H.R. 1852 and Revisiting the FHA Premium Pricing Structure: Proposed Legislation in the 110th Congress

Darryl E. Getter
Specialist in Financial Economics

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Summary

The intent of H.R. 1852 as stated would "modernize and update the National Housing Act and enable the Federal Housing Administration to use risk-based pricing to more effectively reach underserved borrowers, and for other purposes." Specifically, the bill would make reforms to the Federal Housing Administration (FHA) program, a federally operated mortgage insurance program primarily serving less creditworthy borrowers, that would make it a more viable option for borrowers unable to access it under current regulations. H.R. 1852 was passed and agreed to in the House of Representatives on September 18, 2007, and referred to Senate Committee on September 19, 2007. Among the many reforms proposed in the bill, FHA's premium pricing structure would be modified. FHA would be allowed to risk-base price or charge different premium rates to borrowers based on their levels of credit risk.

In addition, because collection of annual premiums is common in the mortgage insurance industry, modification of FHA's pricing structure could allow the program to rely less on the option to charge upfront premiums and instead rely solely upon fee collection via annual premiums. As introduced, the bill proposed giving FHA more annual premium pricing discretion than it currently has. The bill as passed by the House, however, would allow FHA to charge a higher upfront premium but retain the same amount of annual premium pricing flexibility. This would limit the ability of FHA to operate using an annual premium structure as its primary collection tool. This report briefly summarizes H.R. 1852 and the current and proposed changes to the FHA premium pricing structure. After discussing the utility of pricing flexibility, a brief analysis follows that indicates lower-income borrowers might be unlikely to pay higher rates relative to high-income borrowers since creditworthiness exhibits much variability. This report will be updated as significant legislative developments occur. For an introduction to the FHA program, please see CRS Report RS20530, *FHA-Insured Home Loans: An Overview*, by Bruce E. Foote and Katie Jones.

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Overview of H.R. 1852, 110th Congress

H.R. 1852 was introduced in the 110th Congress on March 29, 2007, by Representative Maxine Waters and Representative Barney Frank, chairman of the House Financial Services Committee. The bill was reported (amended) by the House Financial Services Committee and placed on the Union Calendar, Calendar No. 133 on June 28, 2007. The bill would provide reforms intended to allow FHA to better respond to recent changes in the mortgage market. For example, the bill would raise single-family mortgage loan limits, in particular in high cost areas, so that more borrowers would be eligible for FHA insurance. New homebuyers would be able to purchase their homes with little or no downpayment and still be eligible to obtain FHA-insured mortgages. H.R. 1852 would also establish a national housing trust fund where excess proceeds generated from the program could be used to finance borrower counseling and other affordable housing initiatives.

H.R. 1852 would also modify FHA's premium pricing structure. Legislation was introduced in the previous Congress addressing the issue of greater premium pricing flexibility for FHA. In H.R. 5121 (109th Congress), which passed the House but was not voted on in the Senate, the upfront premium was increased to 3.0% from 1.5%, and the annual premium was increased to 2.0% from 0.55%. This pricing structure would have provided FHA with greater pricing flexibility than it currently has under existing law. In the current Congress, H.R. 1852 as introduced would increase the upfront premium to 3.0%, but the annual premium would be increased to 0.75%. H.R. 1852 as amended would maintain the current annual premium at 0.55%. If this bill were enacted into public law, then FHA would be able to charge up to twice as much for the upfront premium but would see no change in the flexibility over its annual premium. Furthermore, H.R. 1852 would require FHA to rebate some portion of the upfront premium charged to its riskiest borrowers after they have made five years of timely mortgage payments. Hence, under the pricing structure proposed by H.R. 1852 as passed by the House, FHA would not gain appreciably greater flexibility over its current premium structure.

Background on Insurance Premium Pricing Issues

Mortgage insurance is usually required for borrowers lacking either a downpayment or home equity that equals 20% of the property value. Prime (or conventional) as well as subprime homebuyers may purchase private mortgage insurance, and FHA homebuyers buy mortgage insurance from FHA. Should the borrower default on a mortgage loan obligation, mortgage insurance will reimburse the lender for the loss. Over the past several years, the mortgage insurance industry, along with FHA, saw business decline with the increased use of "piggyback" or second mortgages to cover the 20% requirement. Many borrowers avoided mortgage insurance, since insurance premiums were not tax deductible, unlike mortgage interest. During the 109th Congress, however, a new law making mortgage insurance temporarily tax deductible was enacted. In addition, the migration away from FHA may have been due in a large part to rising house prices between 2001 and 2005, which put home prices above the FHA maximum loan limits in many regional markets. H.R. 1852 proposes increasing the FHA loan limits and relaxing the downpayment requirements so more borrowers may be eligible for FHA insurance.

Currently, a borrower obtaining an FHA-insured mortgage would pay an up-front mortgage insurance premium of 1.5% of the mortgage loan amount and then pay subsequent annual insurance premiums. The amount of the annual premium is inversely related to the size of the downpayment. Assuming a standard 30-year fixed-rate mortgage, if the borrower makes a downpayment greater than 10% of the house price, the annual premium is 0.5% for only the first 11 years of the loan. If a downpayment between 5% and 10% is made, the annual premium charged will cost 0.5% per year for all 30 years of the loan. If a downpayment of less than 5% is made, the annual premium charged will cost 0.55% per year for all 30 years of the loan. All of these premiums are capped by law. The FHA is a self-financing program under which premiums must be sufficient to cover its costs and potential losses.

The current annual premium structure could be considered a form of "risk-based pricing," where different prices are charged to borrowers based upon the amount of downpayment (or loan-to-value), which acts as a proxy for their credit risk. This pricing authority was given to FHA at a time when borrowers were expected to make some financial commitment in the form of a downpayment. Upfront insurance premiums at that time were not considered burdensome because mortgages with little or no downpayment were not as commonplace as they are today. In contrast to FHA's near "one-size-fits-all" pricing structure, the private sector charges borrowers different rates depending upon their combination of credit scores and downpayment size. Mortgage insurance premiums in the private sector are typically collected annually rather than with a large upfront premium fee. Hence, FHA would require congressional authority to update its premium pricing structure to reflect current mortgage insurance industry practices.

In order to estimate how high annual premiums would need to be to replace the current upfront premium, the equivalent annual premium rate can be computed from FHA's current premium structure of a 1.5% upfront and 0.5% annual premium. Assuming an average mortgage life of six years, the equivalent annual premium would be 0.75% per year with no upfront premium charge. If FHA, in an attempt to be more consistent with the private mortgage industry, wanted to collect insurance fees primarily using only its annual premium mechanism, it would be at a cost disadvantage. FHA may not collect 0.75% under the current annual limit caps. When compared with private insurers, 0.75% per year would still be insufficient to cover high-risk borrowers with very low credit scores. Borrowers with a 5% downpayment and a credit score above 620 pay approximately 0.96% for a standard 30-year fixed loan in the private sector.

Consequently, increases in the annual premium would allow FHA to adequately cover the higher risk should more A-minus and subprime borrowers migrate back to FHA. With an annual premium of 1.5% and no upfront premium charges, FHA could support a loan with a 540 credit score and a 5% downpayment, a loan with a 550 credit score with a 3% downpayment, or a loan with a 640 credit score with 0% downpayment. FHA borrowers with higher credit scores and downpayments would pay less than 1.5% for mortgage insurance since they would pose less risk. FHA insurance rates for all borrowers of all risk levels would be less expensive when compared to private insurers since the insurance has the backing of the U.S. government. The lack of annual premium pricing flexibility, however, would make it difficult for FHA to mimic present industry premium collection practices. This suggests FHA would still have to rely heavily on upfront premiums to collect its insurance fees.

Advantages of Annual and Upfront Premium Pricing Flexibility

Asserted Advantages of Annual Premium Pricing Flexibility

Collection of insurance fees via an annual premium mechanism can reduce financial burdens on homeowners under certain circumstances. If the borrower lacks sufficient cash to cover an upfront premium charge, rolling the fee into the mortgage increases the interest costs of the mortgage, since the principal amount has been increased by the upfront fee. Furthermore, the additional balance must be paid back to the insurance company should a homeowner decide to sell before the upfront premium has been completely amortized. If a borrower's home has not appreciated in value enough to cover the upfront fees when he or she is ready to sell, the borrower may either attempt to raise the selling price or repay the premium in a lump sum amount. When mortgage insurance charges are paid annually, however, the borrower neither pays additional interest nor has to worry about recouping the upfront charges in the case of an early sell. Higher annual premiums coupled with little or no upfront premium charges are therefore arguably less burdensome on most borrowers.

Greater flexibility over the annual premium would potentially allow FHA to reduce or eliminate upfront premium charges. FHA could also make cost adjustments via the annual premium easier than by calculating a fair or correct rebate to an upfront premium charge. If, for example, a borrower who was charged an upfront premium became eligible for an FHA rebate, the borrower would still pay mortgage interest on any rebated amount that was initially used to compute the borrower's monthly mortgage payment. This would raise the question of whether FHA also owes interest on the rebated portion of the loan. Hence, flexibility over the annual premium would make it easier to compute rebates or appropriate annual premium reductions.

Asserted Advantages of Upfront Premium Flexibility

Upfront premium charges might be advantageous for borrowers planning to reside in their homes for more than the average time of six or seven years. The monthly payment with an upfront premium amortized over a longer time frame may provide more cash flow to the borrower over longer time horizons, depending upon downpayment sizes and mortgage rates. Hence, even if FHA wanted to use an annual premium pricing structure as the primary means to collect its fees, it could still be advantageous for FHA to have the ability to offer borrowers an upfront premium option. Borrowers may prefer having options, and the flexibility to use either tool or some combination may be useful to FHA for various circumstances.

Would Lower Income Borrowers Pay More for Insurance?

Assuming that reforms to FHA's pricing structure would allow the agency to charge higher premium rates to high-risk borrowers, hesitancy about greater annual premium pricing flexibility may stem from an assumption that low-income households would pay on average relatively higher amounts for their insurance. For this to occur, low-income households would need to have consistently worse delinquency rates than higher income households. Credit score information is proprietary and difficult to obtain; however, severe delinquency information can be a useful proxy. Income and delinquency data can be found in the 2004 Survey of Consumer Finances (SCF). The SCF asks respondents "Were you ever behind in your (loan) payments by two months or more (in the past year)?" **Table 1** shows the percentage of households self-reporting being delinquent by various income categories.

Table 1. Two Months or More Behind Paying Bills by Household Income and Race

Income Brackets	All Households	White Households	Black & Hispanic Households
$20,000-$35,000	7.64%	7.77%	7.30%
$35,001-$50,000	8.29	6.32	14.85
$50,001-$65,000	6.49	6.61	5.73
$65,001-$80,000	4.04	4.20	2.74
$80,001-$95,000	3.18	3.69	0.00

Source: Author's analysis using SCF 2004, Federal Reserve Board.

Although a more apparent inverse relationship between income and delinquency would be expected, the relationship is less evident, especially when focusing on the first three income categories. The first three income categories include households earning $65,000 or less, which was approximately the median income in this sample. The majority of FHA loans have traditionally been made to households at or below area median incomes. For white households, the delinquency rate does not fall dramatically from the $20,000-$35,000 group to the $50,001-$65,000 group. The fall in delinquency over the large income range is slightly over 1%. For black and Hispanic households, the delinquency rates actually *increase* between the $20,000-$35,000 and $35,001-$50,000 groups. Minority households with incomes above the median have lower delinquency rates than white households. Hence, creditworthiness exhibits much variability, in particular for incomes at or below the median.

The tenuous inverse relationship between income and delinquency described in **Table 1** for households is likely to be even less pronounced in the FHA portfolio of borrowers. The sample in **Table 1** is representative of all U.S. households, and FHA's portfolio of borrowers might bear a similar pattern if it contained a similar proportion of credit-worthy borrowers. FHA's portfolio of borrowers, however, is more likely to consist of a disproportionate amount of credit-impaired borrowers unable to get conventional loans reserved for prime borrowers, which could consist of more higher-income borrowers. Consequently, an inverse pattern between income and delinquency is arguably even less likely to be observed when a larger percentage of the sample consists of relatively higher-risk borrowers from low-to-median income groups. In fact, a high-income borrower choosing to obtain an FHA-insured mortgage, rather than a less expensive conventional loan, is more likely to have credit problems. Hence, a flexible premium pricing structure for FHA would not necessarily result in lower-income FHA borrowers on average paying comparatively higher insurance premiums than higher-income FHA borrowers.

Conclusion

If H.R. 1852 lifts the FHA loan limits to facilitate an influx of high-risk borrowers eligible for FHA insurance, premiums must increase to adequately cover the increase in portfolio risk. While it would be advantageous for FHA to have greater flexibility to adjust both its upfront and its annual premiums, there are reasons why annual premium flexibility could be more important than the ability to charge a higher upfront premium. In terms of the fairness issue, the FHA portfolio is likely to consist of a disproportionately larger share of higher-risk borrowers from all income classes. Thus, it is arguably unlikely that higher-income households would pay less than lower-income households for mortgage insurance, since most FHA borrowers are more likely to have less than perfect credit.

Author Contact Information

Darryl E. Getter
Specialist in Financial Economics
dgetter@crs.loc.gov, 7-2834