Insight

6 Effects of FHA's Premium Cut

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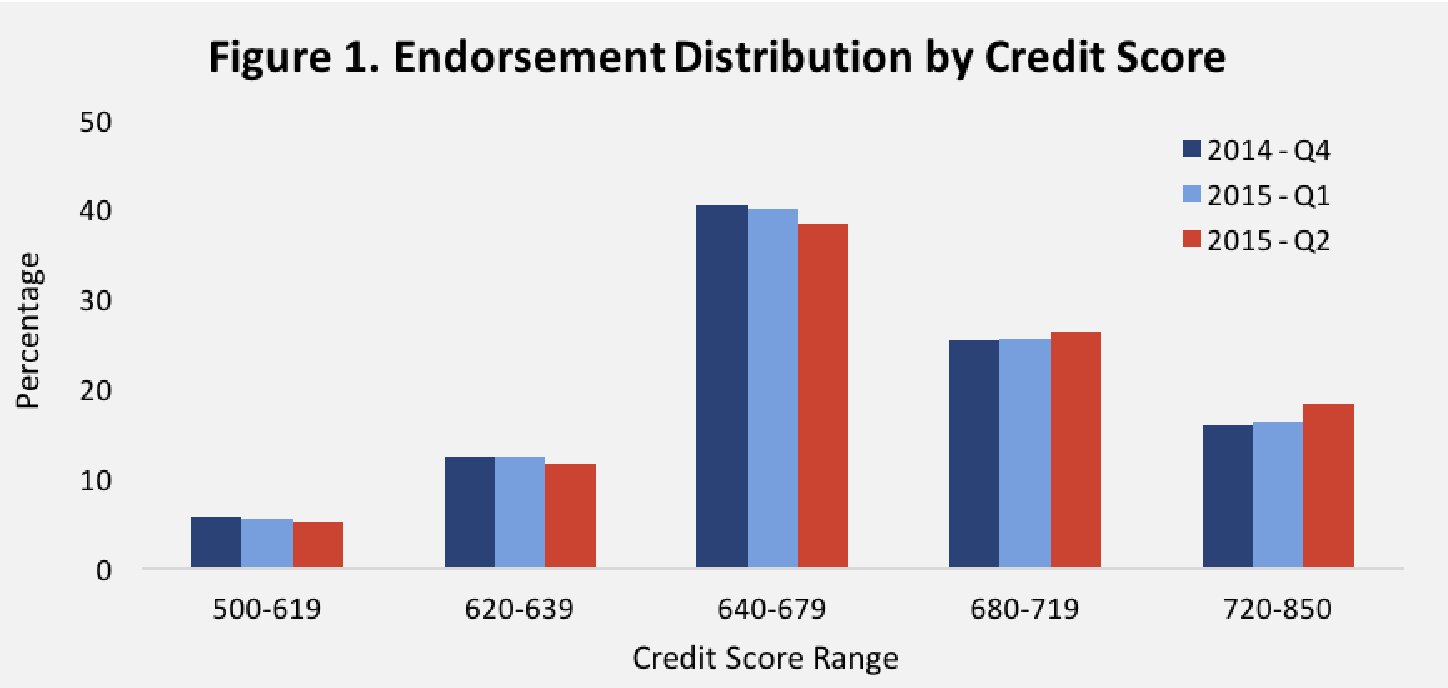
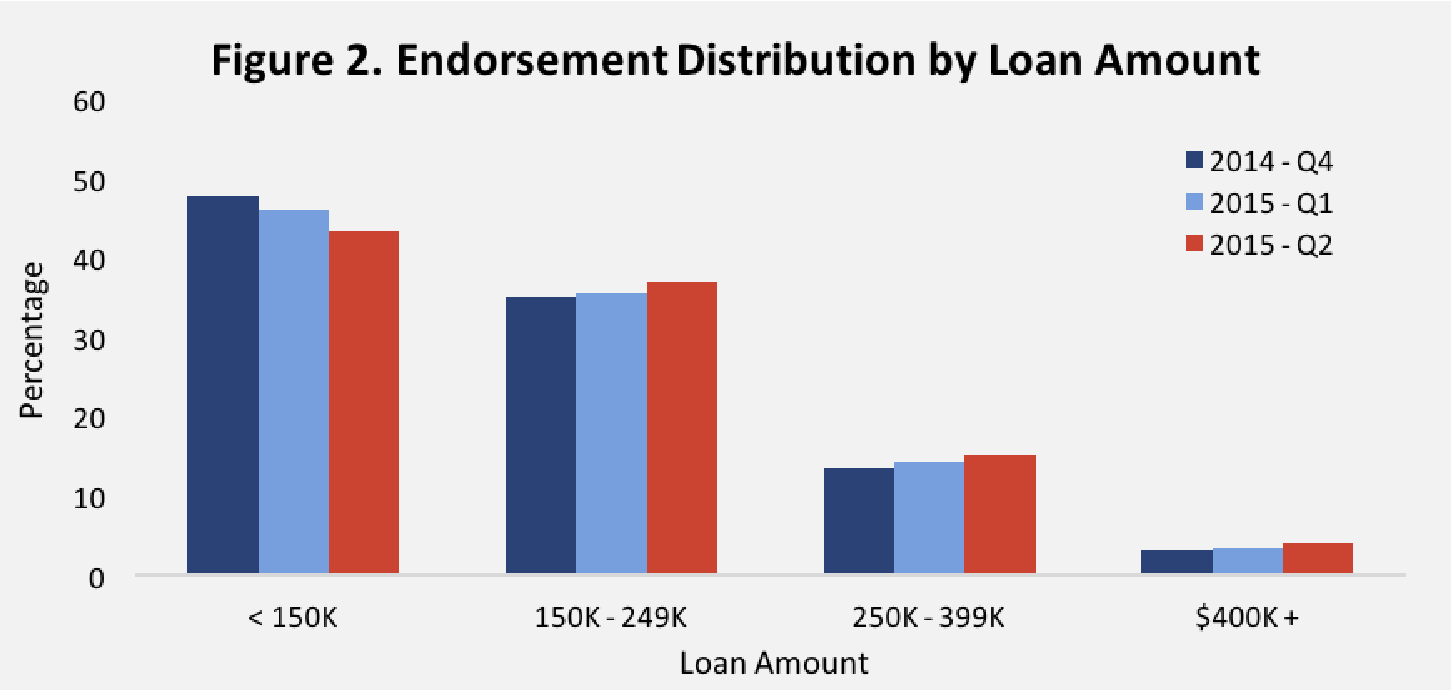
Effective January 26, 2015, the Federal Housing Administration (FHA) reduced its annual mortgage insurance premiums by 50 basis points (bp) or .50 percent. This is part of a concerted administration effort to "expand access to mortgage credit." When proposed, AAF documented how that premium reduction could jeopardize the agency's financial health and expand the government's footprint in housing finance. The verdict is now in; here is a look at a few of the price cut's effects:

1. **The distribution of new FHA endorsements has shifted slightly toward borrowers with higher credit scores.** As previous AAF research predicted, "With the [premium] reduction, FHA dominates mortgages with [credit scores] below 680 and narrows the gap for [credit scores] between 680 and 720, regardless of LTV." The share of new FHA endorsements with credit scores above 680 has in fact grown from 41 percent in the fourth quarter of 2014 to 45 percent in the second quarter of 2015, as shown in Figure 1 below. FHA's more competitive pricing for this slice of borrowers has allowed it to push out private companies.



2. **The distribution of new FHA endorsements has also shifted slightly toward more expensive loans.** Figure 2 below shows how the distribution of new FHA endorsements in the first and second quarter of 2015 have shifted toward higher loan amounts. Moreover, the percentage of loans less than $150,000 has fallen from 48 percent of new endorsements in the fourth quarter of 2014 to 43 percent in the second quarter of 2015. These higher balance loans add further risk to FHA's still-recovering balance sheet and likely do not help those "locked out" of home buying. Research by American Enterprise Institute's Edward Pinto

corroborates this trend. He noted that in such an inventory-constrained market FHA's premium reduction "was largely capitalized into the purchase of higher priced homes," with little impact on accessibility.



3. **FHA originations jumped 5.5 percent, capturing a 32 percent market share.** Inside Mortgage Finance reported that private mortgage insurance coverage fell 5.3 percent from Q4 2014 to Q1 2015 while FHA loan originations were up 5.5 percent, pushing FHA's market share to 32 percent. Paradoxically, Michael Stegman, housing policy adviser on the National Economic Council and former Treasury official, has noted, "There is no sound policy reason for the government to support the overwhelming majority of mortgage credit extended in this country when there is sufficient private capital able to responsibly bear this risk." And yet FHA's action appears to pull business away from capable private entities.

3. **Prepayments(full payoffs and FHA refinances) have jumped 163 percent.** With the drop in prices, many FHA borrowers have refinanced into lower monthly payments, which helps those borrowers but may alter also FHA's revenue projections. Prepayments have a mixed impact on FHA finances as they prevent FHA from collecting future premium revenue but terminate the loan without the potential for costly default. Table 1 below highlights these changes.

Table 1. FHA Single-Family Insured Mortgage Portfolio Changes						
	FHA Refinances		Full Payoffs		Total Prepayments	
	Count	Balance ($M)	Count	Balance ($M)	Count	Balance ($M)
Jan-May 2014	52,353	$7,528	215,097	$32,823	267,450	$40,351
Jan-May 2015	142,989	$32,536	324,782	$55,270	477,771	$87,806
% Change	173%	332%	51%	68%	79%	163%

Source: FHA Production Reports

5. **FHA has revised its premium revenue downward.** With annual premiums cut by nearly 40 percent, it is not surprising that FHA reduced its incoming cash flow. According to FHA's most recent quarterly report to Congress, FHA's subsidy rate has been revised from -9 percent down to -5 percent. A negative subsidy rate indicates that the government stands to make a paper profit from the loan guarantees under current federal credit accounting rules. Yet FHA has a long history of overestimating the value of its Mutual Mortgage Insurance Fund and this time appears no different.

5. **The shares of first-time and minority- homebuyers are unchanged from one year ago.** In May 2015, 33 percent of FHA endorsements went to minority borrowers and 83 percent went to first-time homebuyers. Both levels are unchanged from one year earlier. Supporters of FHA's move to cut premiums frequently lauded the action as necessary to help low-income and minority borrowers buy homes. "Lots of people have been locked out of the market, particularly lower-wealth borrowers and borrowers of color, by the high prices at FHA," said Julia Gordon, director of housing finance and policy at CAP. Yet so far, shares of first-time and minority-homebuyers are unchanged from a year ago. Furthermore, as detailed above, FHA's premium cut has more likely simply helped borrowers take on more debt.