FHA-Insured Home Loans: An Overview

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Summary

The Federal Housing Administration (FHA) was created by the Housing Act of 1934 in order to broaden homeownership, protect lending institutions, and stimulate the building industry. FHA does not make mortgage loans. Rather, it insures mortgage loans made by private lenders that meet certain underwriting and other criteria, thereby expanding the availability of mortgage credit beyond what may be available otherwise. While FHA insures a range of mortgage types, including multifamily properties and hospital facilities, this report focuses on FHA's single-family insurance program.

FHA's share of the housing market has fluctuated through the years, in part due to economic conditions. In recent years, due to housing market turmoil and a contraction of private lending, FHA's market share has risen considerably. In FY2011, FHA-insured loans comprised about 17% of single-family purchase and refinance mortgage originations. FHA-insured mortgages, like all mortgages, have experienced increased default rates in recent years, leading to some concerns about the stability of the FHA insurance fund for single-family mortgages, the Mutual Mortgage Insurance Fund (MMIF). In response to these concerns, FHA has recently adopted a number of new policies designed to limit the risk to the MMIF.

This report discusses the basic features of the FHA program to insure loans on single-family homes and recent changes to the program.

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A Brief History of the FHA Home Loan Insurance Program

The Federal Housing Administration (FHA) was created by the National Housing Act of 1934,[1] during the height of the Great Depression, to broaden homeownership, shore up and protect home financing institutions, and stimulate employment in the building industry.

Prior to the creation of FHA, few mortgages exceeded 50% of the property's value and most mortgages were written for terms of five years or less. At the end of the five-year term, the remaining loan balance had to be repaid or the mortgage had to be renegotiated. Borrowers generally had little trouble in obtaining new mortgages. During the Great Depression, however, lenders were unable or unwilling to refinance many of the loans that became due. Thus, many borrowers lost their homes through foreclosure, and lenders lost money because property values were falling. Lenders became wary of the mortgage market.

FHA institutionalized a revolutionary idea: 20-year mortgages on which the loan would be completely repaid at the loan term. If borrowers defaulted, FHA insured that the lender would be fully repaid. Mortgage instruments were standardized, and a new confidence was instilled in the mortgage market. Investment in housing was stimulated, and its ripple effects were felt throughout the economy. Eventually, lenders began to make long-term mortgages without FHA insurance if borrowers made significant downpayments. Over time, 25- and 30-year mortgages have become standard mortgage products.

When the Department of Housing and Urban Development (HUD) was created in 1965, FHA became an agency of HUD. This report discusses the features of the FHA program to insure loans on single-family homes. Single-family homes are defined as properties containing from one to four dwelling units.[2]

Features of the Program

Eligibility and Underwriting Guidelines

FHA-insured loans are available to owner/occupants who can demonstrate the ability to repay the loans according to the terms of the contract. In general, parties who have previously defaulted may not be eligible for FHA-insured loans. FHA-insured loans must be underwritten in accordance with accepted practices of prudent lending institutions and FHA requirements. The FHA credit analysis worksheet is used to examine the applicant's personal and financial status, monthly shelter expenses, funds required for closing expenses, effective monthly income, and debts and obligations. As a general rule, the applicant's prospective mortgage payment should not exceed 31% of gross effective monthly income. The applicant's total obligations, including the proposed housing expenses, should not exceed 43% of gross effective monthly income.[3] If these

[1] The National Housing Act, P.L. 73-479, 12 U.S.C. 1701 et seq.

[2] FHA also insures loans on multifamily properties, manufactured homes, nursing homes, and hospitals, but these insurance programs are not discussed in this report.

[3] U.S. Department of Housing and Urban Development, Housing Handbook 4155.1, "Mortgage Credit Analysis for (continued...)

ratios are not met, the borrower should present compensating factors, such as savings history and past credit management.

Effective October 4, 2010, FHA imposed a minimum credit score requirement of 500, and increased downpayment requirements for borrowers with credit scores below 580. See the "Downpayment" section for more information on downpayment requirements for FHA-insured loans.[4]

Maximum Mortgage

There is no income limit for borrowers seeking FHA-insured loans. However, FHA-insured mortgages cannot exceed a maximum mortgage amount set by law. The maximum mortgage amounts allowed for FHA-insured loans are set area-by-area, and different limits are in effect for one-family, two-family, three-family, and four-family properties. Limits for high- and low-cost areas are subject to a statutory floor and ceiling.[5]

In early 2008, Congress enacted the Economic Stimulus Act of 2008 (ESA, P.L. 110-185), which temporarily increased the maximum mortgage amounts to 125% of area median home prices, with a high-cost area limit of $729,750 and a floor of $271,050.[6] The Housing and Economic Recovery Act (HERA, P.L. 110-289) established new statutory limits of 115% of area median home prices, with a high-cost area limit of $625,500 and a floor of $271,050. However, the American Recovery and Reinvestment Act of 2009 (ARRA, P.L. 111-5) amended the maximum mortgage amounts for 2009, setting them at the higher of (1) the 2008 limits set in ESA, or (2) the original 2009 limits set in HERA. Since the floor is the same under both ESA and HERA, the floor is set at $271,050 under ARRA. Since the high-cost area limit is higher under HERA, the high-cost area limit is set at $729,750 under ARRA.[7] Finally, ESA set the limits for all other areas at 125% of 2007 area median home prices while HERA set the limits at 115% of more current area median home prices; which of these limits is higher will vary by area.[8]

(...continued)

Mortgage Insurance," http://www.fhaoutreach.gov/FHAHandbook/prod/contents.asp?address=4155-1.

[4] U.S. Department of Housing and Urban Development, Mortgagee Letter 2010-29, September 3, 2010, http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/10-29ml.pdf.

[5] The FHA maximum mortgage amounts are codified at 12 U.S.C. § 1709(b)(2).

[6] Immediately prior to ESA's enactment, the limits had been set at 95% of area median house prices, with a ceiling of $362,790 and a floor of $200,160 for a one-unit home. See U.S. Department of Housing and Urban Development, Mortgagee Letter 2008-02, January 18, 2008, available at http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/letters/mortgagee/2008ml.

[7] The statutory ceilings and floors are generally set as a percentage of the Freddie Mac conforming loan limit, not as dollar amounts. Currently, the floor is set at 65% of the conforming loan limit and the ceiling is set at 175% of the conforming loan limit. The Freddie Mac conforming loan limit is currently $417,000, so the floor is $271,050 (65% of $417,000), and the ceiling is $729,750 (175% of $417,000). Prior to the Economic Stimulus Act of 2008 (ESA), the floor was set at 48% of the Freddie Mac conforming loan limit, and the ceiling was set at 87% of the conforming loan limit. Congress can change the ceilings and floors either by 1) changing the percentages of the Freddie Mac conforming loan limit that constitute the ceiling and the floor, or 2) changing the Freddie Mac conforming loan limit itself.

[8] FHA calculates area-by-area limits each year based on the prior year's area median home price data, so the actual limit in a given area can change from year to year. The ESA limits are 125% of 2007 area median home prices. The original HERA limits were 115% of 2008 area median home prices, while current HERA limits would be 115% of the most recent area median home price data available. FHA has followed a policy of not allowing HERA limits to fall relative to the original HERA limits, so if current HERA limits (based on more recent area median home prices) are (continued...)

The ARRA limits that set the maximum mortgage amount at the higher of the ESA or HERA limits have been extended several times, most recently by the Consolidated and Further Continuing Appropriations Act, 2012 (P.L. 112-55), which was enacted after the last extension had expired at the end of FY2011 and the limits briefly fell to their HERA levels. P.L. 112-55 extends the ARRA limits until December 31, 2013. Unless Congress acts to extend the current mortgage limits beyond December 31, 2013, the maximum mortgage amounts will revert to their HERA levels at that time, with the maximum mortgage amount in high cost-areas falling to $625,500 for a one-unit home, and the maximum mortgage amounts falling in some areas between the floor and the ceiling as well.

The FHA loan limits in effect until December 31, 2013, are summarized in **Table 1**.

Table 1. FHA Maximum Mortgage Amounts, through December 31, 2013

Property Size	High-Cost Area[a] (Upper Limit)	All Other Areas	Low-Cost Area[b] (Lower Limit)
1-family	$729,750	The higher of 125% of the 2007 area median home price or 115% of 2008 or later area median home prices	$271,050
2-family	$934,200	The higher of 125% of the 2007 area median home price or 115% of 2008 or later area median home prices	$347,000
3-family	$1,129,250	The higher of 125% of the 2007 area median home price or 115% of 2008 or later area median home prices	$419,400
4-family	$1,403,400	The higher of 125% of the 2007 area median home price or 115% of 2008 or later area median home prices	$521,250

Source: P.L. 112-55 and Department of Housing and Urban Development, Mortgagee Letter 2011-39, "Federal Housing Administration Maximum Loan Limits Effective October 1, 2011 through December 31, 2012."

Note: FHA mortgage limits by state, county, and MSA are available at https://entp.hud.gov/idapp/html/hicostlook.cfm.

a. Areas where the higher of 125% of the 2007 area median home price or 115% of 2008 or later area median home prices exceeds 175% of the Freddie Mac limit. The National Housing Act provides that mortgage limits for loans in Alaska, Guam, Hawaii, and the Virgin Islands may be adjusted up to 150% higher than the statutory ceiling.

b. Areas where the higher of 125% of the 2007 area median home price or 115% of the 2008 area median home price is lower than 65% of the Freddie Mac limit.

Loan Term

FHA-insured loans may be obtained for mortgages with terms of up to 30 years. In special cases, low-income borrowers may be eligible for 35-year loans to make the mortgage more affordable.

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lower than the original HERA limits, FHA uses the original HERA limits for the purposes of calculating the maximum mortgage amount in that area. For the maximum mortgage amounts in each area for calendar year 2012, see FHA Mortgagee Letter 11-39, "Federal Housing Administration Maximum Loan Limits Effective October 1, 2011 through December 31, 2012," available at http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/.

Downpayment

Under changes made by the Housing and Economic Recovery Act of 2008 (HERA, P.L. 110-289), borrowers are required to contribute at least 3.5% in cash or its equivalent to the cost of acquiring a property with an FHA-insured mortgage. (Prior law had required borrowers to contribute at least 3% in cash or its equivalent.) Amounts borrowed from a family member are considered as cash for this purpose. Prohibited sources of funding for the required funds are the seller or any entity that financially benefits from the transaction, or any third party that is directly or indirectly reimbursed by the seller or by anyone that would financially benefit from the transaction.[9] HUD has interpreted the 3.5% cash contribution as a downpayment requirement and has specified that contributions toward closing costs cannot be counted toward it.[10]

FHA guidelines put in place beginning on October 4, 2010 require a 10% downpayment from borrowers with credit scores between 500 and 579, while borrowers with credit scores of 580 or above are still required to make a downpayment of at least 3.5%. FHA will no longer insure loans to borrowers with credit scores below 500.[11]

Owner Occupancy

Generally, for loans closed on or after December 15, 1989, borrowers must intend to occupy the property as a principal residence. Property that has been acquired by FHA as a result of default or foreclosure may be sold to owner-occupants or investors, and in some cases the borrowers may obtain FHA-insured loans.

Eligible Loan Purposes

FHA-insured loans may be used to purchase one-family detached homes, townhomes, rowhouses, two- to four-family buildings, manufactured homes and lots, and condominiums in developments approved by FHA.[12] FHA-insured loans may also be obtained to build a home; to repair, alter, or improve a home; to refinance an existing home loan; to simultaneously purchase and improve a home; or to install a solar heating and cooling system or other weatherization improvements.

Mortgage Insurance Fees

Borrowers of FHA-insured loans pay an up-front mortgage insurance premium (MIP) and annual mortgage insurance premiums. The maximum amounts that FHA is allowed to charge for the annual and the upfront premiums are set in statute. However, since these are maximum amounts, HUD has the discretion to set the premiums at lower levels.

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[9] For more information on seller-funded downpayment assistance programs and FHA, see CRS Report RS22934, *Treatment of Seller-Funded Downpayment Assistance in FHA-Insured Home Loans*, by Bruce E. Foote.

[10] U.S. Department of Housing and Urban Development, Mortgagee Letter 2008-23, September 25, 2008, http://portal.hud.gov/hudportal/documents/huddoc?id=DOC_19737.pdf .

[11] U.S. Department of Housing and Urban Development, Mortgagee Letter 2010-29, September 3, 2010, http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/10-29ml.pdf.

[12] Particular requirements that apply to FHA insurance of manufactured housing, condominium, and co-op loans are described in FHA Mortgagee Letters, which are available at http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/.

Annual Mortgage Insurance Premiums

In August 2010, President Obama signed P.L. 111-229, which raised the maximum annual mortgage insurance premium that FHA can charge. The amount of the maximum annual premium varies based on the loan's initial loan-to-value ratio: (1) if the loan-to-value ratio is 95% or higher, the maximum annual premium is 1.55% of the loan balance; (2) if the loan-to-value ratio is less than 95%, the maximum annual premium is 1.5% of the loan balance.

Since April 18, 2011, FHA has administratively set these premiums at 1.15% of the loan balance for mortgages where the loan-to-value ratio is 95% or higher, and at 1.10% of the loan balance for mortgages where the loan-to-value ratio is below 95%.[13] FHA has increased these premiums from prior levels to their current level as a way to bring more money into the FHA insurance fund.

Up-Front Mortgage Insurance Premiums

HERA increased the maximum up-front mortgage insurance premium that FHA is permitted to charge to 3% from 2.5% of the mortgage amount for a borrower who has not received homeownership counseling, and to 2.75% from 2% of the mortgage amount for a borrower who has received homeownership counseling. Currently, however, HUD is not charging different up-front premiums to borrowers who do and do not receive homeownership counseling.

Administratively, HUD has set the up-front premium at 1% of the loan amount for loans insured on or after October 4, 2010, whether or not the borrower received homeownership counseling, and regardless of whether the loan is a home purchase loan, a general home refinance loan, or a streamline refinance loan.[14]

If borrowers prepay their loans, they may be due refunds of part of the up-front insurance premium that was not "earned" by FHA. The refund amount depends on when the mortgage closed and declines as the loan matures (see **Table 2**). The Consolidated Appropriations Act 2005 (P.L. 108-447) amended the National Housing Act to provide that, for mortgages insured on or after December 8, 2004, borrowers will not be eligible for refunds of up-front mortgage insurance except when borrowers are refinancing existing FHA-insured loans with new FHA-insured loans. After three years, all of the up-front insurance will be considered as "earned" by FHA, and these borrowers will not be eligible for any refunds. Borrowers whose mortgages were insured prior to December 8, 2004, will continue to be eligible for refunds according to rules in effect at the time the mortgages were closed. For mortgages insured on or after January 1, 2001, but prior to December 8, 2004, borrowers are eligible for refunds for up to five years after the mortgages are originated.

The annual insurance premiums are not refundable. For loans closed on or after January 1, 2001, the annual mortgage insurance premium will be automatically cancelled when, based on the initial amortization schedule, the loan balance reaches 78% of the initial property value.

[13] U.S. Department of Housing and Urban Development, Mortgagee Letter 2011-10, "Annual Mortgage Insurance Premium Changes and Guidance on Case Numbers," February 14, 2011, http://portal.hud.gov/hudportal/documents/huddoc?id=11-10ml.pdf.

[14] U.S. Department of Housing and Urban Development, Mortgagee Letter 2010-28, "Changes to FHA Mortgage Insurance Premiums," September 1, 2010, http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/10-28ml.pdf.

Borrowers may also request cancellation of the mortgage insurance when the 78% loan-to-value ratio is reached due to advance payments by the borrower, although in most cases at least five years must have elapsed since the mortgage was originated.

Table 2. Up-Front Mortgage Insurance Premium Refunds

Date of Closing	Refund Amount If Mortgage Paid After:					
	6 Months	1 Year	3 Years	4 Years	5 Years	7 Years
On or after December 8, 2004[a]	70%	58%	no refund 3 years after mortgage closed			
On or before December 7, 2004	no refund after December 7, 2009					

Source: Department of Housing and Urban Development Mortgagee Letters 2005-03, 00-46, and 94-1.

a. Only borrowers that refinance an existing FHA-insured loans with new FHA-insured loans are eligible for refunds.

Interest Rates

The interest rate on FHA-insured loans is negotiated by the borrower, seller, and lender. The borrower has the option of selecting a loan with an interest rate that is fixed for the life of the loan or one on which the rate may be adjusted annually.

Defaults

A mortgage is considered delinquent any time a payment is due and not paid. Once the borrower is 30 days late in making a payment, the mortgage is considered to be in default. In general, foreclosure may be initiated when three monthly installments are due and unpaid and must be initiated when six monthly installments are due and unpaid, except when prohibited by law.[15] A program of loss mitigation strategies was authorized by Congress in 1996 to minimize the number of FHA loans entering foreclosure,[16] and has since been revised and expanded to include additional loss mitigation options. The loss mitigation strategies that servicers are instructed to pursue on FHA-insured loans are summarized in **Table 3**.[17]

Additional loss mitigation options are available for certain populations of borrowers. By written agreement with the lender, a borrower in military service may suspend the principal portion of monthly payments and pay interest only for the period of military service, plus three months.[18] On

[15] 24 *CFR* 203.355. State law may prohibit the start of foreclosure proceedings within the time frame specified by HUD. Also, military service of the borrower may delay foreclosure proceedings (24 *CFR* 203.346).

[16] The loss mitigation program replaced an assignment program; under the assignment program, servicers would assign a defaulted loan to FHA, which would pay the claim to the lender and then attempt to help the borrower avoid foreclosure directly. Under the loss mitigation program, servicers are given the responsibility of pursuing loss mitigation options before completing a foreclosure. P.L. 104-99, the Balanced Budget Downpayment Act, I, terminated the mortgage assignment program and authorized additional loss mitigation activities.

[17] FHA Mortgagee Letters instruct FHA servicers on how to pursue loss mitigation strategies. For example, see Mortgagee Letter 2000-05, "Loss Mitigation Program – Comprehensive Clarification of Policy and Notice of Procedural Changes." Additional aspects of FHA's loss mitigation program are addressed in other Mortgagee Letters.

[18] In addition, as amended by HERA, the Servicemembers Civil Relief Act, P.L. 108-189, provides that individuals called into military service may apply to have any legal action against their homes stayed until nine months after the release from military service, and foreclosure can be prevented until one year after release from military service.

resumption of payment, loan payments are adjusted so that the loan will be paid in full according to the original amortization.[19] In the past, FHA has also temporarily relaxed rules on the use of partial claims and loan modifications in specific areas in response to certain presidentially-declared major disasters, such as Hurricane Katrina.[20]

Table 3. Loss Mitigation Strategies

Possible Remedies for FHA Loans in Default	
Special forbearance	Lender/servicer works out a repayment plan that may include partial or suspended payments for a specified period of time.
Loan modification	The original mortgage is modified to include the total unpaid amount due. Changes may be made to the term, interest rate, or type of loan.
Partial claim	FHA provides an interest-free loan to the borrower to pay the arrearage. The borrower must repay FHA at the end of the original loan term or when the property is sold.
FHA-HAMP	The borrower's monthly mortgage payments are reduced to 31% of monthly income using a combination of a loan modification and a partial claim. The partial claim can be used to provide a limited amount of principal forbearance, as well as to repay the arrearage.
Pre-foreclosure sale	Borrower sells the property and uses the proceeds to satisfy the mortgage debt. FHA pays a partial claim to the lender to make up the difference if the property is sold for less than the mortgage amount.
Deed-in-lieu-of-foreclosure	Borrower deeds the property to FHA and is released from the mortgage.

Sources: 24 CFR 203, Subparts B and C; *An Assessment of FHA's Single-Family Mortgage Insurance Loss Mitigation Program Final Report* (Abt Associates, 2000); HUD Mortgagee Letter 2009-23.

Program Funding

The FHA home mortgage insurance program is funded by the FHA Mutual Mortgage Insurance Fund (MMIF), which has been sufficient to fund the operations of the FHA home mortgage insurance program without appropriations from Congress.[21] MMIF income comes from insurance premiums, interest earnings, and proceeds from the sale of foreclosed homes. Cash flows out of the MMIF to cover administrative costs, claims on foreclosed mortgages, and refunds of mortgage insurance premiums.

FHA maintains both a financing account and a capital reserve account within the MMIF. The financing account includes enough capital to cover all expected costs associated with the MMIF's entire book of outstanding loans, based on current assumptions. The capital reserve account includes additional funds to cover unexpected losses. If the assumptions regarding the costs associated with the current book of business are adjusted, FHA moves funds between the financing account and the capital reserve account as needed to ensure that there are sufficient funds in the financing account to cover projected expenses.

[19] 24 *CFR* 203.345 and 203.346.

[20] See, for example, Mortgagee Letter 2005-46, December 1, 2005, available at http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/letters/mortgagee/2005ml.

[21] FHA does receive congressional appropriation for salaries and administrative contract expenses related to the MMIF.

Section 205 of the National Housing Act[22] requires HUD to ensure that the MMIF maintains a capital ratio of 2.0% at all times. The capital ratio is defined as the ratio of capital on hand to cover unexpected losses to the remaining principal amount on outstanding insured mortgages. In other words, FHA is required by statute to have cash equaling at least 2% of its total outstanding loan balances in the capital reserve account to cover unexpected future losses. The most recent actuarial study shows that the capital ratio is currently below this statutorily mandated level, at 0.24%.[23]

FHA has taken a number of steps designed to return the capital ratio to 2% or more, and it has indicated that it will continue to take steps to strengthen the insurance fund.[24] The steps that it has already undertaken include increasing the mortgage insurance premiums charged to borrowers; strengthening underwriting requirements, such as by instituting higher downpayment requirements for borrowers with the lowest credit scores; and increasing oversight of FHA-approved lenders.

Program Activity

In FY2011, FHA insured nearly 1.2 million single-family purchase and refinance mortgages that together had an initial loan balance of $218 billion. FHA-insured mortgages represented about 17% of all mortgage originations, including both home purchase and refinance loans, in FY2011, and about 30% of home purchase mortgages alone.[25]

At the end of FY2011, FHA was insuring a total of about 7.3 million single-family loans that together have an outstanding balance of $1 trillion.[26] From 1934 through FY2011, FHA has insured a total of over 40 million home loans.[27]

[22] 12 U.S.C. § 1711.

[23] U.S. Department of Housing and Urban Development, *Annual Report to Congress, Fiscal Year 2011 Financial Status, FHA Mutual Mortgage Insurance Fund*, November 15, 2011, p. 33, http://portal.hud.gov/hudportal/documents/huddoc?id=FHAMMIFundAnnRptFY2011.pdf.

[24] For example, see U.S. Department of Housing and Urban Development, *FHA Announces Policy Changes to Address Risk and Strengthen Finances*, January 20, 2010, press release, available at http://portal.hud.gov/portal/page/portal/HUD/press/press_releases_media_advisories/2010/HUDNo.10-016.

[25] U.S. Department of Housing and Urban Development, *FHA Annual Management Report Fiscal Year 2011*, page 8, http://portal.hud.gov/hudportal/documents/huddoc?id=FHAFY11AnnualMgmntRpt.pdf.

[26] U.S. Department of Housing and Urban Development, "Monthly Report to the FHA Commissioner on FHA Business Activity, September 2011," http://portal.hud.gov/hudportal/documents/huddoc?id=11sep.pdf. These totals include Home Equity Conversion Mortgages (HECMs), which are reverse mortgages insured by FHA.

[27] U.S. Department of Housing and Urban Development, *FHA Annual Management Report Fiscal Year 2011*, p. 3, http://portal.hud.gov/hudportal/documents/huddoc?id=FHAFY11AnnualMgmntRpt.pdf.

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