



The FHA's Annual Report, Its Financial Health, and How It Should Cut Pricing

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Each year, the Federal Housing Administration (FHA) delivers a report on its financial health to Congress. The most important part of the report is its determination of the level of the FHA's Mutual Mortgage Insurance (MMI) Fund, which provides a useful snapshot of the FHA's health and affects a wide range of decisions about how to price and otherwise manage its business. The MMI Fund is a measure of the capital the FHA has to cover unexpected losses on its current book of business, and is equal to its cash on hand, plus the revenues it expects to get from the loans it currently insures, less its expected losses on those loans. The FHA is required by law to maintain capital in its MMI Fund equal to 2 percent of its total insurance in force.

The FHA's 2021 report was released on November 15 and shows an MMI capital ratio of 8.03 percent, a significant jump from its 2020 level of 6.1 percent and well above the statutory minimum (FHA 2021). The increase was driven largely by the dramatic rise in home prices nationwide, which pushed the capital ratio on the FHA's forward business from 6.31 percent to 7.99 percent and pushed the ratio on its reverse business from *negative* 0.78 percent to 6.08 percent.¹

The FHA's improving health puts it in a position to provide more benefit to its borrowers, through measures that will ultimately reduce its net revenues and thus its capital reserves. In this brief, we assess how much room the FHA has to work with and how it could use that room most effectively. We find that the FHA's financial health provides considerable flexibility, despite an unnerving level of stress in its portfolio, and that the best course is to provide deep, targeted cuts to help borrowers who would most benefit from them.

How to Think about the FHA's Buffer

Approximately 660,000 FHA borrowers are more than 90 days past due on their mortgage, 310,000 of whom are still in forbearance, with promising prospects for recovery. Borrowers who cannot return to their monthly payments after their forbearance period ends will be offered lower payments or other relief through the FHA's recently implemented loss mitigation waterfall.² We expect the cure rate among these borrowers to be high, consistent with the low rate of foreclosure starts among FHA borrowers since the moratorium was lifted.

It is more difficult to assess the prospects of the roughly 350,000 seriously delinquent FHA borrowers who are *not* in forbearance. Many of these borrowers have been delinquent since before the pandemic, missing more than a year of payments, while others failed to cure coming out of forbearance or have been unreachable.³ The level of stress among these borrowers is high, suggesting that many will be unable to perform again, even with considerable relief.

In its report, the FHA assumes that almost *all* its seriously delinquent borrowers will cure. This may turn out to be true for the 310,000 borrowers in forbearance, given how little distress a borrower needed to show to enter forbearance and how generous the FHA's loss mitigation options are for those coming out of forbearance. It seems unlikely to be true for the 350,000 borrowers who are not in forbearance, however. Even factoring in how home price appreciation and amortization before default will allow some of these borrowers to sell their homes to pay off their mortgage, many will be unable to cure.

Nonetheless, even if we assume that only 40 percent of the loans that are not in forbearance eventually cure and that the FHA suffers an average loss of 40 percent on the loans that fail to cure, the losses would only reduce the MMI capital ratio to 7.1 percent. If we also assume that only 60 percent of those *in* forbearance cure, an unlikely outcome given the robustness of the FHA loss mitigation waterfall, the MMI capital ratio still only falls to 6.7 percent. The heightened level of stress in the FHA's book of business simply does not fundamentally change the considerable capital buffer in its MMI Fund.

The size of the *current* buffer in the MMI Fund is not, however, the most important factor the FHA must weigh in deciding whether to adjust policies to allow for less revenue or greater losses. More important is the size of the buffer going forward, which will be driven in significant part by how much money the FHA expects to make on each new loan, or (in government budgeting language) its negative subsidy rate (if its subsidy rate is positive, the FHA *requires* a subsidy).

According to the Office of Management and Budget, the FHA is generating a negative subsidy rate of 2.69 percent on new loans, or an average estimated profit of 269 basis points per loan (OMB 2021). If maintained, this level of profitability would likely continue the rapid increase of the MMI Fund for years to come. If instead the FHA were to take policy steps that eliminated its profitability on new loans—that is, steps that reduced the negative subsidy rate on new loans to zero—the capital already in the MMI Fund would have to stretch to cover more and more insurance in force, lowering its capital ratio.

If the economic projections used in this year's modeling hold, zeroing out the negative subsidy on new loans would drive down the MMI Fund's capital ratio, but only gradually, pushing it to 2 percent after 25 years. There is no reason to assume that current projections will hold indefinitely, however, and it would not take much to speed the decline. If home price appreciation were lower, loss rates were higher, or prepayments were to come in slower than expected in years to come, the MMI Fund would deteriorate rapidly absent a profit on new loans.

The Great Recession offers a reminder of how changing economic conditions can lead to dramatic swings in the MMI Fund. The fund tumbled from 7.38 percent in 2006, to 0.53 percent in 2009, to negative 1.44 percent in 2012, wiping out a buffer comparable to today's buffer in only six years. The FHA should maintain material profitability on its new business to mitigate this kind of swing. Retaining a negative subsidy rate of 50 to 150 basis points should be adequate, keeping the fund above 2 percent even if we have a repeat of the Great Recession. The administration could retain an even larger buffer to guard against even more dramatic swings in the economic conditions that drive both the MMI Fund's capital ratio and the negative subsidy rate, but it must strike a balance between the need for caution in the face of economic uncertainty and its mission to serve a population whose access to homeownership often turns on how the FHA sets its pricing and other policies.

What the FHA Should Do with Its Buffer

The FHA would be able to reduce its estimated profitability per loan by 119 to 219 basis points and still retain a negative subsidy rate of 50 to 150 basis points. It could use this room in any number of ways, by, for instance, expanding its credit box, providing incentives for more housing counseling, or covering closing costs for some of its borrowers. We focus here on how best to use the room to cut pricing, but the administration should consider a wider range of uses, whether in lieu of price cuts or in conjunction with them.

For 175 basis points, the FHA could eliminate its up-front premium, cut its 85 basis-point annual premium to 58 basis points, or cut its annual premium to 69 basis points and then eliminate it once a borrower's loan amortizes to a 78 percent loan-to-value (LTV) ratio (table 1). Although these options would all cost the FHA the same, they present different benefits to borrowers. As borrowers tend to finance their up-front fee into their loan balance, removing the fee would simply reduce their loan balance by that amount, which translates into less of a reduction in monthly mortgage payment than would result from a comparable cut in their annual premium. And as only 10 percent of FHA borrowers are in their mortgage for the 11 or so years it takes to bring their LTV ratio down to 78 percent, 9 in 10 borrowers would see no benefit from the elimination of an annual fee that kicks in only then. Of the three across-the-board cuts, an immediate cut of the annual rate would have the biggest impact on affordability.

TABLE 1

What to Cut

For a borrower taking out a \$200,000 loan at 3.25 percent interest, the math of a premium cut that costs the FHA 175 basis points is as follows.

- **The FHA could cut the borrower's annual fee from 85 to 58 basis points.**^a Assuming the borrower has rolled the up-front premium into the new loan, the 27 basis-point cut in their annual premium would reduce their monthly payment from \$1,028 to \$983, saving them \$45.
- **The FHA could eliminate the borrower's up-front fee of 175 basis points.** As the borrower would have rolled that fee into their loan, it will reduce their loan balance from what would have been \$203,500 to \$200,000. Their monthly payment would drop from \$1,028 to \$1,012, saving them \$16.
- **The FHA could cut the annual premium from 85 to 69 basis points and then remove it once the loan reaches a 78 percent LTV ratio.** On average, removing the annual premium at a 78 percent LTV ratio would shorten the duration of the revenue stream for the FHA by a year, costing it 85 basis points. This would allow the FHA to cut the annual premium by 16 basis points at the loan's outset, reducing the borrower's monthly payment from \$1,028 to \$1,001, saving them \$27.^b

Source: Urban Institute calculations.

Note: FHA = Federal Housing Administration; LTV = loan-to-value.

^aWe use the Office of Management and Budget's assumed weighted average life of loan of 6.47 years, so 175 basis points / 6.47 years = 27 basis points per year.

^bFor this calculation, we use a 5.47-year duration, as the mortgage insurance premium stops when the LTV ratio reaches 78 percent; 90 basis points / 5.47 years = 16 basis points per year.

Whichever price cut the FHA chooses, there is nothing that *requires* it to provide the cut across the board, and there is little reason to provide it that way. Instead of cutting the annual fee for all new borrowers by 27 basis points, the FHA could cut the fee for those who make below 80 percent of the area median income (AMI) by 66 basis points (table 2). Thus, for the same cost, the FHA could provide more than twice the relief for the borrowers who would most benefit from it.

TABLE 2

Targeting MIP Price Cuts

	Borrower Income (as a Share of AMI)			
	< 80%	80–100%	100–120%	≥ 120%
Share of FHA loans	48%	16%	12%	24%
Share of FHA balances	41%	16%	13%	30%
Base scenario: Equal MIP cut for all borrowers				
MIP cut	0.27%	0.27%	0.27%	0.27%
Reduction (%)	4.38%	4.38%	4.38%	4.38%
Reduction (\$) on a \$200,000 loan	\$45.00	\$45.00	\$45.00	\$45.00
Alternative 1: MIP cut only for those earning < 80% of AMI				
MIP cut	0.66%	N/A	N/A	N/A
Reduction (%)	11.00%	N/A	N/A	N/A
Reduction (\$) on a \$200,000 loan	\$110.10	N/A	N/A	N/A
Alternative 1: MIP cut only for those earning < 100% of AMI				
MIP cut	0.48%	0.48%	N/A	N/A
Reduction (%)	7.74%	7.74%	N/A	N/A
Reduction (\$) on a \$200,000 loan	\$79.47	\$79.47	N/A	N/A

Source: Urban Institute calculations from 2019 Home Mortgage Disclosure Act data.

Note: AMI = area median income; FHA = Federal Housing Administration; MIP = mortgage insurance premium; N/A = not applicable.

The FHA could directly target borrowers with the most need through an income limit, or indirectly target them through loan limits. The former would capture the target group most accurately, but it would be more difficult for lenders to implement. Incomes are often fluid and difficult to document, whereas initial loan sizes are straightforward. Given how well loan size at origination tends to track income, using loan size to target deeper price cuts likely offers the better approach (table 3).

TABLE 3

Loan Size, by Borrower Income

Loan size	Borrower Income (as a Share of AMI)			
	< 80%	80–100%	100–120%	≥ 120%
≤ \$100,000	13.1%	5.9%	4.2%	2.7%
≤ \$150,000	36.1%	21.8%	16.5%	11.4%
≤ \$200,000	60.7%	45.6%	36.9%	26.8%
≤ \$250,000	78.4%	68.4%	59.0%	45.7%

Source: Urban Institute calculations from 2019 Home Mortgage Disclosure Act data.

Note: AMI = area median income.

With all this in mind, we recommend that the FHA target borrowers with lower loan balances for the mortgage insurance premium cut. One way to do this simply and effectively would be to eliminate the annual fee for borrowers taking out loans up to \$200,000. This would save a borrower with a \$200,000 loan \$142 a month and cost the FHA only 161 basis points, leaving it with a relatively conservative profitability buffer of 108 basis points. An even better approach, at least in theory, would be to offer an economically equivalent range of cuts to borrowers taking out loans up to \$250,000 that deepen depending on how small the loan is, better matching the relief with the need.⁴ Which of these approaches is preferable depends on whether the FHA could handle the complexity of the scaled approach. If it can, it should take that approach; if not, it should apply the simpler single cut.

Conclusion

The FHA's report to Congress shows it to be in good health, even with an unnerving number of borrowers behind on their mortgages. As it looks to the future, however, the FHA's room to maneuver will be defined less by the MMI Fund dissected in that report than by the profitability on the loans it makes going forward. Fortunately, here, too, the FHA has room. But as it reduces its margin on new loans to something more befitting a mission-focused government agency, it should not simply follow tradition and provide a modest cut to everyone taking out an FHA loan but target borrowers who could most use the help with enough to make a meaningful difference.

Notes

¹ In its forward business, the FHA insures loans of a fixed term and amount that are collateralized by a property. In its reverse business, it insures lines of credit that are collateralized by a property. The reason the capital ratio for the two businesses together is higher than it is for either business individually is that the combined ratio includes

the mandatory appropriation from Congress in 2013 that was needed to cover the 2012 shortfall in the MMI Fund. The appropriation accounts for 0.13 percent of the capital ratio.

- ² Laurie Goodman and Karan Kaul, “The FHA’s New Loss Mitigation Waterfall Will Offer Much-Needed Relief to Borrowers Exiting Forbearance,” *Urban Wire* (blog), Urban Institute, August 25, 2021, <https://www.urban.org/urban-wire/fhas-new-loss-mitigation-waterfall-will-offer-much-needed-relief-borrowers-exiting-forbearance>.
- ³ Black Knight reports that, across the entire market, 1.695 million borrowers were more than 90 days delinquent on their mortgages (including those in foreclosure), 1.171 million of whom were in forbearance (Black Knight 2021). Of the 524,000 who were not in forbearance, 298,000 were seriously delinquent before the pandemic. These 524,000 borrowers include those in active loss mitigation plans, those who fell out of forbearance programs but are not in active loss mitigation, and those who were never in forbearance programs.
- ⁴ We know 29.5 percent of 2019 originations were for loans up to \$200,000 and another 19.3 percent of originations were for loans of \$200,000 to \$250,000. If the FHA wanted to spend 175 basis points, it could reduce the premium on loans up to \$200,000 loans to 20 basis points and reduce the premium on loans of \$200,000 to \$250,000 to 45 basis points.

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Laurie Goodman is an Institute fellow and the founder of the Housing Finance Policy Center at the Urban Institute. The center provides policymakers with data-driven analyses of housing finance policy issues that they can depend on for relevance, accuracy, and independence. Before joining Urban, Goodman spent 30 years as an analyst and research department manager at several Wall Street firms. From 2008 to 2013, she was a senior managing director at Amherst Securities Group LP, a boutique broker-dealer specializing in securitized products, where her strategy effort became known for its analysis of housing policy issues. From 1993 to 2008, Goodman was head of global fixed income research and manager of US securitized products research at UBS and predecessor firms, which were ranked first by *Institutional Investor* for 11 straight years. Before that, she held research and portfolio management positions at several Wall Street firms. She began her career as a senior economist at the Federal Reserve Bank of New York. Goodman was inducted into the Fixed Income Analysts Hall of Fame in 2009. Goodman serves on the board of directors of MFA Financial, Arch Capital Group Ltd., Home Point Capital Inc., and DBRS Inc. and is a consultant to the Amherst Group. She has published more than 200 journal articles and has coauthored and coedited five books. Goodman has a BA in mathematics from the University of Pennsylvania and an AM and PhD in economics from Stanford University.

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