay off a mortgage in as short a time as possible."
- "…qualified and impartial appraisers…protect the interest of the borrower…Thus for the first time, does the borrower have as much protection as the lender."
- "The possession of a home, free and clear of all debt at the earliest possible date, should be the goal of every American family."

[1]FHA, How to Have the Home You Want, 1936 (available in Bibliography)

1938: Underwriting Manual-nature of mortgage risk[1]

- “Each and every mortgage investment is hazardous to some degree.”
  - “The most important group of factors which affect mortgage risk is the one which embraces the relationship between the physical property and the neighborhood in which it is located.”
    - “Marketability is a basically important characteristic of good mortgage security.”
  - “Also included are all those elements of risk associated with the earning power of the prospective borrower, his attitude towards obligations, his ability to pay, and his prospects for the future.”
    - “In the final analysis the probability that a borrower will be able to pay and willing to meet the mortgage obligation represents the first line of defense against trouble with the mortgage investment.”
    - It is not income of a borrower that is rated, rather the ability to pay debt service
  - “All the individual elements which contribute to mortgage risk are presumed, in the final analysis, to combine and constitute the over-all risk involved in the insurance of the mortgage loan.”
  - “In this sense, mortgage risk is considered to be an entity susceptible to measurement and expression as a single numerical rating.”

[1]FHA, Underwriting Manual (UW Manual), Feb. 1938, all references herein to UW Manual are to the 1938 edition (available in Bibliography)

1938: UW Manual-essentials in risk measurement

- “Mortgage risk lies in the future”
  - [r]isk rating involves forecasting and prediction”
  - “Risk rating…is equivalent to predicting chances or likelihoods as seen at the time of analysis”
    - “[t]he weaker elements impose their penalties in greater ratio than do the stronger elements”
    - “[e]conomic soundness cannot be determined on the basis of loan-to-value alone”
      - “It cannot throw sufficient light on the possibility of default by the borrower nor can it fully indicate what relationship may exist between the loan and the property value at a future time”
      - “This ratio…is only a part of [the risk rating]”
    - “Valuation analyses include consideration of a great number of factors”
      - “[v]aluation of property is for the purpose of establishing an estimate of the price which a purchaser is warranted in paying, while risk rating determines the quality of a mortgage investment”

1938: UW Manual: practice implementing theory[1]

- Mortgage rating score from 0-100 points, with 50 points needed for approval
  - Valuation related items account for 73-84% of total score:
    - LTV is based on a rigorous determination of value – see slides #21-23
      - As default usually preceded by a period of financial distress, lower LTV means less chance of loss
      - Should a default be threatened, lower LTV means borrower better able to dispose without claim
      - 20% of mortgage risk rating score
        - » Highest score for <60% LTV, lowest score for 75% LTV and up, to legal limit
    - Ratio of total payment to rental value
      - The ability of the income of a property to pay total monthly payments as they become due, even if borrower is under financial stress
      - Numerator: principal, interest, taxes, homeowners insurance, mortgage insurance, utilities, maintenance, and repairs; denominator: subject's rental value (principal and interest calculated at maximum term)
      - 10% of mortgage risk rating score
        - » Highest score for <60%, lowest for 111%-130%, over 130% - reject
    - Ratio of life of mortgage to economic life of building
      - 5% of mortgage risk rating score
        - » Highest score for <50%, lowest for 80%-100%, over 100% - reject
    - Rating of property – see slide #24
      - 16%-27% of total mortgage risk rating score[2]
    - Rating of location – see slide #25
      - 16%-27% of total mortgage risk rating score[2]
  - Rating of borrower accounts for 16-27% of total score - see slide #26-30[2]

[1]Relating to the valuation of amenity income (owner-occupied) dwellings,
[2]The lowest, middle, and highest rating for the property, location, and borrower were given a maximum score weight of 27%, 22%, and 16% respectively. This feature introduced the concept of compensating factors.

1938 UW Manual: Valuation Axioms for Mortgage Loan Purposes

- Valuation presupposes a sale in which the buyer is well informed, and acts intelligently, voluntarily, and without necessity.
- Valuation presupposes a sale in which the seller is well informed, and acts intelligently, voluntarily, and without necessity.
- Valuation endeavors to estimate prices which represent the worth, at the time of appraisal, of future benefits from long-term use which will arise from ownership, rather than merely prices which can be obtained in the market
- Valuation recognizes the importance and usefulness of sales prices, provided it is determined whether or not such sales prices, were fair and warranted; and provided the motives, intelligence, and wisdom of the parties to the sales, as well as other conditions surrounding them and influencing the determination of the sales prices, as ascertained and weighed
- Valuation presupposes and recognizes that intelligent buyers and sellers consider the utility of real property
- Valuation recognizes that value may be much less than either replacement cost or available market value
- Valuation presupposes and recognizes that well-informed buyers and sellers compare the advantages and disadvantages of renting with those involved in ownership

These axioms placed the appraiser in the role of the well-informed buyer and seller

1938: UW Manual-valuation for mortgage loan purposes

- Methods of dwelling valuation—the character of value
  - The word "value" refers to the price which a purchaser is warranted in paying for a property for continued use or a long-term investment.
  - The value to be estimated, therefore, is the probable price which typical buyers are warranted in paying.
  - This valuation is sometimes hypothetical in character, especially under market conditions where abnormalities in price levels indicate the presence of serious quantitative differentials between the two value concepts [warranted value and available market price].
  - Marked differences between "available market prices" and "values" will be evident under both boom and depression conditions of market.
  - Attention is directed to the fact that speculative elements cannot be considered as enhancing the security of residential loans. On the contrary, such elements enhance the risk of loss to mortgagees who permit them to creep into the valuations of properties upon which they make loans.

1938: UW Manual-valuation for mortgage loan purposes

- Value does not exist unless future benefits are in prospect. Its measure is the present worth of expected benefits which may be realized only upon the occurrence of future events.
- The first step in the basic valuation procedure, the study of future utility, includes the selection of possible uses, the rejection of uses which are obviously lower uses than others, and the determination of uses in terms of alternative kinds of possible buyers and differing motives of such buyers.
- No other definition is acceptable for mortgage loan purposes inasmuch as one of the objectives of valuation in connection with mortgage lending is to take into account dangerous aberrations of market price levels. The observance of this precept tends to fix or set market prices *nearer* to value.

1938: UW Manual: valuation of "Amenity Income Dwellings"

- Requires a rigorous determination for "Mortgage Loan Purposes" of the V (value) in LTV
- Three methods used
    - "Derived capital value"
        - The essence of valuation and the major attempt to ascertain a proper valuation
        - Useful in evaluating differences between "available market price" and "warranted value"
    - "Total cost of replacement of property" – generally sets an upper limit of possible value due to application of substitution theory
    - "Available market price" – generally sets an upper limit of possible value due to application of substitution theory
  - Based on substitution theory, value for mortgage loan purposes is the lowest of the three estimates
  - The subject property's income and amenity rental value has a fundamental role in the value determination, as does the current rent being paid by a first-time home buyer which relates to the ability to pay debt service (payment shock)

1938: UW Manual: method 1: derived capital value

- The gross returns a property is capable of producing, converted into an estimate of derived capital value
  - Goes beyond "ratio of total payment to rental value" of subject
  - Properties of greater rental value have a higher value than those of lesser rental value
  - Differences in this relationship exist according to various price ranges
  - Remaining economic life, tax burden, maintenance costs, and neighborhood stability impacts capital value of properties with same rental value
- Step 1: Determine "monthly rental value" of subject property
- Step 2: Determine "owner-occupancy appeal" of subject property
  - Evaluate the relative intensity of the desire for ownership and owner-occupancy of the subject property which would be aroused on the part of the typical person who could afford to own the property and which is in market to purchase and occupy a home
- Step 3: Determine "amenity increment percentage"
  - The extent to which the services of the subject property may be more valuable to a typical owner-occupant than to a typical tenant-occupant; i.e. the extent to which the [amenity] returns a typical owner-occupant would receive may have a monthly value in excess of the monthly rental value
- Step 4: Determine "derived monthly [rental] value" of subject property
  - Multiply "monthly rental value" by the "amenity increment percentage"
- Step 5: Determine "derived capital value": the relationship between the level of returns a property is capable of producing and the value of a property
  - Multiply "derived monthly value" by the "conversion [capitalization] factor"
  - The "conversion factor" reflects the certainty, quality, and duration of the derived monthly value

1938: UW Manual: method 2: total cost of replacement of property

- Total cost of replacement of property
  - Separate estimate of the "replacement cost of property in new condition"
    - Includes all items of expense to which a typical prospective owner would be subjected if he were to undertake to replace or reproduce the improvements upon a site of equal value
      - Cost of survey, site preparation and improvement, cost of building improvements in new condition, appraisal fee, FHA fee, title and service charges, revenue stamps, mortgage preparation and recordation, note preparation, notary fee, settlement fee, insurance premiums and taxes on land and improvements during construction and interest on invested capital during construction period
      - Builder's overhead and profit included as and where appropriate
  - Separate estimate of land value
    - Determining a fair price at which comparable sites are available in the same or in competing localities
    - Market sales data does not absolutely control the establishment of land value by comparison
      - Sales prices are of varying usefulness and importance according to the rapidity with which site price levels may be changing
        - » In an unusually active sales market, such as exists in "boom" times, rising prices, stimulated by strongly competing buyers, reach a point where fairness disappears, insofar as prices are concerned. Such prices are almost worthless as information in estimating value
        - » Only in times of comparative stability of the general economic structure, and during periods where there is a fairly well-balanced relation between the factors of supply and demand, will sales prices approximate or actually equal value

1938: UW Manual: method 3: available market prices

- Based on consideration of sales data relating to similar improved properties of similar type and characteristics in the same or in competing neighborhoods
  - In making such comparisons, consideration is given to the entire range of data useful in estimating property value
- Value a property would bring in a reasonable time if offered for sale in the market
  - An obtainable, but not necessarily warranted value
- Marked differences between "available market prices" and "values" will be evident under both boom and depression conditions of market
  - Market prices not acceptable when prices paid are influenced by existing market conditions resulting in buyers' actions tending to create and support a market at inflated price levels
  - Since available market price alone is insufficient to determine warranted price, this is tantamount to indicating that the estimate of available market price is not a method of valuation

1938: UW Manual: rating of property (16-27 points)

- Durability
  - Structural soundness (25%)
  - Resistance to elements (10%)
  - Resistance to use (5%)
- Function
  - Livability and functional plan (20%)
  - Mechanical and convenience equipment (10%)
- Architectural attractiveness (20%)
- Adjustment for nonconformity (-12%-0%)
  - Suitability of use type
  - Appropriateness of functional characteristics
  - Harmony of design
  - Relationship of expense of ownership to family income levels

1938: UW Manual: rating of location (16-27 points)

- Relative economic stability (40%)
- Protection from adverse influences (20%)
- Freedom from special hazards (5%)
- Adequacy of civic, social, and commercial centers (5%)
- Adequacy of transportation (10%)
- Sufficiency of utilities and conveniences (5%)
- Level of taxes and special assessments (5%)
- Appeal (10%)

1938: UW Manual: rating of borrower (16-27 points)

- Social and economic characteristics (15%)
  - Character
    - In most cases a borrower's character is evidenced in the reputation established
  - Family life and relationships
    - Harmonious home life is a significant factor in the desire for maintaining a home
  - Associates
    - Highest rating ascribed in cases where associates substantial, law abiding, sober-acting, sane-thinking people of acceptable ethical standards
  - Maturity
    - Maturity contributes to stability
  - Attitude toward obligations
    - Borrower's performance with respect to past financial obligations will be a clue to his future attitude in the assumption and payment of obligations
  - Ability to manage affairs
    - The borrower with a sense of balance will guard against assuming obligations that do not enhance his own or his family's opportunities with a full measure of compensation
    - Will also maintain a position that will permit some adjustment or adaptation to unforeseen exigencies
    - He will save, plan, budget his income in a manner that will allow him to adjust, adapt, or arrange his affairs

1938: UW Manual: rating of borrower (16-27 points)

- Motivation in relation to transaction (25%)
  - Cash investment
    - Cash investment is a directly contributing element to motivation
    - The greater the investment, the greater the incentive that motivates the borrower to faithful performance
  - Motives for borrowing
    - While the use of proceeds for the purchase of a home is generally sound, the use is unsound if the home is excessively priced, cheaply constructed, poorly located, or too costly in relation to income
    - The refunding of obligations for speculation, pleasure trips, or other purposes which gratify transitory desires may generally be regarded as unsound motives
  - Importance of property to borrower
    - Represented by the degree of sacrifice the borrower will make in order to retain the property and should be analyzed from the aspects of owner occupancy, of an investment, or of speculation
    - Most borrowers will subject themselves to more sacrifices in the maintenance of a home than any other obligation
    - The advantages or disadvantages presented by a comparison between the expenses incident to home ownership and the cost of rent for similar accommodations are another element to this factor
    - The same concepts apply to the comparison of price and value
    - The borrower who owns a property as an investment for rental purposes will attach importance to it only so long as it affords or promises a net return

1938: UW Manual: rating of borrower (16-27 points)

- Employability and earning stability (20%)
  - An analysis of the borrower's ability to establish and maintain stability of income and the future continuity of income and not on the amount of income
    - Versatility
      - An analysis of the attributes that qualify the borrower for employment
      - A degree of versatility may be developed by education and training
      - Knowledge derived from either education or training, or both, when practicably applied, is an essential contribution to earning stability
        - » This does not mean the borrower must necessarily have an advanced education to qualify as proficient in his chosen line of endeavor, or in any other work in which he evidences inherent aptitude
    - Personality
      - A borrower's ability to become and remain employed is in a measure dependent upon his personality
    - Employment [stability]
      - Dependent upon the exercise of mental faculties, the use of ones hands, the employment of funds, or combination of these
        - » The inherent potential for advancement
        - » The stability of the employer
    - Occupational impairment which presents hazards to earning stability
      - Artistic careers subject to rapid decline in popular favor
      - Occupations where skills or faculties become gradually impaired
      - Lines of endeavor in which gradual occupational impairment results from the occupation itself

1938: UW Manual: rating of borrower (16-27 points)

- Employability and earning stability (20%) - continued
  - Reemployment possibilities
    - The demand for the borrower's services and his ability to compete with others employed in similar lines of endeavor, or other lines in which he shows sufficient aptitude to receive adequate compensation
  - Reserves and contributions
  - Age
    - Affects employability and consequent earning capacity
      - » While a young borrower may not have established complete training and experience, youth may be regarded as an asset rather than a liability
      - » A borrower in his advanced years may have passed the height of proficiency to the extent that demand for his services has diminished and may effect employment stability
  - Health
    - Significant only in so far as it will affect future employment
- Relation of obligations to transaction (15%)
  - Low rating where other ascertained obligations will precede the proposed mortgage payments in the family budget
  - High rating where proposed mortgage payments will be accompanied in the budget by the bare necessities of food and clothing
  - Where mortgage payments do not exceed rent payments which the mortgagor would be forced to pay for ordinary shelter, the rating shall reflect the relatively favorable position of the mortgage payments
    - Nature of obligations
      - Classified as those pertaining to and not pertaining to family matters
      - Analyzed in light of necessities and other benefits which the borrower and his family require to maintain their standard of living
    - Effects of obligations of capacity
      - Analyzed as to the effect the nature and amounts have on earning capacity and stability

1938: UW Manual: rating of borrower (16-27 points)

- Relation of income to transaction (25%)
  - The ability of the borrower's income to pay the contemplated mortgage obligation
    - Ratio of property value to annual income
      - If the value of the owned or purchased property is not properly related to the borrower's income, a substantial mortgage risk is involved
        - This rule is not to be ascertained mechanically
      - An excessive ratio usually forces a standard of living out of proportion to borrower's income
        - Consideration must be given to the expense of owning and maintaining larger and more expensive property than his earning capacity would ordinarily justify
    - Ratio of total monthly payment to income
      - The degree to which the monthly mortgage payment absorbs monthly income, and therefore the proportion of the income available for other living expenses and obligations
      - Consideration is given to other living expenses and obligations, such as number of children and other dependents, the borrower's scale of living, cost of home maintenance, and payments required by other obligations
      - Although two borrowers may have the same amount of monthly incomes and monthly mortgage obligations, a lower feature rating may result in one case than in the other because of a wide difference in the nature of their family responsibilities and other obligations
      - If the monthly payment will not allow a sufficient remainder of income for other necessities and responsibilities, it will be obvious that the borrower is attempting to maintain or purchase a property that is too expensive for him and not within his ability to pay

1938: UW Manual: FHA's Counter-cyclical features

- Ratio of total payment to rental value
  - As this ratio increases, mortgage pattern score decreases
  - If prices go up faster than rents (a fundamental), this acts to restrain maximum lending value
- Ratio of LTV
  - As ratio increases, mortgage pattern score decreases
- In a booming market "derived capital value" becomes predominant factor used to compute value in LTV
  - This allows for the comparing and contrasting of the advantages of renting with the advantages of buying

1938: Underwriting metrics

- Median averages for selected characteristics[1]

Year	Loan term in years	LTV in %	Property value	Land value/ property value	Number of rooms	Annual gross income	Mortgage payment as % of income	Home value as a ratio of income	% of homes with garages
1938	20.8	85.7	$5,326	14.7%	5.7	$2,603	13.0	2.05	80
1954	22	80.5	NA	NA	NA	$5,880	15.0	NA	NA

[1]For 1938: John P. Dean, Home Ownership Is it Sound?, Harper & Brothers, 1945. For 1954: John P. Herzog and James S. Earley, Home Mortgage Delinquency and Foreclosure, 1970 with estimates based on interpolation of data for loans on new and existing homes (available in Bibliography).

1934-1938: FHA's Lessons for wealth building

- Rigorous lending standards promote low defaults and burgeoning homeownership rates
- Mortgage risk must be measured dynamically
- Each classification of risk must stand on its on so as to avoid cross-subsidization
- Weaker elements need to be compensated for as they impose risk penalties in greater ratio than do the stronger elements
- Valuation related items are the primary risk inputs
- Sustainable lending relies on analyzing the transaction from the perspective of renting before, during, and after the home purchase
- The potential for marked differences between available market prices and values must be rigorously evaluated
- Important to determine if borrower is attempting to purchase a property that is too expensive for him and not within his ability to pay
- A well-underwritten borrower and property combined with shorter loan terms and upfront equity provides a debt-free highway to home ownership

Update on Wealth Building Home Loan

- Neighborhood Assistance Corporation's "Freedom Loan" being offered nationally through their 30+ offices to low-income borrowers
- Androscoggin Bank (ME) began offering a market rate "Wealth Builder Home Loan" in November month
  - Has 100% of buying power of an FHA 30 year loan and a Fannie 97% LTV 30 year loan (with a 700 FICO)
  - https://www.androscogginbank.com/Personal/Loans/Mortgage/Wealth-Builder
- Under consideration by almost all private mortgage insurers
- More to come--stay tuned

Bibliography of historically significant valuation and mortgage risk documents

- AEI's International Center on Housing Risk has assembled a bibliography of historically significant valuation and mortgage risk books and documents from the first half of the 20th century
  - This includes the documents referenced herein along with may others relevant to FHA's first 30 years
- To receive a copy of the bibliography and request access to available PDF copies of most of the documents, please contact Lilla Lukacs at Lilla.Lukacs@AEI.org. While certain of the documents are not in the public domain, they may still be in print or vintage copies may be available for purchase over the Internet