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SEP 13 1962

MEMORANDUM FOR: JENKINS files
FROM: ^{RCS} Richard C. Stearns
SUBJECT: Racial Content of FHA Underwriting Practices,
1934 - 1962

The purpose of this memorandum is to set forth a historical record of those portions of the Federal Housing Administration ("FHA") Underwriting Manual,^{*7} 1934 to 1962, which refer, directly or indirectly, to race as a factor to be considered in determining the value of property proposed for federal mortgage insurance. By detailing this history, this memorandum may serve as the basis for proposed stipulations of fact on FHA insuring practices.

A. 1930s

The FHA, created under the National Housing Act of 1934, was launched in an effort to encourage home-building and mortgage lending during the Depression. The FHA immediately had a revolutionizing effect on the entire mortgage lending industry. Prior to passage of the National Housing Act, the typical mortgage financing vehicle was a short-term (3-5 year) loan with a large balloon payment at the end. During the Depression large numbers of homeowners lost their homes when they could not pay these balloon payments. Beginning in 1934, FHA offered a long-term (30 year) loan with a high loan to value ratio, low interest

^{*7} United States Federal Housing Administration, "Underwriting Manual, Underwriting and Valuation Procedure Under Title II of the National Housing Act."

PLAINTIFF'S EXHIBIT NO. 48
CASE NO. MJG 95 - 309
IDENTIFICATION: _____
ADMITTED: _____

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rate and fixed monthly payments. Large numbers of renters because homeowners through the FHA single family programs. Even where FHA insurance was not directly involved, FHA practices had a strong impact on private mortgage lending; the mortgage financing industry quickly adopted the long-term fixed interest rate loan as the industry norm. FHA programs (and the similar home-owern programs of the Veterans Administration) and their impact on the private lending industry are largely credited with increasing the percentage of American families who are homeowners from forty percent in 1920 to seventy percent in 1970.

In contract to its trendsetting role in the area of mortgage instruments, the FHA in 1934 adopted and applied existing local customs and practices about race and its relations to property values in its property appraisal methods. FHA policy adopted the assumptions of local governments and the private housing industry concerning the desirability of maintaining a racially dual housing market, and the agency endorsed prevailing practices used to exclude and segregate minorities.

This federal policy of racial exclusion and segregation was originally expressed in the first FHA Underwriting Manual, issued _____, 1934 to implement the 1934 Act. Paragraphs 309-311, "Protection from Adverse Influences," stated:

309. The points of consideration here are the factors which afford protection and preservation of the desirable neighborhood character. Numerous influences can so change the characteristics of a neighborhood that it will become entirely undesirable for residential purposes. Protection against some adverse influences is obtained by the proper zoning and deed restrictions that prevail in a neighborhood. Other unfavorable factors may

exist outside of the neighborhood and cannot be controlled. Published and utilized city planning affords some assistance in preventing the occurrence of adverse influences. Sometimes the character of a neighborhood may be so well established that it is relatively free from undesirable influences although no zoning or deed restrictions or similar protection may exist. The natural geography of a neighborhood may also be such that adverse influential factors are kept out.

310. Some adverse influences may be immediately noticeable while others arise gradually or are destined to occur after a certain number of years. The estimated time of such occurrence must, therefore, be compared to the life of the mortgage to arrive at a proper rating. The more important among the adverse influential factors are the ingress of undesirable racial or nationality groups; infiltration of business or commercial uses of properties; the presence of smoke, odors, fog, heavy trafficked streets, and railroads. Nuisances which affect the entire neighborhood must be included as adverse influences.

311. All mortgages on properties in neighborhoods definitely protected in any way against the occurrence of unfavorable influences obtain a higher rating. The possibility of occurrence of such influences within the life of the mortgage would cause a lower rating or disqualification. The actual rating given must be commensurate with the degree to which the adverse influence occurrence of unfavorable influences obtain a higher rating. The possibility of occurrence of such influences within the life of the mortgage would cause a lower rating or disqualification. The actual rating given must be commensurate with the degree to which the adverse influence occurs or is likely to occur. (Emphasis added)

The 1934 manual even exhorted the use of a model covenant, providing that "no persons of any race other than [race to be inserted] shall use or occupy any building or any lot, except that this covenant shall not prevent occupancy by domestic

servants of a different race domiciled with an owner or tenant."

The 1935 manual, effective June 1, 1935, listed the important factors which the FHA considered "adverse." Among these factors was "infiltration of inharmonious racial or nationality groups," (section 310, 1935). "Rapid transition to use by a lower class of inhabitants, is to be considered positive instability," (section 307, 1935). The appeal of a residential neighborhood results from "the kind and social status of the inhabitants," (section 315, 1935). Sections 309-312, "Protection from Adverse Influences," of the 1935 manual read:

309. The matters to be considered in rating this feature are the factors which afford protection to and preservation of the desirable characteristics of residential neighborhoods. Numerous influences can so change these characteristics that the neighborhood will become entirely undesirable for residential purposes. Protection against some adverse influences is obtained by the existence and enforcement of proper zoning regulations and appropriate deed restrictions. Some unfavorable factors may exist outside of the neighborhood and may be uncontrollable. Published and utilized programs of city planning afford some assistance in preventing the occurrence or growth of adverse influences. Sometimes a neighborhood may be so completely built up and well planned that although no zoning regulations or deed restrictions exist, the adverse influences against which such controls protect may be absent or of remote probable occurrence. The natural geography of a neighborhood may also present effective barriers against some adverse influences.

310. Important among adverse influences besides those mentioned above are the following: infiltration of inharmonious racial or nationality groups; infiltration of business or commercial development or use; the presence of smoke, odors, fog; proximity to noisy or high-speed traffic arteries, to railroads, and to nuisances.

311. Some adverse influences develop in intensity very gradually and cannot readily be discovered in their early stages. Some occur only after the neighborhood has been developed for a number of years. The time of such occurrence and probable intensity of the influence must also be considered in order to arrive at a proper rating.

312. All mortgages on properties in neighborhoods protected against the occurrence or development of unfavorable influences, to the extent that such protection is possible, will obtain a high rating of this feature. The absence of protective measures will result in a low rating or, possibly, in rejection of the case. The actual rating given must be commensurate with the degree in which adverse influences exist or are likely to occur, the remoteness of such occurrence, and the extent to which protection is provided. (Emphasis added).

The 1936 manual, revised November 1, 1936, perfected and expanded the racial and social doctrine of 1935. It warned that "the mixed neighborhood" in competition with the "homogeneous" neighborhood would suffer, and that "the chances are that within a comparatively short period of time a lower grade of social occupancy will exist," (section 210(d), 1936). Section 228 specified techniques for avoiding "infiltration" of inharmonious racial groups:

Deed restrictions are apt to prove more effective than a zoning ordinance in providing protection from adverse influences. Where the same deed restrictions apply over a broad area and where these restrictions relate to types of structures, use to which improvements may be put, and racial occupancy, a favorable condition is apt to exist. Where adjacent lots or blocks possess altogether different restrictions, especially for type and use of structures and racial occupancy, the effect of such restrictions is minimized and adequate protection cannot be considered to be present . . . (Emphasis added).

Section 233 also advised the FHA Valuator to investigate areas surrounding the property location to determine whether or not

. . . incompatible racial and social groups are present, to the end that an intelligent prediction may be made regarding the possibility or probability of the location being invaded by such groups. If a neighborhood is to retain stability it is necessary that properties shall continue to be occupied by the same social and racial classes. A change in social or racial occupancy generally leads to instability and a reaction in values.

To guarantee racial and class separation the manual prescribed that:

Recorded deed restrictions should strengthen and supplement zoning ordinances and to be really effective should include the provisions listed below. The restrictions should be recorded with the deed and should run for a period of at least 20 years. Recommended restrictions include the following:

* * * *

(G) Prohibition of the occupancy of properties except by the race for which they are intended.

(H) Appropriate provisions for enforcement.

(Section 284(3), 1936). This recommended restriction followed immediately after a recommendation against nuisances such as stables, pig pens, etc. Further, section 266 of the 1936 Manual recognized the critical role that public schools could play in determining the racial and ethnic characteristics of a neighborhood, and, consequently, its property values:

The social class of the parents of children at the school will in many instances have a vital bearing. Thus, although physical surroundings of a neighborhood area may be favorable and conducive to enjoyable, pleasant living in its locations, if the children of

people living in such an area are compelled to attend school where the majority or a goodly number of the pupils represent a far lower level of society or an incompatible racial element, the neighborhood under consideration will prove far less stable and desirable than if this condition did not exist. In such an instance it might well be that for the payment of a fee children of this area could attend another school with pupils of their same social class. The question for the Valuator to determine is the effect created by the necessity for making this payment upon the occupants of the location. Under any conditions the rating could not be as favorable as if the desirable school were available without additional cost. In many instances where a school has earned a prestige through the class of pupils attending, it will be found that such prestige will be a vital element in maintaining the desirability of the entire area comprising the school district. (Emphasis added).

The 1938 manual compressed the policy statement against racially integrated neighborhoods into two sections, sections 935 and 937, which advised the underwriter to examine the property location to determine whether natural barriers might be effective in forestalling the incursion of adverse influences:

Natural or artificially established barriers will prove effective in protecting a neighborhood and the location within it from adverse influences. Usually the protection from adverse influences afforded by these means includes prevention of the infiltration of business and industrial users, lower class occupancy, and inharmonious groups.

Areas surrounding a location are investigated to determine whether incompatible racial and social groups are present, for the purpose of making a prediction regarding the probability of the location being invaded by such groups. If a neighborhood is to retain stability, it is necessary the properties shall continue to be occupied by the same social and racial classes. A change in social or racial occupancy generally contributes to instability and a decline in values. (Emphasis added).

The 1938 manual even advised against allowing minorities who had achieved success in the business world to reside in a non-minority community. Underwriters were to examine "the type of people with whom the borrower associates socially, rather than those with whom he is associated in business activities. The highest rating could hardly be ascribed in cases where the borrower's chosen associates are other than substantial, law-abiding, sober-acting, sane-thinking people of acceptable ethical standards," (section 1014, 1938).

Thus, FHA underwriting policy in the 1930s can be summarized as fostering a racially dual housing market. It should be noted, however, that racial segregation was well-entrenched when FHA was created in 1934. The FHA Underwriting Manual followed the existing rule of thumb of the private real estate industry that homogenous neighborhoods were the most stable in terms of maintenance of real estates values. This rule included homogeneity of religion, ethnicity and national origin as well as race. Although clearly discriminatory in its intent and effect, the rule was regarded as good business practice at the time.

B. 1940s

The revised 1940 manual ~~was~~³ made few changes. The reference to "inharmonious racial and nationality groups" in the same category as "smoke, odors, fog" continued. Section 110 required the underwriter to estimate "the probability of any change in occupancy which would tend to change desirability for residential purposes. The underwriter was also instructed to evaluate the

degree of compatibility of the inhabitants of the neighborhood since "the pressure of incompatible groups in a neighborhood tends to lessen or destroy owner-occupancy appeal," (section 1215(4)(d), 1940).

The 1947 manual, revised January 1, 1947, contained the first significant changes in FHA's racial policies. On the one hand, all references to "inharmonious racial groups" and mortgages in areas threatened by minority infiltration were omitted. In their place, the manual instructed the Valuator to investigate the "compatibility among neighborhood occupants" or "user groups" in accessing the desirability of a neighborhood. For example, section 1320(1) of the 1947 manual stated:

The tendency of user groups to seek compatible conditions can sustain and enhance, diminish or destroy neighborhood desirability. Neighborhoods constituted of families that are congenial, physical conditions being acceptable, generally exhibit strong appeal and stability. Consideration of these attitudes is essential in the evaluation of the feature Physical and Social Attractiveness. (Emphasis added).

The 1947 manual no longer advised that racially or ethnically integrated neighborhoods automatically constituted a negative influence on property values. Instead, section 1320(2) instructed the Valuator to determine whether or not a mix of "user groups" rendered the neighborhood less desirable than homogeneous neighborhoods:

If a mixture of user groups is found to exist it must be determined whether the mixture will render the neighborhood less desirable to present and prospective occupants. If the occupancy of the neighborhood is changing from one user group to another, or if the areas adjacent to the

immediate neighborhood are occupied by a user group dissimilar to the typical occupants of the subject neighborhood or a change in occupancy is imminent or probable any degree or risk is reflected in the rating. It is to be noted that additional risk is not necessarily involved in such change. (Emphasis added).

On the other hand, the 1947 manual continued to reflect the industry-wide belief that existing neighborhoods generally decline in value as residents move away and are replaced by new occupants of a different race or ethnic background. Section 1302(i) stated:

[N]ew and old residential districts undergo a change in quality which is directly related to the changing user groups that come successively into occupancy.

Section 1303(7) continued:

[N]eighborhoods tend to decline in investment quality over a substantial period of time. Usually, when occupancy is passing or tending to pass from one user group to another, the successor group exhibits a lower income level than its predecessor group. Transition, therefore, gradually results in poorer maintenance of properties and lower owner-occupancy appeal. (Emphasis added).

A second significant policy change occurred in December 1949. On December 2, FHA agreed not to insure mortgages on properties subject to racial restrictive covenants filed after February 15, 1950. This change -- which took place a year after the Supreme Court ruled in Shelley v. Kraemer that judicial enforcement of those covenants was a violation of the 14th amendment -- did not affect properties with restrictive covenants filed prior to February 1950. FHA ignores racial covenants executed before February 1950 as having no force and effect.

Since that date, all FHA mortgage forms have contained a covenant under which the mortgagor agrees that so long as the insured mortgage is in existence he will not file for record any restrictive covenant. FHA also eliminated the model restrictive covenant and all references to it from the manual.

Third, two weeks later, on December 16, 1949, FHA amended the manual to clearly state that race would not be a factor in property valuation by FHA. A new section, no. 242, was added to the manual:

Underwriting considerations shall recognize the right to equality of opportunity to receive the benefits of the mortgage insurance system in obtaining adequate housing accommodations irrespective of race, color, creed or national origin. Underwriting considerations and conclusions are never based on discriminatory attitudes or prejudice. Determinations which adversely affect the eligibility for mortgage insurance, the degree of mortgage risk, or the valuation of the property to be insured shall be supported by observable conditions, precedent or experience directly applicable to the subject case.

The 1947 and 1949 changes mark the end of FHA's policy of intentional racial discrimination which had existed since 1934. Henceforth, FHA's policy was one of open occupancy in housing. However, FHA made no particular immediate effort to carry out its anti-discrimination policies and, consequently, its new policies had little effect in reversing the impact of its former practices.

C. 1950s - 1960s

No truly significant changes to the FHA Underwriting Manual occurred between 1949 and 1962. However, 1962 brought the most

dramatic change in FHA policies to date. On November 20, 1962, President Kennedy signed Executive Order 11063 on Equal Opportunity in Housing. The first expression of a national policy on equal housing opportunity, the Executive Order prohibited discrimination in all federally-assisted housing contracted for after the date of the Order, and called for abandonment of discrimination in federally-assisted housing that originated prior to that date. With respect to loans insured or guaranteed by the FHA, the Order directed that the agency take all action necessary and appropriate to prevent discrimination by private lending institutions. Housing developers, realtors and lenders could be cut off from funding or barred from future participation in federal housing programs should they violate the proscription against discrimination. The policies embodied in Executive Order 11063, later expanded by Title VIII of the Civil Rights Act of 1968, marks the beginning of FHA's affirmative efforts to promote fair housing.

D. Proposed Stipulations

The following stipulations of fact concerning FHA's underwriting practices 1934-1962 might be proposed to all parties:

(1) The Federal Housing Administration's Underwriting Manual for approximately fifteen years in the 1930s and 1940s followed the general rule of thumb of the private real estate industry that homogeneous neighborhoods were the most stable in terms of maintenance of real estate values. This rule included

homogeneity of religion, ethnicity and national origin as well as race.

(2) Beginning in the late 1940s, FHA adopted an official policy of open occupancy in housing. In December 1949 FHA amended its Underwriting Manual to state that race may not be used as a factor in property valuation, and removed all references to race contained in the Manual. At the same time FHA also announced that it would ignore all racial covenants in deeds and loan instruments executed before February 1950 as having no force and effect, and would not insure mortgages on properties subject to racial restrictive covenants filed after February 1950.

3. On November 20, 1962, President Kennedy signed Executive Order 11063, which prohibits discrimination because of race, color, creed or national origin in the sale or rental of residential property owned or operated by the federal government, or provided with the aid of loans or grants made by or insured by the federal government.