Research

Reducing FHA Premiums: Policy & Market Implications

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- FHA's reduction in annual premiums will expand the government's role in housing and add doubt to its fiscal recovery.
- Reducing annual premiums gives FHA a pricing advantage over private companies for many low downpayment loans, particularly those to borrowers with FICO scores under 720.
- Despite receiving more than $4 billion in money from legal settlements and the Treasury Department, FHA's capital reserves remain below their congressionally mandated level and will be impacted by the recent premium announcement.

In laying out his Administration's agenda for 2015, President Obama announced in early January that the Department of Housing & Urban Development (HUD) would reduce Federal Housing Administration (FHA) mortgage insurance premiums from 1.35 percent to 0.85 percent.[1] While some have labeled the announcement "welcome news for prospective FHA borrowers," the costs merit further exploration;[2] HUD's decision will certainly affect FHA's finances and lead to an expanded government role in the mortgage market.

Market-Shifting Implications

The outsized role the government plays in housing continues to be a primary bipartisan concern, and lowering FHA premiums will exacerbate the problem. The effort will likely preserve or even expand FHA's market share by making its mortgage insurance cheaper for prospective borrowers than what is offered by private companies. In Table 1, boxes are shaded red if FHA-insured mortgages elicit cheaper monthly payments than conventional mortgages (private mortgage insurance with a GSE[3] guarantee). Conversely, they are shaded green if conventional mortgages would have lower monthly payments than FHA.

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The 50 basis point (bp) reduction in premiums allows FHA to undercut conventional pricing for most low-downpayment (i.e. high loan-to-value or LTV) mortgages and those for borrowers with low FICO scores, loan characteristics generally acknowledged to have greater inherent risk. With the reduction, FHA dominates mortgages with FICOs below 680 and narrows the gap for FICOs between 680 and 720, regardless of LTV. Though other factors play into choosing whether to opt for private mortgage insurance or FHA, pricing premiums lower across the board makes FHA a cost effective choice for many more borrowers.

Adding to the likelihood that FHA captures business that might otherwise go to private mortgage insurers, the implementation window for the premium reduction was made curiously short when compared to prior premium changes, giving companies little time to adjust. Shown in Table 1, the announced 50 bp decrease in annual premiums becomes effective January 26, only nine business days after FHA released a mortgagee letter instructing lenders on the change. Earlier premium changes gave mortgage market participants anywhere from 22 to 82 business days between announcement and effective dates.

TABLE 2. FHA PREMIUM CHANGES SINCE 2010

	MORTGAGEE LETTER	ANNOUNCEMENT DATE	EFFECTIVE DATE	DAYS TO IMPLEMENT*
50 BP UFMIP INCREASE	2010-02	JANUARY 21, 2010	APRIL 5, 2010	50
125 BP UPMIP DECREASE & 35 BP ANNUAL MIP INCREASE	2010-28	SEPTEMBER 1, 2010	OCTOBER 4, 2010	22
25 BP ANNUAL MIP INCREASE	2011-10	FEBRUARY 14, 2011	APRIL 18, 2011	43
10 BP ANNUAL MIP INCREASE & 75 BP UFMIP INCREASE	2012-04	MARCH 6, 2012	APRIL 9, 2012	23
25 BP ANNUAL MIP INCREASE**	2012-04	MARCH 6, 2012	JUNE 11, 2012	67
10 BP ANNUAL MIP INCREASE	2013-04	JANUARY 31, 2013	APRIL 1, 2013	40
45 BP ANNUAL MIP INCREASE***	2013-04	JANUARY 31, 2013	JUNE 3, 2013	82
50 BP ANNUAL MIP DECREASE	2015-01	JANUARY 9, 2015	JANUARY 26, 2015	9

* BUSINESS DAYS ONLY—EXCLUDES WEEKENDS AND FEDERAL HOLIDAYS

**FOR LOANS EXCEEDING $625,500

*** FOR LOANS WITH LTV < 78 PERCENT

NOTE: FHA CHARGES TWO FEES – AN UPFRONT MORTGAGE INSURANCE PREMIUM (UFMIP) AND ANNUAL MORTGAGE INSURANCE PREMIUM (ANNUAL MIP). THE RECENT PREMIUM ANNOUNCEMENT IS A 50 BP REDUCTION IN THE ANNUAL MIP, WHICH IS PAID OVER THE LIFE OF THE LOAN WHEREAS THE UPFMIP IS DUE WHEN THE LOAN IS INITIALLY MADE.

The short implementation window stands in contrast to previous changes, but is also unexpected given the market-shifting and controversial nature of the decision. Yet, more importantly, when coupled with FHA's resulting competitiveness, private mortgage insurers have been given little time to respond despite the obvious impacts on their businesses. Mortgage insurers may find it further difficult to compete given ongoing efforts to raise their capital standards in anticipation of still pending Federal Housing Finance Administration (FHFA) private mortgage insurance eligibility requirements (PMIERs).[4][5]

Effect on FHA's Fiscal Outlook

While the effect FHA's premium reduction will have on private competition certainly merits attention, FHA's decision affects all taxpayers, not just companies and prospective homebuyers. Lawmakers have voiced concerns over whether a price reduction is warranted given the fact that FHA needed a $1.7 billion appropriation from the Treasury Department to bolster it mutual mortgage insurance fund (MMIF) just over a year ago. Many are concerned FHA is not suitably prepared to weather a future economic downturn since its capital buffer has not been restored to the minimum level mandated by Congress.[6] In particular, Rep. Jeb Hensarling (R-TX), chairman of the House Committee on Financial Services, has requested the written analysis and data used to justify the premium change in a letter written to the HUD Secretary.[7]

These concerns have merit given the fact that lowering premiums stands to substantially alter the projected fiscal outlook. First, lower prices result in less revenue than anticipated. FHA must pull in enough new volume, whether from borrowers previously priced out of buying or borrowers that would have chosen private mortgage insurance, to make up for the lower revenues. Yet both options come with caveats.

Buyers who found FHA cost-prohibitive previously and were therefore unable to purchase a home are likely to have high LTVs and/or low FICO scores that private mortgage insurers would not serve. Shown in Table 3, lower credit score borrowers are more likely to become delinquent and therefore result in losses for FHA, which could easily turn to taxpayer losses without a restored capital reserve. The second option, pulling borrowers away from private companies, runs firmly against the bipartisan policy objective of limiting the government's involvement in mortgage markets following years of unprecedented and risky government support.

TABLE 3. ALL FHA SINGLE FAMILY LOANS BY CREDIT SCORE

CREDIT SCORE RANGE	SERIOUSLY DELINQUENT RATE (%)
UNDER 500	27.64%
500-579	25.83%
580-619	18.79%
620-659	8.84%
660-719	4.11%
720-850	1.79%

ALL	6.59%
SOUCE: FHA[8]	

Uncertainty surrounding the effects the premium reduction will have on the FHA's fiscal health is made all the more pressing by FHA's documented history of missing financial projections. Shown in Figure 1, in every actuarial review since 2004 the economic value of FHA's single-family fund has come in lower than what was projected the previous year, and 2014 was no exception.[9] For many, this enhances the perception that FHA downplays risks borne by taxpayers and casts doubt on the assumption that FHA will continually improve as projected, particularly as it lowers prices to entice high LTV, low FICO borrowers.

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In fact, legislative attempts to reform FHA in the last Congress would have raised its mandated capital reserve ratio even higher to either 3 percent or 4 percent, levels FHA's MMIF is not expected to reach until 2018 and 2019 respectively.[10] FHA's capital buffer is meant to protect taxpayers in an economic downturn while preserving FHA's ability to fulfill its mission. The decision to lower premiums may jeopardize the MMIF's return to its mandated capital level. Furthermore, many worry that FHA's current economic value is overstated due to the influx of money from major mortgage-related legal settlements and the one-time appropriation of $1.7 billion from the Treasury Department (See Table 4).

TABLE 4. MAJOR SETTLEMENTS

	SETTLEMENT PAYMENT TO FHA	AUDIT REPORT	DATE
BANK OF AMERICA/COUNTRYWIDE	$471,000,000	2012-CF-1809	JUNE 2012
DEUTSCHE BANK/MORTGAGEIT	$196,000,000	2012-CF-1811	JULY 2012
CITI	$122,800,000	2012-CF-1814	SEPTEMBER 2012
ALLY FINANCIAL, BANK OF AMERIC	$315,200,000	2012-CH-1803	SEPTEMBER 2012
JP MORGAN CHASE	$336,000,000	2014-CF-1807	SEPTEMBER 2014

REUNION	$1,040,000	2014-CF-1810	SEPTEMBER 2014
BANK OF AMERICA	$437,600,000	2014-FW-1808	SEPTEMBER 2014
US BANK	$144,199,970	2014-CH-1801	SEPTEMBER 2014
SUNTRUST	$300,000,000	2015-PH-1802	DECEMBER 2014
TOTAL	$2,323,839,970		
SOURCE: HUD OFFICE OF INSPECTOR GENERAL (HUDOIG) AUDIT REPORTS			

Since 2012, the MMIF has been bolstered by approximately $4 billion in funds from legal settlement money and a one-time Treasury infusion.

Conclusion

While the decision to lower FHA premiums has been lauded as a solution to boost housing markets and aid low-income borrowers, it is not costless. It has the potential to hurt private businesses, expand the government's role in housing markets, and add hosts of risky borrowers to FHA's already weak portfolio. Without a restored capital reserve, FHA may easily need another taxpayer-funded appropriation to boost its finances. Though implementation of the plan is already underway, revisiting the costs and benefits may be warranted given the risks involved.

Note: A previous version of this paper listed the FHA pricing for a 95 LTV loan after premium reductions as $1,262. This has been corrected.

[1] Remarks by the President on Housing – Phoenix, AZ, (January 8, 2015); http://www.whitehouse.gov/the-press-office/2015/01/08/remarks-president-housing-phoenix-az