Robert Young
(212) 816-8332
robert.a.young@ssmb.com

FHA Mortgage Insurance Changes

FHA has released a new policy regarding mortgage insurance paid by FHA borrowers. The new policy generally reduces the cost of a FHA mortgage:

The up-front MIP is being reduced from 2.25% to a flat 1.50%.

1 The up-front mortgage insurance premium (MIP) is being reduced from 2.25%[20] to a flat 1.50%.

2 The annual 50bp MIP (not to be confused with the up-front MIP) will be canceled when the LTV reaches 78% if the MIP has been paid for at least five years (on 30-year loans). However, unlike the cancellation of private mortgage insurance (PMI), this cancellation will occur through **amortization only** because no new appraisal value is allowed (so, home appreciation will not help lower the LTV as defined by FHA).

3 The refund schedule for the up-front MIP is being changed. Previously, borrowers prepaying within seven years of closing could receive a partial refund. This period is being shortened to five years. Unlike the other two provisions, this one **increases** the cost of a FHA mortgage (refunds will be smaller, according to FHA). Secretary

[20] It can be less in some cases, like 1.75% for first-time homebuyers who obtain housing counseling, for example.

Cuomo's speech press release implied that this refund was entirely new. **Our understanding is that this is not the case; the new five-year schedule merely replaces the old seven-year schedule.**

These changes go into effect for loans closed on or after January 1, 2001.

These changes go into effect for loans closed on or after January 1, 2001. They appear to be a done deal because FHA does not need Congress's approval to make this change. It is not completely clear whether the changes affect homebuyers only or include refinancers, but at this time, it appears that they will apply to **all loans**, refinance and purchase alike. (FHA is itself not completely clear on this point. But its best guess is that the provisions apply to all loans.) Also, FHA plans to come out with additional information about refinancing roughly within a month.

Implications (Assuming Changes Apply to All Loans)

Prepayments on Existing Collateral

On the surface, it might appear that the cost of refinancing an FHA mortgage will decline by three-quarters of a point because of the first provision. However, a couple of factors blunt this effect: (1) the third change **reduces** the refund that a refinancer receives (the exact schedule has not yet been finalized, but it will be lower according to FHA); and (2) FHA borrowers already often refinance into a conventional loan when they can qualify.

The second change seems likely to have a negligible effect. First, as noted, only amortization (but not home appreciation) is considered in measuring the LTV, so reaching 78% will usually take a number of years. Second, provisions already exist to cancel the annual MIP in certain cases.[21] Finally, FHA borrowers already often refinance into a conventional loan when they can qualify (for these loans home appreciation would be included in the measurement of LTV).[22]

These changes make existing Ginnie Mae pass-throughs only marginally more refinancible.

So, these changes appear to make existing Ginnie Mae pass-throughs only marginally more refinancible (and there is no corresponding change for VA, which accounts for roughly 30% of Ginnie Mae borrowers). To obtain a ballpark estimate, assume the changes reduce the effective costs by approximately 0.0-0.25 points instead of the stated 0.75. This would imply an elbow shift of roughly 0bp-5bp which translates into about a 0 to 2-tick drop in price on 7.5s, for example.

Prepayments on 2001 (and Beyond) Originated Collateral

Future new collateral will be worth a little more.

Future new collateral that reflects these MIP changes will be worth a little more because of the following factors: the first change will allow borrowers that previously were only close to qualifying (i.e., most likely slow refinancers) to enter Ginnie pools, and the second change might make it marginally more attractive to stay in a FHA loan versus switching to a conventional loan.

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[21] Although most FHA borrowers pay the annual 50bp MIP, there are exceptions: (1) FHA 30-year borrowers with LTVs under 90% pay the 50bp for only seven years; and (2) FHA 30-year borrowers with a loan resulting from a streamline refinancing also pay the 50bp for only seven years.

[22] And, it does not quite seem sensible for FHA to rescind the 50bp MIP only for new loans with an appropriately low LTV. Given the actions and activism in recent years to make sure conventional borrowers can stop paying PMI when their LTV drops to around 80%, one could speculate that the 50bp MIP might be removed for all low-LTV loans at some point.

Supply

Runoff will slightly increase because of slightly higher prepayments, but this would likely be recycled back into FHA loans. Additional new issuance due to the lower up-front MIP would likely be the dominant effect on supply. As a result of these MIP changes, some subprime borrowers and renters, for example, may be able to qualify for a FHA loan. To obtain an order of magnitude ballpark estimate, we start with the fact that FHA insured almost 1.3 million mortgages in fiscal 1999. If this new rule increases supply by an order of magnitude 1% of 1.3 million, then we might see an order of magnitude increase of about $1 billion in issuance, which is not very much.