State Down Payment Assistance Poses Minimal Risk to the FHA

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In a July 2015 report, the US Department of Housing and Urban Development's (HUD's) Office of the Inspector General (OIG) alleged that some of the state housing financing agencies (HFAs) were permitting down payment assistance (DPA) that was being paid for through higher mortgage rates. Because the assistance was not being provided as a gift, it did not meet Federal Housing Administration (FHA) requirements for DPA. Moreover, the OIG alleged, these loans were putting the FHA mortgage insurance fund at unnecessary risk.

The FHA and HUD's general counsel disagreed that the assistance was inconsistent with FHA's requirements, and disagreed with the claim that it posed an unnecessary risk to the insurance fund.[1] The dispute led the OIG to send a letter sharing its findings with the House Financial Services Committee, which issued a sharp press release rebuking the FHA.[2] The controversy has threatened to freeze the HFA DPA program, as the institutions that service the loans involved are concerned that originating and servicing these loans may leave the institutions open to legal action.

In this brief, we explore the two core empirical claims in dispute: that borrowers are paying a premium for this assistance and that the program poses an increased risk to the FHA. After reviewing the publicly available data, we found that the number of loans for which a possible premium was charged is small and that state HFA DPA loans are net present value positive, not negative, to the FHA insurance fund. We do not address what this might mean to the various legal claims at issue.

The Number of HFA DPA Loans for Which a Premium Is Being Paid Is Likely Quite Small

It is difficult to isolate the kind of pricing premium the OIG alleges causes the HFA DPA program to violate FHA requirements. In a normal market, many interest rates are offered, reflecting different costs and risks associated with individual loans.[3] One would expect interest rates on HFA DPA loans to fall on the higher end of that spectrum even without charging the kind of premium in dispute, not only because these loans tend to be riskier, but also because HFA DPA borrowers are more likely to have their closing costs rolled into the interest rate on their loan to make the up-front cost of getting the loan more affordable. HFA DPA loans are also often smaller than most FHA loans, so closing costs can be a significant percentage of the loan amount.[4] All this makes it difficult to discern when an HFA DPA loan includes a premium or is simply more expensive given the profile and needs of the borrower involved. Because we have not taken demographic factors or loan size into account, the analysis below is conservative.

We begin our analysis with origination data, produced by Ginnie Mae and available through eMBS. While the OIG and FHA have access to additional nonpublic data, we are relatively confident that additional nonpublic data would not change our results. We came close to replicating the public HFA DPA numbers that were based on nonpublic data available to the FHA.

The first step in our analysis is to separate the HFA DPA from other types of down payment assistance, such as gifts from relatives or employers. According to the 2015 actuarial review of FHA forward mortgages (IFE 2015), 78.96 percent of FHA loans originated in 2015 had no gift; 18.09 percent had a gift from a relative; 2.16 percent from a governmental entity (generally a state HFA); 0.67 from a nonprofit, religious, or community group; and 0.13 percent from an employer. Thus, loans with gifts from a government entity make up a small number of FHA loans overall. Table 1 shows all FHA mortgages in our databases, sorted into four categories: US Bank DPA loans, US Bank non-DPA loans, non–US Bank DPA loans, and non–US Bank non-DPA loans. We separate US Bank for this analysis because it is the master servicer for most state HFA lending programs. Comparing US Bank DPA loans (a group that contains most DPA loans originated by state HFAs and some loans with other types of DPA) with loans in the other categories, US Bank DPA loans tend to be smaller, with higher original loan-to-value ratios, a higher percentage of first-time homebuyers, and a higher note rate. There is no consistent difference in credit scores among the categories.

TABLE 1

FHA Loan Characteristics by Category and Fiscal Year

	2016 Origination				
	Original LTV	**Average credit score**	**Original loan amount**	**FTHB**	**Note rate**
US Bank DPA	95.98	695.607	167,832.444	0.889	4.287
US Bank non-DPA	94.806	694.478	171,205.944	0.802	4.016
Non–US Bank DPA	94.799	675.374	188,838.37	0.802	3.988
Non–US Bank non-DPA	91.782	680.801	195,522.366	0.703	3.867
All	92.253	681.069	193,577.17	0.727	3.894
	2015 Origination				
	Original LTV	**Average credit score**	**Original loan amount**	**FTHB**	**Note rate**
US Bank DPA	95.849	690.894	158,697.339	0.901	4.27
US Bank non-DPA	94.332	691.048	166,771.666	0.778	4.054
Non–US Bank DPA	94.779	676.163	177,294.428	0.776	4.059
Non–US Bank non-DPA	92.329	681.918	193,798.512	0.692	3.984
All	92.693	682.046	190,620.367	0.715	4.001
	2014 Origination				
	Original LTV	**Average credit score**	**Original loan amount**	**FTHB**	**Note rate**
US Bank DPA	95.14	684.809	132,488.241	0.905	4.355
US Bank non-DPA	94.623	682.404	147,342.792	0.776	4.326
Non–US Bank DPA	94.754	676.935	163,335.413	0.724	4.272
Non–US Bank non-DPA	92.459	675.168	169,814.567	0.663	4.276
All	92.75	675.792	167,734.881	0.68	4.279
	2013 Origination				
	Original LTV	**Average credit score**	**Original loan amount**	**FTHB**	**Note rate**
US Bank DPA	95.358	689.117	132,102.763	0.878	3.774
US Bank non-DPA	93.457	696.936	155,825.768	0.647	3.655
Non–US Bank DPA	94.897	688.371	166,211.561	0.759	3.617
Non–US Bank non-DPA	91.833	695.911	177,738.954	0.487	3.687
All	92.102	695.406	175,700.423	0.523	3.683
	2012 Origination				
	Original LTV	**Average credit score**	**Original loan amount**	**FTHB**	**Note rate**
US Bank DPA	95.606	687.261	124,098.888	0.917	3.986
US Bank non-DPA	93.094	707.797	170,526.369	0.45	3.739
Non–US Bank DPA	94.978	688.86	161,219.584	0.805	3.881
Non–US Bank non-DPA	92.509	701.904	177,719.405	0.42	3.882
All	92.841	700.479	174,721.664	0.472	3.878

Sources: eMBS and Urban Institute.
Notes: DPA = down payment assistance; FTHB = first-time homebuyer; LTV = loan-to-value.

Next, we look at the distribution of mortgage rates on loans in these four categories of loans (table 2). We compare the rate on each loan originated over the last two years with the Primary Mortgage Market Survey (PMMS) rate eight weeks earlier. We use the PMMS because it is the best estimate of

the prevailing mortgage rate on prime conventional mortgages, and there is typically an eight-week lag between the date on which the interest rate on a loan is locked in and the date the loan closes.

TABLE 2

Spread Distribution: FHA Note Rate Less PMMS Rate (%)

	Difference between Note Rate and PMMS Rate (x)								
	x<-0.40	-0.40≤x<-0.20	-0.20≤x<0	0≤x<0.2	0.2≤x<0.4	0.4≤x<0.6	0.6≤x<0.8	x≥0.8	All
US Bank DPA	5.88	5.86	8.59	10.39	15.86	26.03	18.52	8.87	100
US Bank non-DPA	13.46	12.64	16.02	13.89	14.59	13.29	6.64	9.46	100
Non–US Bank DPA	6.89	11.13	18.72	21.12	17.95	11.55	6.1	6.53	100
Non–US Bank non-DPA	8.52	13.14	20.46	22.45	17.36	9.7	4.32	4.05	100
All	8.44	12.75	19.86	21.76	17.29	10.42	4.94	4.54	100

Sources: eMBS, Freddie Mac, and the Urban Institute.
Note: Fiscal year 2014–16 origination. DPA = down payment assistance; PMMS = Primary Mortgage Market Survey.

The difference between the loan rate and the PMMS rate on US Bank DPA loans is larger than the difference on almost all other loan categories. However, the difference is modest: 9 percent of US Bank DPA borrowers have rates at least 80 basis points over the PMMS rate, compared with about 4 percent of non–US Bank non-DPA loans. Moreover, there is almost no difference between US Bank's DPA and non-DPA loans, which makes it difficult to conclude that there is a pervasive use of excessive rates in the HFA DPA loans. Including closing costs creates more loans with larger spreads because two points of closing costs can add 70 to 80 basis points to the loan's interest rate.

The OIG report states, "an estimated 60,000 FHA loans are originated each year, using the program's borrower-reimbursed funding arrangements" (OIG 2015). We could not come anywhere close to this number using data available to us. In fiscal year 2015, there were 1.2 million FHA mortgages made. During the first three quarters of 2015, 2.16 percent of mortgages had gifts from government entities. Applying this to total 2015 production suggests that 26,017 loans had government assistance. Table 3 shows the number of FHA loans using government-provided DPA since 2002; the 2015 number was the highest since 2002. Based on our loan rate analysis, we conclude that a 9 percent ceiling of government DPA loans—or 2,341 loans—might have included a premium, though that figure seems high given the points made above.

The number of loans that might have had included the kind of premium in dispute thus appears quite small relative to the number of FHA loans made or even to the number of loans with DPA from state HFAs.

TABLE 3

FHA Government Down Payment Assistance Loan Count by Fiscal Year

Fiscal year	FHA loans originated	Percentage of FHA loans using a government-provided DPA	Number of FHA loans using a government-provided DPA
2002	1,101,649	1.48	16,304
2003	1,243,571	1.42	17,659
2004	771,121	2.04	15,731
2005	475,467	3.03	14,407
2006	386,629	4.18	16,161
2007	410,011	3.40	13,940
2008	1,051,104	1.71	17,974
2009	1,829,433	0.59	10,794
2010	1,652,202	0.79	13,052
2011	1,179,780	1.11	13,096
2012	1,209,931	0.99	11,978
2013	1,319,627	0.97	12,800
2014	789,789	1.62	12,795
2015	1,204,496[a]	2.16[b]	26,017

Source: IFE (2015), eMBS, and the Urban Institute.

Notes: DPA = down payment assistance; FHA = Federal Housing Administration.

[a] Fiscal year 2015 loan counts are based on eMBS data, as the number from the actuarial review only covers the first three quarters of fiscal year 2015.

[b] Based on first three quarters of fiscal year 2015.

These Mortgages Pose Little Risk to the MMI Fund

Assuming that these 2,341 loans had premium pricing, what effect might that have on the Mortgage Market Insurance (MMI) Fund? Sources suggest the answer is "not much."

The 2015 actuarial report shows the percentage of claims by type of down payment assistance (table 4). We added a final column showing the claims rate on government DPA loans divided by the claims rate on loans with no gift. Since 2010, the claims rate on government DPA loans has been the same as or lower than the rate on loans with no gift. State DPA loans in the early 2000s were competing with the private-label securities market, which enabled lenders to offer borrowers lower loan rates. So the loans that received HFA DPA were an adversely selected subset. Since 2006, the ratio between the claims rate for government DPA and the rate for no gift has never exceeded 1.29.

TABLE 4

Cumulative-to-Date Percentage Claim Rates by Down Payment Assistance Source

Origination year	No gift	Relative	Nonprofit, religious, or community	Government	Employer	Government/no gift
2002	6.26	7.52	18.49	16.39	8.51	2.62
2003	6.71	9.2	21.46	18.23	12.45	2.72
2004	8.95	10.98	23.36	17.28	14.09	1.93
2005	12.94	15.12	27.45	21.33	19.05	1.65
2006	16.44	18.41	28.93	21.2	26.32	1.29
2007	18.63	19.55	30.62	23.32	23.62	1.25
2008	15.37	14.06	23.16	19.45	15.14	1.27
2009	8.57	7.2	16.72	10.84	9.5	1.26
2010	4.11	3.79	4.06	4.63	4.17	1.13
2011	1.88	1.66	1.69	1.92	1.05	1.02
2012	0.71	0.65	2.87	0.73	0.77	1.03
2013	0.27	0.2	0.27	0.15	0.12	0.56
2014	0.04	0.03	0.04	0.02	0	0.50
2015	0	0	0	0	0	

Source: IFE (2015) and the Urban Institute.

To establish a high-end of risk, though, let us assume that loans with government DPA default at 1.25 times the rate of default for loans without gifts. Li and Goodman (2014) defined an ex-ante probability of default as the weighted average of a normal and a stressed scenario. The normal scenario, for which we use the 2001–02 experience, is weighted 90 percent, and the stressed scenario, for which we use the 2005–06 experience, is weighted 10 percent. We assume a 65 percent probability that the loans 90 or more days delinquent will liquidate and that these defaults result in a 50 percent loss in value for the FHA in the normal scenario and a 65 percent loss in the stressed scenario. The expected loss calculation is shown in tables 5 and 6. Using this methodology, we derive an expected loss rate of recent vintage FHA loans of 3.16 percent.

TABLE 5

Delinquency and Losses by FICO Category

FICO score	Normal Market Conditions		Stressed Market Conditions		Weighted (90/10)
	Delinquency rate	Expected loss rate	Delinquency rate	Expected loss rate	Expected losses
580–619	19.1	6.21	41.5	17.53	7.34
620–639	12.7	4.13	32.1	13.56	5.07
640–679	9	2.93	24.5	10.35	3.67
680–710	5.4	1.76	17.1	7.22	2.30
>720	2.7	0.88	9.8	4.14	1.20

Sources: eMBS and Urban Institute.

TABLE 6

FHA Fiscal Year 2014–16 Credit Composition and Expected Losses

FICO score	Volume share (%)	Expected losses
580–619	6.41	7.34
620–639	10.08	5.07
640–679	35.40	3.67
680–710	27.41	2.30
>720	20.71	1.20
All	100.00	3.16

Sources: eMBS and Urban Institute.
Note: FHA = Federal Housing Administration.

State HFA loans have roughly the same FICO scores as overall FHA loans, and fewer very low FICO scores. Based on the comparative claim rates on government DPA and no gift loans, we assume the government DPA loans will generate losses at 1.25 times our overall FHA estimate, or 3.95 percent.

To determine the risk to the FHA insurance fund from these loans, we compare these estimated losses with the mortgage insurance premiums on the loans. The up-front mortgage insurance premium is 1.75 percent, and the annual premium is 85 basis points. Assuming the average duration of the mortgage is six years, the amount of insurance paid is 6.85 percent (1.75 + [0.85 x 6]). Based on expected losses on non-DPA loans of 3.16 percent, the MMI Fund can be expected to net 3.69 (6.85–3.16) percent on those loans. If the losses on the state HFA DPA loans are 25 percent higher, at 3.95 percent, the expected net to the fund would be 2.90 percent. That is, our calculations indicate state HFA DPA programs are still profitable for the MMI Fund.

Conclusion

While some loans made with down payment assistance provided by state HFAs may have included a premium, the scope of a possible problem is small, nowhere near the 60,000 loans suggested by the OIG. Moreover, the economics of these loans strongly suggest that they present minimal risk to the MMI Fund. While the nonpublic numbers to which the OIG and FHA have access may change our numbers, we believe it unlikely that they would change our numbers enough to change these conclusions.

Notes

1. See Ed Golding, letter to stakeholders, May 25, 2016, http://portal.hud.gov/hudportal/documents/huddoc?id=FTDO_DASP_052516.pdf; and Helen Kanovsky, "Permissible Source of Funds for Governmental Entities Downpayment Assistance Programs," memorandum to Edward L. Golding, August 11, 2016, http://portal.hud.gov/hudportal/documents/huddoc?id=prmssrcefndsgoventdpa.pdf.
2. Financial Services Committee, "Down Payment Assistance Funding Scheme Violates Law, Forces Borrowers to Accept Higher Interest Rate Mortgages," press release, August 8, 2016, http://financialservices.house.gov/news/documentsingle.aspx?DocumentID=400960.

3. There is no expectation that the borrower will repay the down payment assistance that they have received. They have the right to prepay the mortgage at any time.
4. The average loan size of DPA loans that used the HFA program was $158,700 in 2015, compared with $193,800 for non-DPA loans.

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