MORTGAGE BANKERS ASSOCIATION

December 18, 2014

The Honorable Julian Castro
Secretary
U.S. Department of Housing and Urban Development
451 7th Street, S.W.
Washington, D.C. 20410

Secretary Castro:

MBA has been a consistent supporter of FHA throughout its 80-year history. We recognize the need for FHA to be on a sound financial footing so that it can support its mission of providing financing to first-time homebuyers and other underserved borrowers. At this time, however, MBA thinks mortgage insurance premiums are counterproductively high and recommends that they be reduced to better serve borrowers and meet FHA's stated policy objectives.

FHA has a statutory mandate to recapitalize the Mutual Mortgage Insurance Fund (MMIF) in order to achieve a two percent capital ratio. That ratio currently stands at 0.41%. The rate of recapitalization is affected by a tradeoff between the pricing of FHA insurance on one hand, and the corresponding volume of endorsements and their credit quality, on the other. High insurance premiums tend to decrease volume and worsen credit quality, a dynamic that is exacerbated when there are other competitive sources of mortgage funds available in the market.

The announcement that Fannie Mae and Freddie Mac are about to begin purchasing loans with down payments as low as three percent will have just such an impact on FHA's origination volumes. A recent study by Bank of America/Merrill Lynch Global Research indicates that approximately 30 percent of FHA's 2014 volume between 95 and 97 percent loan to value (LTV) would qualify for at least one of the new GSE programs. The study further estimates that most of those borrowers would opt for a conventional loan, given the cost advantages of private mortgage insurance.

The pace of recapitalization of the MMIF depends critically on the ability of recent vintages and near term future books of business to contribute positively to the overall economic value of the MMIF. Reduced origination volume directly translates into a slower rate of recapitalization, even without considering the credit quality changes to the portfolio.

Of course, the value of the MMIF is obviously also sensitive to the particular mix of borrowers that results from FHA's pricing strategy. FHA insurance pricing is comprised of an up-front fee as well as an annual life of loan premium. Because these fees are fixed across borrowers, i.e., average rather than risk-based pricing, there is an implicit subsidy from higher credit quality borrowers with lower expected claims to lower credit quality borrowers with higher expected claims. However, in today's market, it is increasingly possible for higher credit quality borrowers to acquire better mortgage pricing elsewhere. A good example, again, would be the reentry of Fannie Mae and Freddie Mac into 95% - 97% LTV lending.

When such competition is present, the flight of relatively better credit risk borrowers can lead to adverse selection whereby the resulting pool of FHA borrowers is of lower quality than forecasted. The result of adverse selection is to slow the recovery of the economic value of the fund because of a higher claims rate relative to a fixed premium, even if FHA's credit quality remains sound.

FHA is intentionally relinquishing its counter-cyclical role of supporting the entire mortgage market in favor of its historic mandate to support underserved portions of the market, and especially first time homebuyers. This is a worthy goal. However, MBA believes that this goal can be achieved over a longer time frame with somewhat lower pricing, with the advantage that the MMIF could be returned to its mandated level more quickly.

As housing markets and the economy more generally have recovered from the Great Recession, other government and government-sponsored mortgage programs have become increasingly competitive in vying for mortgage originations. At the same time, FHA has increased both the up-front mortgage premium, as well as the annual MIP, moved to life-of-loan MIP rather than automatic cancellation, and lower loan limits. While the higher premiums helped to increase the economic value of the MMIF in the wake of the crisis, leaving these premium levels unchanged now that the conventional market is recovering exposes the fund to adverse selection that will slow the MMIF's return to solvency and over time could reverse its recovery.

In addition, the sustained higher MIPs have directly impacted the ability of first time home buyers to attain an FHA mortgage, reducing support for this segment of the market. With respect to purchase origination volume, our analysis of FHA loan level data suggests the most recent increase to annual MIPs in April of 2013 resulted in a loss of nearly 5 percentage points in FHA's share of all purchase originations in the US. For refinances, the loss in share was nearly 1 percentage point. Based on the per loan value of endorsements provided in the FY2013 Actuarial Review of FHA MMIF Forward Loans, the loss in volume for purchase and refinance mortgages equates to a $2.9 billion decrease in MMIF economic value.

We also examined changes in the expected distribution of borrowers by credit quality as reported in the FY2013 and FY2014 Actuarial Reviews. The change in the forecasted credit mix of borrowers resulted in a $1.5 billion loss in MMIF value for just the FY2014 forward book. Combined, we estimate that the capital ratio could have been as high as 75-80 bps rather than 41 bps if a lower pricing strategy had been utilized.

And these estimates serve as a lower bound to losses in both volume and credit quality due to MIP pricing. The pricing for the new 97 LTV product for first time buyers by the GSEs means that competition for the best credit quality borrowers is increasing.

Looking forward, the economic value of the MMIF will also be sensitive to the path of interest rates. An unexpected fall in rates instigating more refinances would be negative for the MMIF, as stronger credit borrowers would prepay, and FHA would be less likely to recapture these borrowers if the MIP remains high. Higher than expected interest rates, if accompanied by economic growth, would be less damaging as it could draw additional first-time homebuyers into the market.

As you know, there is long lag time before pricing and underwriting changes show up in the performance of the fund. For this reason, it is important to anticipate the impact of current pricing and underwriting standards on the future performance of the MMIF. We think it is important for HUD to take steps now to restructure and reduce FHA's premiums in ways that also support long-term actuarial soundness.

In closing, we recommend that FHA lower premium rates to reflect what has been learned from the most recent rounds of increases, namely that the gain in premium revenue was more than offset by a loss of volume and a drop in credit quality for new endorsements. For the medium term, FHA should prioritize their objectives of strengthening the economic value of the fund, and increasing their support for first-time homebuyers in the market, allowing a longer time before reaching their target mix of business.

Sincerely,

Bill Cosgrove
Chairman
Mortgage Bankers Association

cc: Biniam Gebre
Acting Assistant Secretary and FHA Commissioner