



Improving and Standardizing Mortgage Refinancing

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The Federal Housing Administration (FHA), the Veterans Administration (VA), and the government-sponsored enterprises (GSEs) all have their own rules for mortgage refinancing. The FHA and the VA have a streamlined refinance program, which allows loans on which the entity already holds the risk to avoid cumbersome re-underwriting. The GSEs do not have such a program. Encouraging refinancing reduces the risk to the credit risk holders, as the borrower is making a lower payment. It is important to balance borrowers' interests to save money on their mortgage with investors' interests, when the higher interest rate revenue stream is replaced with a lower-rate loan. If it were too easy for borrowers to refinance for minimal savings, investors would require a higher rate to invest in the mortgage-backed security, resulting in higher interest rates to the borrower. It is also important to make sure the borrower is actually realizing the savings on their refinancing and that refinancing is not just generating fees for mortgage originators. This has been particularly abused in the case of VA loans.¹ Moreover, investors in both mortgage-backed securities and the GSE credit risk transfer programs want predictability on when refinances can be expected, making modeling easier.

All government and government-sponsored entities have penalties for lenders whose loans prepay faster than most other lenders. In the case of the GSEs, it is typically through higher guarantee fees (g-fees), limits on the volume of GSE purchases, or limits on using the cash window. In the case of the FHA and the VA, Ginnie Mae requires that the mortgages be placed into custom pools that often trade at a discount. These penalties are meant to protect investors from excessive prepayments, but these penalties often act against putting the consumer in a stronger financial position. That is, because the penalties are for relative performance, lenders are often unsure when a penalty trigger will be breached,

which often leaves lenders unwilling to reach out to borrowers to let them know when a refinance would benefit them.

In this brief, we highlight the lack of uniformity among various refinancing policies across the FHA, the VA, and the GSEs. We show that current refinancing policies often work against consumers. That is, some of the rules do not allow consumers to refinance, even when it is in their interest to do so. And the current system can be gamed. Some servicers do too many marginally beneficial refinances, to the detriment of both consumers and investors. We propose a set of net tangible benefit tests that are harder to pass and harder to game than those currently in use. Along with these tests, we propose (1) expanding streamlined refinancing to the GSE market and (2) rationalizing up-front fees, including loan-level pricing adjustments (LLPAs) and mortgage insurance premiums (MIPs).

These net tangible benefit tests are solely for rate-term refinances, which should not be done without clear borrower benefit. Cash-out refinances require borrower requalification, so this analysis would not apply. These tests would constitute a safe harbor for the servicer doing the refinancing; if servicers pass these tests, they would not be subject to penalties for excessive prepayments.

We have designed these net tangible benefit tests to make sure all refinancing activity is economically beneficial to the borrower. But we have tried to calibrate our tests so that they do not substantially increase overall refinancing volume and hence would not result in investors widely seeking higher mortgage rates. If these actions were to result in higher mortgage rates because it becomes easier to refinance, this method could be recalibrated.

This topic is important for the functioning of the mortgage market and has equity implications. Research has shown that borrowers with smaller loans refinance less often than borrowers with larger loans, all else equal.² Black and Hispanic borrowers are less apt to refinance than white borrowers. In fact, most of the difference between the mortgage interest rates of Black and Hispanic borrowers and white borrowers can be explained by a failure to refinance when it is opportune to do so, rather than interest rate differentials at origination (Aronowitz, Golding, and Choi 2020; Berger et al. 2024; Gerardi, Loewenstein, and Willen 2020).

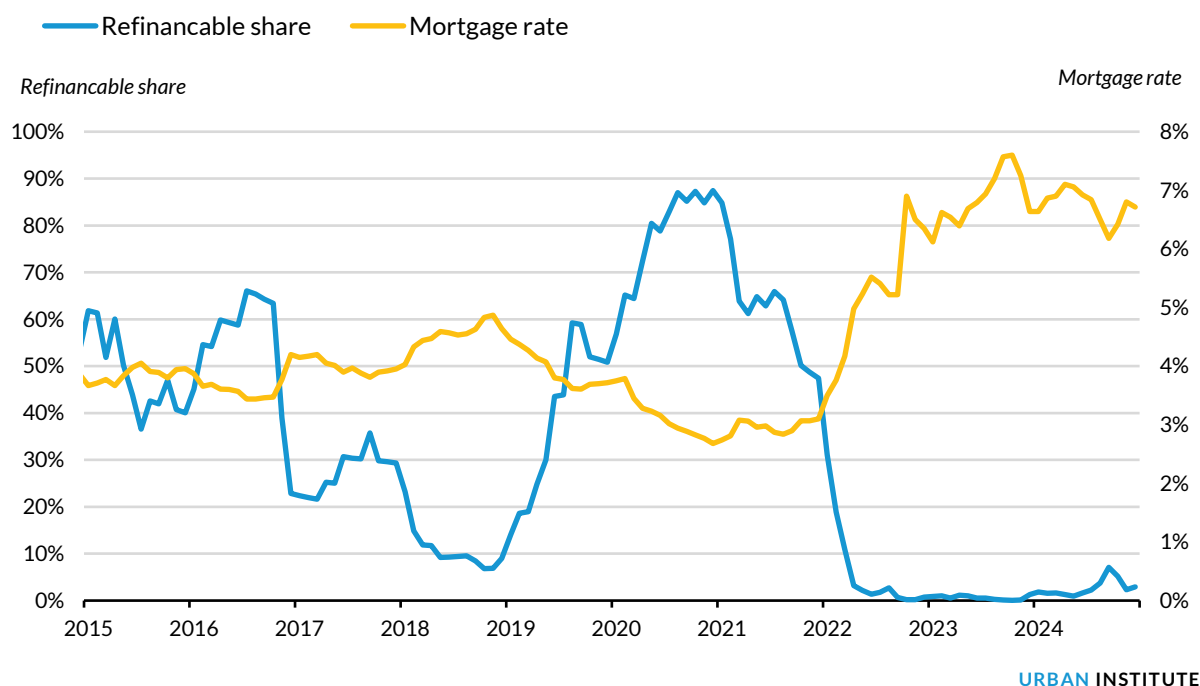
The outline of this paper is as follows. The first section makes a case for reforming refinancing policies by illustrating the differences between FHA, VA, and GSE mortgages. The second section describes the various policies the FHA, the VA, and the GSEs each employ. The third section shows how these policies can be gamed to produce refinances that are not economically beneficial to borrowers. The final section outlines policies that could be used across all government and government-sponsored entities to simplify and improve the mortgage market.

The Data

Figure 1 shows the share of the mortgage market that has been refinanceable since 2015 and shows the Primary Mortgage Market Survey (PMMS) rate. The PMMS rate is the rate on new mortgages (with 80 percent loan-to-value ratios), as measured by Freddie Mac. We determine a mortgage to be

refinanceable if the spread between the rate on the outstanding mortgage and the PMMS rate is more than 50 basis points. The blue line measures what percentage of the agency mortgage market is refinanceable.

FIGURE 1
Refinancable Share of Mortgages



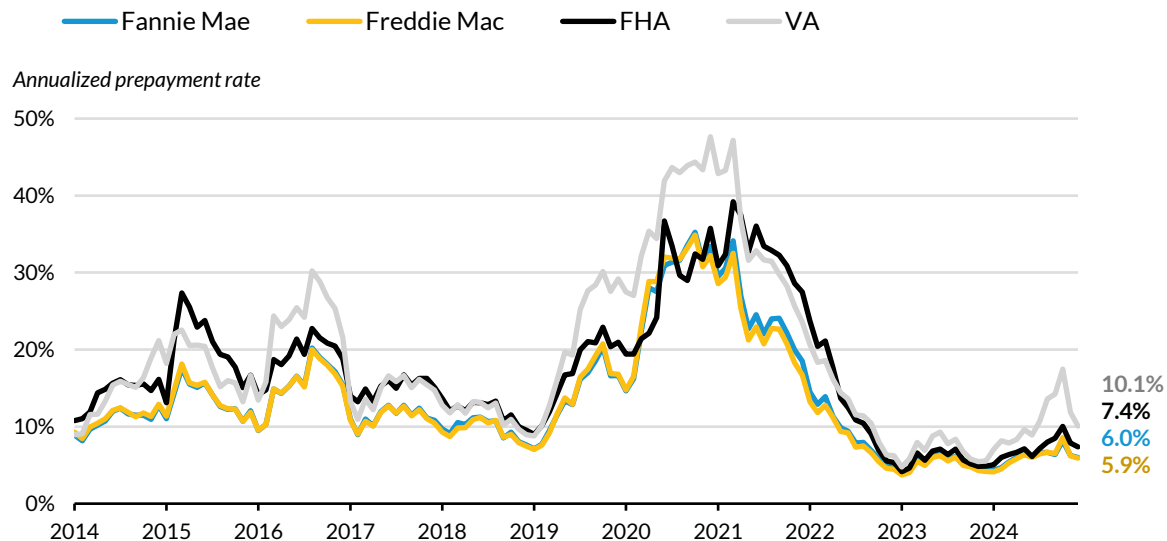
Source: Urban Institute calculations, taken from Laurie Goodman, Janneke Ratcliffe, Michael Neal, et al., *Housing Finance: At a Glance Monthly Chartbook, January 2025* (Washington, DC: Urban Institute, 2025).

That share was close to 90 percent during late 2020 and most of 2021, when mortgage interest rates were very low. That share is now about 2 percent.

Figure 2 shows prepayment speeds by agency. Speeds for VA mortgages are generally considerably faster than speeds on FHA and GSE mortgages. And speeds for FHA mortgages are somewhat faster than speeds on GSE mortgages. Let us look at the rules to understand why.

FIGURE 2

Prepayment Rates, by Agency



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Source: Recursion, taken from Laurie Goodman, Janneke Ratcliffe, Michael Neal, et al., *Housing Finance: At a Glance Monthly Chartbook, January 2025* (Washington, DC: Urban Institute, 2025).

Note: FHA = Federal Housing Administration; VA = US Department of Veterans Affairs.

Refinance Policies

There are several differences between the FHA, VA, and GSE programs regarding refinancing mortgages. The most important difference is that the GSEs do not have a streamlined refinance program. Every refinance requires a full underwriting, including rate-term refinances for which the entity already holds the risk and that risk will be reduced because the borrower will receive a lower payment (resulting from a lower interest rate and, usually, a term reset to a full 30 years). This stems in large part from the Consumer Financial Protection Bureau's (CFPB's) ability-to-repay/qualified mortgage rule, which requires lenders to make a good-faith determination of a borrower's ability to repay the loan. These rules apply to most conventional loans, with limited carve-outs. Rate-term refinances, even with the same guarantor, do not receive carve-outs. Loans the FHA and the VA insure are not subject to the CFPB's rules; they are subject to their own ability-to-repay rules. Because of these CFPB rules, each GSE refinance requires the borrower to document income and prove creditworthiness and often requires an appraisal and new title insurance.

Moreover, it means the borrowers who often need the payment reduction the most will be unable to qualify for a new mortgage, because of unemployment spells or because their creditworthiness has declined. In fact, these rules are counterproductive, as the refinance will actually decrease the risk to the guarantor. The CFPB should create a rule to exempt refinance transactions where the balance is not

increasing from the ability-to-repay rule, as long as it benefits the borrower. The phrase “benefits the borrower” would have to be strictly defined.

In addition, because the loan being refinanced is treated as a new loan, the borrower must also pay the up-front LLPAs the GSEs charge. The result is that each borrower will pay thousands of dollars in fees and incur a time commitment to find the necessary information.

VA Refinancing Rules

The VA charges a 2.15 percent funding fee on purchase loans the first time the program is used and charges 3.3 percent thereafter. The refinance funding fee is 0.5 percent. But many borrowers are exempt from these fees, including those with service-related disabilities or surviving spouses of a veteran. VA data indicate that about 65 percent of all borrowers are exempt from these fees.

For borrowers who paid the initial funding fee by rolling it into their rates (and very few do), the mortgage will be in the money almost immediately—that is, the fee for initial purchase is 2.15 percent, which is converted into approximately a 54 basis-point rate increase.³ The fees for a refinance loan are 0.5 percent, or an additional 12 basis points, but are 42 basis points lower than the original mortgage. But in 98 percent of VA loans, the borrower finances the funding fee in their loan amount. The VA does not have a maximum loan-to-value ratio on its streamlined refinances. (These are referred to as VA interest rate reduction refinance loans, or IRRRLs.)

The VA has several additional requirements to limit immediate refinances or churning:

- 210 days must pass between the first payment due date and the refinancing date (seven months of seasoning, six months of payments), regardless of the size of the rate drop in the interim.
- The borrower must be current at the time of refinancing and must have had no more than one late payment in the previous year.
- The VA has a net tangible benefit test. This requires that the savings between the old and new payments be lower by an amount that allows any fees associated with the new loan to be recouped in 36 months or sooner. In addition, on a fixed-rate-to-fixed-rate refinancing, the interest rate savings must be at least 50 basis points. IRRRL rates are somewhat lower than purchase rates, as the IRRRL process is streamlined, limiting the cost to the originator. This makes it easier to pass the net tangible benefit test.

FHA Refinancing Rules

The FHA also has a streamlined refinance program. If the refinance occurs within three years of origination, the borrower receives partial credit for the original up-front MIP. The FHA has additional requirements:

- The seasoning requirement is the same as for VA loans: at least 210 days from the first payment date to the close date of the refinanced loan, regardless of the size of the drop in the interim.
- The borrower can have no late payments in the previous six months cannot have more than one late payment in the previous year.
- Fees cannot be rolled into the loan amount, but the up-front MIP can.
- There is a benefit test: if there is no term reduction, or if a term reduction is less than three years, a 50 basis-point minimum reduction in the mortgage rate is required. For a term reduction of more than three years, the mortgage rate must simply be lower.

The GSEs have no tangible benefit test for refinancings.

What Is Wrong with the VA and FHA Benefit Tests?

Both the FHA and the VA have benefit tests to make sure the refinance is cost-efficient for the borrower. Let us start with the VA test, in which the borrower has to recoup any fees during a three-year period, and the fixed-to-fixed rate has to be lower by at least 50 basis points. The refinancing costs can be rolled into the loan amount, as can at least 1 discount point, with some loan-to-value ratio restrictions. The issue is that by rolling the fees into the loan amount, the borrower can refinance even if interest rates do not change.

We can make this point more concretely with the following example of a situation in which market interest rates do not change, but the borrower can pass the VA net tangible benefit test and refinance their loan.

Market interest rate: 6.5 percent

Initial loan: Rather than paying 2 points in origination costs, the borrower agrees to a 7 percent mortgage; they finance the VA fee of 2.15 percent into the loan amount.

Loan amount: \$300,000 (\$293,686 for the property; \$6,314 for VA fees)

Payment: \$1,996

The borrower refinances after one year at a 6.5 percent rate; the balance is \$296,953. The borrower rolls up the 0.75 percent origination fee and the 0.5 percent VA fee into the loan amount.

New loan amount: \$300,665

New payment: \$1,904

This passes the VA net tangible benefit test, as the savings are \$92 a month. The origination fee is \$2,227, so $\$2,227 / \$92 = 24$ months' payback.⁴ In addition, the new rate is 50 basis points lower than the old rate (6.5 percent versus 7.0 percent).

The issue is that although the interest rates and payments are lower, the borrower's balance has increased substantially.

Here is a similar FHA example.

Market interest rate: 6.5 percent

Initial loan: Rather than paying 2.5 points in origination costs, the borrower agrees to a 7.125 percent mortgage; they finance the FHA MIP fee of 1.75 percent in the loan amount.

Loan amount: \$300,000 (\$294,840 for the property; \$5,160 for up-front MIP)

Payment: \$2,021

The borrower refinances the now-outstanding balance of \$293,831 after two years at a 6.625 percent rate (the 6.5 percent base rate plus an extra 12.5 basis points attributable to the 50 basis-point origination fee on the refinance loan). The borrower must pay a new MIP of 1.75 percent, or \$5,142, but receives a credit of 34 percent from the original MIP, or \$1,756. The MIP differential of \$3,386 is rolled into the loan amount. This is an effective MIP of 1.15 percent on the new loan.

New loan amount: \$297,217

New payment: \$1,903

This passes the FHA net tangible benefit test, as the savings are 50 basis points. But the loan amount is larger than the outstanding balance, and the mortgage term has been extended by two years.

The idea of a net tangible benefit test in a refinancing is to let the borrower take advantage of lower interest rates but not to let the borrower refinance if rates do not change. These examples highlight how complicated the issues are. By allowing the borrower to roll the costs of the refinance into the loan amount, they can “pass” the net tangible benefit test, even though market interest rates have not changed, to the detriment of both the borrower and the investor.

A good part of the problem in both these examples is that the “cost” of rolling into the loan amount does not show up in the interest rates. And even if we were to use annual percentage rate (APR) rather than interest rates, the impact of putting closing costs into the loan amount is smaller than the impact of rolling closing costs into the rate. Consider the following example:

APR calculation: Roll closing costs into the loan amount

Loan amount: \$300,000

Closing costs: 2 percent

Interest rate: 6.5 percent

APR: 6.691 percent

APR calculation: Roll closing costs in the rate

Loan amount: \$300,000

Closing costs: 2 percent, rolled into the rate

Interest rate: 7.0 percent

APR: 7.0 percent

The impact of rolling the 2 points into the rate is a 50 basis-point increase in APR but is a 19 basis-point increase if rolled into the loan amount.

Moreover, the seven-month seasoning period on FHA and VA loans is artificial. The idea behind the seven-month seasoning period before the loan can refinance was to provide some protection to the investor. But if there is a genuinely large drop in rates, public policy would ideally allow the borrower to refinance. Is there a solution?

Solution

It would make sense for the GSEs, the FHA, and the VA to have consistent rules for streamlined refinances. These rules should be based solely on a net tangible benefit test that minimizes the incentive to churn. There should not be any comparison between lender prepayment speeds, with penalties for lenders that are “too fast,” as this comparison generates uncertainty about which refinancings can be done and penalizes efficient, low-cost lenders. Consistent rules would make the process simpler for lenders, as they would not be concerned about speeding tickets and could reach out to borrowers more proactively. More importantly, if the rules were harmonized and publicized, there would be greater consumer awareness and greater borrower take-up.

One possible solution would be to require that all costs on the streamlined refinance be rolled into the rate—the loan amount could not be increased at all. To be clear, for the FHA, this would mean the up-front MIP could not be rolled into the loan amount on a refinance loan. For the VA, the funding fee could not be rolled into the loan amount on a refinance loan. No closing costs could be included in the loan amount on a refinance loan; all costs must be included in the rate.

The lender would then compare the note rate on the old mortgage with the APR on the new mortgage.⁵ If the savings were more than 50 basis points, the refinancing could proceed. This approach has the following advantages:

- By eliminating the borrower’s ability to roll the closing costs into the loan amount, we can give the borrower a better picture of the true costs of refinancing.
- By leaving the loan amount constant, the risk to the insurer or guarantor on the refinancing unambiguously drops.
- This rule has no ambiguity.

The 50 basis points number is our best estimate of the correct threshold, using available information. If the spreads on pay-ups for higher interest rates collapse, it might be necessary to adjust this number upward.

We can look at our two prior refinancing examples and see how this would operate. The market mortgage rate was 6.5 percent at origination and at the time of the refinancing. In the case of the VA refinancing, the rate on the original mortgage was 7.0 percent because of the inclusion of some costs. If all refinancing costs (75 basis points) and the VA fee (50 basis points) were rolled into the refinance rate, the new refinance rate would be 6.8125 percent, or a savings of 18.75 basis points from the original mortgage. In our FHA example, because of the inclusion of some costs, the rate on the original mortgage

was 7.125 percent. If all costs (i.e., the 50 basis-point origination fee and the effective up-front MIP of 1.15 percent) were rolled into the note rate, the new rate would be 21 basis points lower than the old rate, well short of a 50 basis-point savings.⁶

There are some periods in the market when it is very costly to roll costs into the rate. For example, although 2 points in up-front costs generally add around 50 basis points to the rate, there are times when it will add much more. This will clearly raise the threshold for refinancing.

Additional Thoughts on Streamlined Refinance Programs

The GSEs do not have a streamlined refinance program, as the CFPB's ability-to-repay/qualified mortgage rule requires lenders to make a good-faith determination of a borrower's ability to repay the loan. These rules apply to most conventional loans, with limited carve-outs. There should be a carve-out for non-cash-out refinancing. The purpose of the CFPB's ability-to-repay rule is to protect the consumer. The purpose of our changes is to do exactly that by making sure borrowers only do refinancings that make economic sense and by making it easier to do those refinancings. Moreover, it makes no sense to requalify a borrower for a loan for which the GSE already holds the risk if a borrower can make the payments on their current mortgage and will be refinancing into a lower interest rate. Lenders should receive a safe harbor from the ability-to-repay rule because the borrower will be able to make their required payment at a lower interest rate. Moreover, the borrowers who are most apt to be rejected during the process are those who are struggling, and the refinancing would have a material positive impact on their financial situation—their credit has deteriorated or they have lost their job. The CFPB should allow rate-term refinancings—with no increase in the loan amount, resulting in a lower payment—to be exempt from the ability-to-repay rules.

Additional Thoughts on the Structure of GSE LLPAs, FHA MIPs, and VA Funding Fees

The GSEs require the payment of LLPAs on refinanced mortgages. This must be paid up front, in cash, by the lender, which requires either that the borrower pay in cash or that the up-front fee be paid for via premium pricing. The LLPAs are meant to compensate the GSEs for the incremental risk. But for a refinance loan, the borrower has already paid the LLPA once, and the risk to the GSE is actually lower, as the borrower has a lower payment. The borrower, however, has generally paid the original LLPA with a higher rate, and we do not want borrowers to be able to refinance immediately with no rate change or with a minimal one. To balance these factors, we suggest allowing the full LLPA to be collected if the loan is refinanced immediately, with the proportion of the LLPA that must be paid linearly declining to zero for a loan that has been outstanding for two years.

The FHA MIP is paid in two parts: as a 1.75 percent up-front fee and as a 50-to-55-basis-point ongoing fee. When the mortgage is refinanced, part of the up-front fee is credited depending on the original loan's holding period. For example, if the old mortgage is outstanding for 10 months, 62 percent

of the fee is credited for a refinancing. If the old loan is outstanding for 18 months, 46 percent of the fee is credited. After three years, there is no refund. The logic of this seems backward. That is, the borrower has already paid the cost, and it seems unnecessary for them to pay it a second time. But we do not want the borrower refinancing instantly with a minimal interest rate change. It would make sense to have the up-front MIP structured similarly to what we suggest with the GSEs LLPA—no credit is given if the loan is refinanced immediately, and full credit for the up-front MIP is given after two years, with a linearly declining schedule in between.

Of course, this assumes the FHA MIP continues as is. One could make the case that it would be more efficient to structure the FHA fee as an annual premium with no up-front component. Mortgage insurers have moved away from up-front fees, and the FHA could do so without jeopardizing the Mutual Mortgage Insurance Fund, which now stands at over 10 percent. For example, rather than 1.75 percent up front, the FHA could increase the annual fee by 25 basis points.

The VA funding fee is an up-front fee, which is 2.15 percent on a purchase loan and 0.5 percent on a refinance loan. Many borrowers are not subject to VA funding fees. The lower refinance fee reflects the economic reality that the VA already holds the risk on the loan. Similar to the recommendation for GSE LLPAs and the FHA MIP, we would phase the refinance funding fee out over two years. That is, no credit is given if the mortgage is refinanced immediately, and full credit is given for the funding fee after two years, with a linearly declining schedule in between.

Conclusion

The current refinancing models across the FHA, the VA, and the GSEs do not provide the proper incentives to borrowers or lenders. The models encourage marginal refinances, to the detriment of borrowers and investors. Lenders do not know how many of their borrowers can be refinanced without triggering “speeding tickets,” as these tickets are based on the speeds of that lender against its peers, a moving target. In this brief, we rationalize refinancing policies across the FHA, the VA, and the GSEs. To do so, we proposed an alternative net tangible benefit test, to the advantage of borrowers, lenders, and investors.

This proposed test requires the following:

- All refinance costs—including closing costs, up-front MIPs, VA funding fees, and GSE LLPAs—must be paid in cash or rolled into the rate. The loan amount cannot increase.
- The up-front MIP, the VA funding fees, and the GSE LLPAs would be payable in full if the refinance was immediate and would linearly decline to zero over two years.
- The FHA, the VA, and Ginnie Mae would eliminate all seasoning requirements.
- The CFPB would change its ability-to-repay rules to exempt GSE refinance loans with a clear net tangible benefit and no increase in the loan amount.

Under this framework, borrowers will no longer be able to be offered noneconomical refinances, and lenders and investors will have clear guidelines on when refinances are permitted. We hope this brief will begin a robust discussion of the need for rationalizing refinance policies.

Notes

- ¹ See, for example, Consumer Financial Protection Bureau, “CFPB Orders NewDay USA to Pay \$2.25 Million for Illegally Luring Veterans and Military Families into Cash-Out Refinance Loans,” news release, August 29, 2024, <https://www.consumerfinance.gov/about-us/newsroom/cfpb-orders-newday-usa-to-pay-2-25-million-for-illegally-luring-veterans-and-military-families-into-cash-out-refinance-loans/>.
- ² See for example, Colin Robertson, “Larger Loan Amounts Require Smaller Mortgage Rate Decreases for a Refinance to Pencil,” *The Truth about Mortgage*, December 13, 2024, <https://www.thetruthaboutmortgage.com/larger-loan-amounts-require-smaller-mortgage-rate-decreases-for-a-refinance-to-pencil/>; and ICE Mortgage Technology (2024, 10).
- ³ We assume throughout this brief that each point in costs translates into a 25 basis-point increase in the interest rate, as roughly a 4:1 ratio.
- ⁴ The VA fee is not included in the payback calculation.
- ⁵ Comparing the old rate with the new APR allows the borrower to use any lender to do the refinance.
- ⁶ An additional obstacle to refinancing a mortgage is escrow accounts, particularly across different originators. In a same-originator refinance, if a borrower has an escrow account deficit because of, for example, rapidly rising insurance payments, the originator can opt to allow the same catch-up plan as if the borrower did not refinance. If a borrower refinances with a different originator, they must often come up with the full amount to fund the escrow accounts, usually two to three months of taxes and insurance. The old servicer will usually remit the escrow account to the borrower after 30 days. The delay is to make sure there are no additional obligations. But this timing mismatch is unnecessary with today’s technology, as the amounts due are known in advance. The topic of reforming the escrow system affects more than refinances. We intend to address it in a future publication.

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Ted Tozer is a nonresident fellow in the Housing Finance Policy Center. Immediately before joining Urban, he was a senior fellow at the Milken Institute's Center for Financial Markets. Previously, Tozer was president of Ginnie Mae for seven years, bringing with him to the institution more than 30 years of experience in the mortgage, banking, and securities industries. As president of Ginnie Mae, Tozer managed Ginnie Mae's nearly \$1.7 trillion guarantees of mortgage-backed securities and more than \$460 billion in annual issuance. He also led the modernization effort of the Ginnie Mae Securitization Platform. Tozer oversaw the transition for a depository-dominated issuer base to an independent mortgage banker-dominated base. He was the Obama administration's point person for rewriting the Home Affordable Refinance Program. Tozer also oversaw the transition from the Ginnie Mae I program to the Ginnie Mae II program. Before joining Ginnie Mae, he was senior vice president of capital markets at the National City Mortgage Company (NCM) for more than 25 years, overseeing pipeline hedging, pricing, loan sales, loan delivery, and credit guideline exceptions. He was instrumental in transforming NCM from an originate-and-hold lender to an originate-and-sell lender. Tozer also serves on the board of directors of PennyMac Financial Services, a mortgage originator. He holds a bachelor's degree in accounting and finance from Indiana University.

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