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The Case for Lower FHA Premiums

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Abstract

The economy has made significant progress since the Great Recession. Job growth is strong and unemployment is quickly declining. Despite these gains, the economy remains uncomfortably far from full employment.

The still-struggling single-family housing market is the principal reason. Housing has recovered somewhat since the bust, but the recovery went sideways last year. Home sales and single-family construction remain well below what is typical in a well-functioning housing market.

Policymakers are thus appropriately focused on addressing the problems that continue to plague housing. Most recently, the Federal Housing Administration announced that it will reduce its annual mortgage insurance premium. For a typical FHA loan, the premium will be reduced by half a percentage point at the end of January. This is a meaningful change that should boost lagging first-time homebuyer demand and prompt more lower-income households to refinance their mortgages to reduce their monthly payments.

The Case for Lower FHA Premiums

BY MARK ZANDI AND CRISTIAN DERITIS

The economy has made significant progress since the Great Recession. Job growth is strong and unemployment is quickly declining. Despite these gains, the economy remains uncomfortably far from full employment.

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Despite the reduction in insurance premiums, they will remain high by historical standards and high enough to ensure the FHA's mortgage insurance fund continues to build. Under reasonable assumptions, the fund will be big enough by early in the next decade to ensure that the FHA will not need taxpayer help if the nation suffers another financial crisis like the Great Recession.

Though the FHA's decision to lower its insurance premium is controversial, it is appropriate. It furthers the FHA's mission to provide affordable mortgage loans to creditworthy first-time and lower-income homebuyers, and it fully protects taxpayers from losses on those loans.

Housing and full employment

The economy has come a long way since the Great Recession. Almost six years into the recovery, job growth is strong, the stock market is near record highs, and the nation's fiscal situation is stable. Consumer and business confidence is as strong as it has been since before the downturn.

Yet, the economy has not fully recovered. Unemployment and underemployment are still painfully high, amounting to an estimated 1.25% of the labor force.[1] Workers' pay has been just keeping up with the pace of inflation, and thus living standards are moribund.

Housing has been critical to shaping the economy's performance since the turn of the century. Booming homebuilding and surging house prices along with the resulting wealth effects powered growth in the early 2000s. Housing's crash was the principal catalyst for the Great Recession. And housing's slow resurrection in the past several years has contributed modestly to the recovery (see Chart 1).

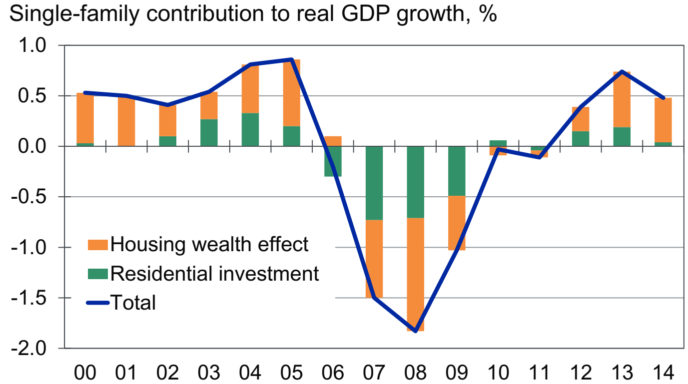
Most of that contribution has been via higher house prices and the wealth effects on consumer spending. Single-family homebuilding remains depressed. Fewer than 650,000 homes were built in 2014, which, outside of the recent period, is the fewest since the height of World War II.

Current construction is well below the level necessary to meet demand in a typical year, an estimated 1.2 million single-family homes.[2] The 550,000-unit shortfall in construction (1.2 million trend housing starts less current construction of 650,000 units) represents close to 2.5% of GDP.[3] This is approximately equal to the current output gap—the difference between actual and potential GDP.

The shortfall in housing construction is also largely responsible for the slack in the labor market. Each single-family start supports approximately 3.5 full-time man-years in a wide range of activities, including construction, manufacturing, transportation, financial services and retailing. Increased housing starts of 550,000 units would thus

Chart 1: Housing Swings to Tailwind

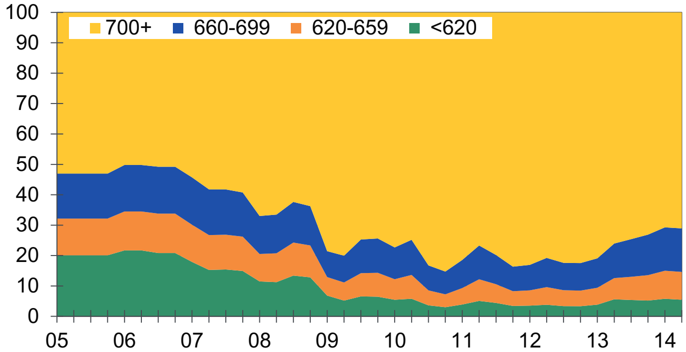
Single-family contribution to real GDP growth, %



Source: Moody's Analytics

Chart 2: Mortgage Lending Standards Are Tight

% of originations by vintage by credit score



Sources: Equifax, Moody's Analytics

generate approximately 1.9 million more jobs, equal to 1.25% of the labor force.

Housing headwinds

The single-family housing recovery has been held back by an unfortunate combination of factors. The heretofore tough job market has been hard on the finances and credit scores of potential homebuyers. And many would-be homebuyers have been frightened by the roller-coaster swings in house prices. Millions of others who remain under water on their homes are unable to move.[4]

Homebuilders have also been focused on building large, expensive homes, and have been aggressive in raising house prices. Any increase in mortgage rates, such as the jump that occurred in summer 2013, makes new homes unaffordable to most potential buyers. Some builders have since begun to build smaller homes and have become more circumspect with their pricing, but this has yet to jog sales.

Arguably the most significant headwind to single-family housing has been the dearth of first-time homebuyers. The lack of first-timers makes it difficult for trade-up buyers to sell their homes, ultimately hurting sales of new homes and single-family construction.

According to the National Association of Realtors profile of homebuyers and sellers, only one-third of sales of primary residences in 2014 went to first-timers.[5] This compares with a peak of one-half of sales in 2010 and an average closer to 40% of sales since the turn of the century.

Demographics have not been helpful. Most households purchase their first home when they are in their mid- to late 30s, and given the bad economy, they may have pushed this off into their early 40s. The population between the ages of 35 and 44 has declined by more than 5 million people, a 10% decrease, since peaking in 2000.[6]

Extraordinarily tight mortgage credit standards have been tough on all homebuyers, but especially first-timers. The nation's largest bank mortgage lenders, which historically have dominated the mortgage lending business, have been particularly cautious in their lending as they scale back their operations. These systemically important banks are grappling with higher capital and liquidity standards, significant changes to lending and servicing regulations, and large legal, regulatory and reputational costs of their lending during the housing bubble.

Smaller nonbank financial institutions are stepping up their mortgage lending to fill the void left by the large bank lenders, but it is taking time, and mortgage loans remain tough to get. This is especially true for those with lower credit scores or thin credit files, like many first-timers (see Chart 2).

FHFA response

Policymakers appear to recognize that revitalizing the stalled housing recovery is critical to quickly returning the economy to full employment. To this end, they have been working to expand the availability of mortgage credit and lower its cost.

Recently notable is the Federal Housing Finance Agency's work with Fannie Mae and Freddie Mac to clarify their representation and warranty process.[7] Lenders generally acknowledge that much of the lending done during the housing bubble was egregious, but they also felt that the rep and warranty guidelines and their implementation were unclear.[8] Without a clear understanding of when the credit risk of a loan transfers from lenders to Fannie and Freddie, lenders balked at underwriting borrowers with less than perfect credit for fear that they would be dragged into a legal fight should the borrowers default.

The FHFA and the government-sponsored enterprises have recently responded to these concerns, changing and clarifying their guidelines to limit long-term liability but requiring more upfront due diligence to screen out problem loans. This appears to have eased lenders' concerns over buybacks on loans that eventually get into trouble and should lead to an easing of underwriting standards and more new lending.

The FHFA's recent decision to allow the GSEs to purchase certain mortgage loans with only a 3% down payment should also increase the availability of mortgage credit. Eligibility for these loans will be restricted to lower-income borrowers who live in their homes, and if the loan is purchased by Fannie Mae, the borrower must also be a first-time homebuyer.

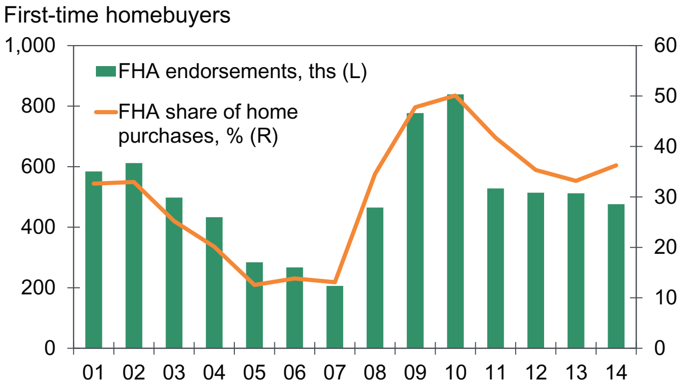
Fannie and Freddie had increased their down payment requirements to 5% just a few years ago over worries that 3%-down loans were too risky. To mitigate this risk, the 3%-down loans Fannie and Freddie will soon begin to purchase will have other restrictions and compensating factors. Borrowers will need to have at least a 660 credit score, they must receive homeownership counseling, and if the loan is purchased by Freddie Mac, their debt-to-income ratio will have to be less than 43%.

FHA's turn

Policymakers are now focused on increasing the availability and lowering the cost of FHA loans. Historically, the availability of FHA lending has been critical for first-time homebuyers, low-income households, and minority families.

Since the housing market hit bottom in 2011, the FHA has provided approximately 500,000 loans to first-time homebuy-

Chart 3: FHA Is Vital to First-Time Homebuyers



Sources: FHA, NAR, Moody's Analytics

ers per year, accounting for one-third of all its purchase loans (see Chart 3). Well more than three-quarters of the purchase loans insured by the FHA during the housing recovery have been for first-timers. Unless the FHA increases its lending, it is hard to see how first-time homebuyers will be able to afford to purchase homes, and thus for housing to contribute to achieving full employment.

The FHA is working to expand credit on a number of fronts, including providing lenders with more clarity and relief around its indemnification policies. The FHA's task is even more complicated than that of the GSEs, given all the parties involved in FHA enforcement, such as the Justice Department and the Department of Housing and Urban Development's inspector general.

The FHA is also modifying its approach to evaluating lenders' credit performance. Lenders are currently judged based on how defaults on their loans compare with industry averages. But in times like these, when the industry is exceedingly cautious in its lending, this type of comparison forces all lenders to be similarly conservative.

The FHA plans to supplement this approach by judging lenders based on their performance compared with the FHA's default tolerance across various borrower risk characteristics. If a lender is making loans to borrowers with lower credit scores, for example, it will have more defaults, but as long as those defaults are within the FHA's expectations, the lender will not be judged poorly. This should encourage lenders to increase origination to more homebuyers.

Lower FHA premiums

Most important, the FHA plans to reduce its mortgage insurance premium (see Box). Homebuyers with a typical FHA loan have been paying record high combined up-front and annual mortgage insurance premiums (see Table 1). Assuming that the typical loan has a five-year duration, the FHA's mortgage insurance premiums add 170 basis points to the loan's mortgage rate. This is nearly double the mortgage insurance premiums on the typical FHA loan at the start of the Great Recession.

Although Fannie and Freddie have also substantially increased their guarantee fees since the recession, the FHA's mortgage insurance premiums have increased even more.[9] FHA loans are currently only a better deal for mortgage borrowers with a credit score of less than 680 who put 5% or less down (see Table 2).[10]

FHA endorsements have weakened substantially. At the peak of FHA lending in 2010, the FHA insured close to $200 billion in purchase mortgages, accounting for 35% of all purchase originations (see Chart 4). Only $100 billion in purchase originations were insured in 2014, accounting for 15% of the market. Without a reduction in the FHA's mortgage insurance premiums, its share of lending is on track to fall substantially further

FHA Mortgage Insurance Premium Tutorial

Homeowners with an FHA-insured mortgage pay insurance premiums to the FHA to protect against the possibility that they will default on their mortgage. There is a onetime up-front premium and an annual premium. The premiums depend on the loan's characteristics, including the maturity of the loan, its loan-to-value ratio, and the loan balance.

The FHA has changed its up-front and annual insurance premiums several times since the recession. The current up-front premium is 1.75% of the homeowner's loan size. The up-front premium is added to the loan balance, although it does not affect the loan's loan-to-value ratio. If the loan is refinanced within 36 months of closing, the FHA will give the borrower a refund on the unused portion of the up-front premium.

The annual premium is paid via the borrower's monthly mortgage payment. The size of the premium depends on the loan's specific characteristics. For a typical 30-year loan with a loan-to-value ratio of more than 95%, the current annual premium is 1.35%. The FHA will reduce the annual premium to 0.85% at the end of January.

First-time homebuyers using the FHA's new Homeowners Armed With Knowledge program receive a discount of 50 basis points on the upfront mortgage insurance premium and up to 25 basis points on the annual premium.

For homeowners with a 30-year FHA loan that was closed before June 3, 2013, the insurance premium is canceled once the loan reaches a 78% loan-to-value ratio and the borrower has paid the premium for at least 60 months. The loan-to-value ratio calculations are based on the FHA's last known value of the home, which for many is the value of the home at the date of purchase. For homeowners with an FHA loan that has closed after June 3, 2013, the insurance premium is paid for the life of the loan.

Table 1: FHA Mortgage Insurance Premiums

Bps

	Up-front MIP	Annual MIP	Mortgage rate impact
1/1/2001 - 7/13/2008	150	50	80
7/14/2008 - 4/4/2010	175	55	90
4/5/2010 - 10/3/2010	225	55	100
10/4/2010 - 4/17/2011	100	90	110
4/18/2011 - 4/8/2012	100	115	135
4/9/2012 - 6/10/2012	175	125	160
6/11/2012 - 3/31/2013	175	125	160
4/1/2013 - current	175	135	170

Note: MIP for typical purchase loans with an LTV of 95% and loan term longer than 15 yrs.

Sources: Ginnie Mae, Moody's Analytics

this year, particularly as the GSEs' 3%-down loan program gains traction.

The FHA's receding footprint reflects in part a healthier mortgage market. In 2010, private lenders were still reeling from the housing crash and financial crisis and were in no position to lend. The FHA admirably played its role as the mortgage market's lender of last resort, filling the void left by private lenders.[11]

But although the private mortgage market is functioning better, it is far from normal. The private-label residential mortgage securities market has yet to recover, and big-bank mortgage lenders are scaling back their activities. While the private market remains on the sidelines, it is appropriate for the FHA to increase its support to the mortgage market by reducing its insurance premiums.

Sizing the premiums

Of course, the FHA's mortgage insurance premiums must balance the agency's mission to provide affordable mortgage loans to creditworthy first-time and lower-income homebuyers with its mandate to fully protect U.S. taxpayers from the cost of defaulting loans.

Since the 1990 National Affordable Housing Act, the benchmark for protecting taxpayers has been to capitalize on the FHA's insurance fund, the Mutual Mortgage Insurance Fund, to at least 2%.[12] The insurance fund was depleted during the housing crash, and the FHA has been understandably reluctant to reduce its mortgage insurance premiums until its 2% capital ratio is restored. According to the FHA's actuary, which provides projections of the performance of the Mutual Mortgage Insurance Fund, this will not happen until fiscal 2016.[13]

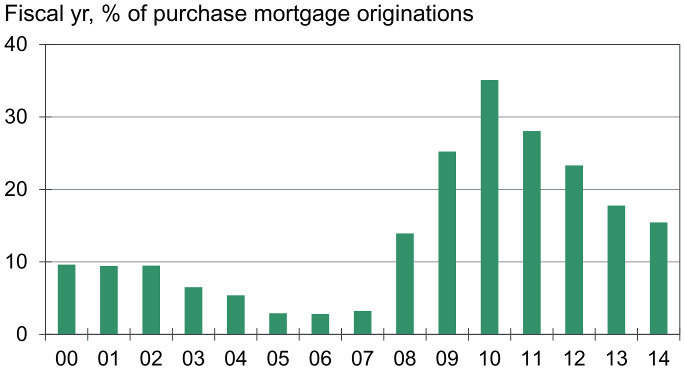
This seems optimistic. The insurance fund includes the FHA's insurance of single-family mortgages through its forward loan program, and reverse mortgages through its Home Equity Conversion Mortgage program. That program is a substantial drag on the fund, and according to the actuary will remain so until fiscal 2019 (see Chart 5).

However, this forecast critically depends on the outlook for long-term interest rates. As forecasts for long-term rates have declined, so too has the present value of the Home Equity Conversion Mortgage program.[14] The program's finances appear more fragile, not because its expected credit performance has changed, but only because the interest rate used to discount its future cash flows is lower. If long-term rate projections continue to be reduced, which is entirely possible since rates remain unexpectedly low, the program's value will fall as well, delaying when the Mutual Mortgage Insurance Fund reaches a 2% capitalization.[15]

There is no particular reason why the FHA's forward loan and Home Equity Conversion Mortgage programs should be lumped together when considering the adequacy of the Mutual Mortgage Insurance Fund.[16] As it is now, the forward loan program is effectively subsidizing HECM. Moreover, conflating the programs complicates evaluating the finances of these very different programs. By excluding HECM, the insurance fund would get back to 2% by mid-2015.

Chart 4: FHA's Mortgage Market Share Recedes

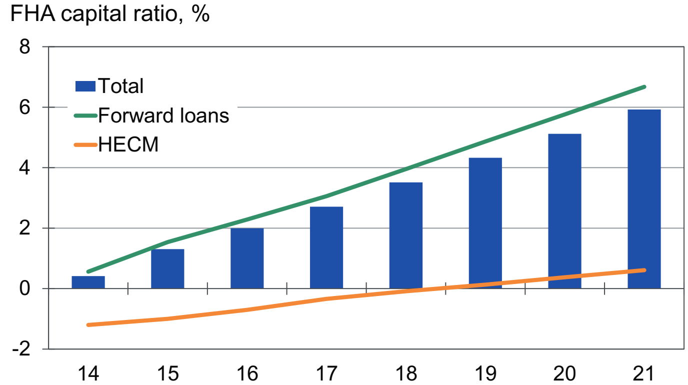
Fiscal yr, % of purchase mortgage originations



Sources: FHA, Mortgage Bankers Association, Moody's Analytics

Chart 5: MMIF Builds Rapidly at Current Pricing

FHA capital ratio, %



Sources: IFE, Moody's Analytics

Table 2: Who Provides the Better Deal: FHA or Fannie/Freddie?

$ savings on monthly mortgage payments, GSE vs. FHA loan

	Monthly savings on GSE loan vs. FHA loan				
Credit score	Current	After 50-bps reduction in FHA premiums	After reduction in GSE LLPA by half	% of purchase originations Fannie/Freddie	FHA
85% LTV					
760+	159	87	94	3.1	0.1
740-759	152	81	88	1.0	0.0
720-739	152	81	88	0.7	0.1
700-719	130	58	72	0.6	0.2
680-699	118	45	65	0.4	0.3
660-679	79	8	42	0.2	0.3
640-659	65	-6	35	0.1	0.2
620-640	65	-6	35	0.0	0.1
90% LTV					
760+	142	66	73	16.1	0.4
740-759	133	58	65	5.6	0.2
720-739	133	58	65	4.3	0.3
700-719	98	22	36	3.5	0.6
680-699	98	22	36	2.5	0.8
660-679	45	-30	-1	1.3	0.8
640-659	31	-45	-8	0.6	0.8
620-639	16	-59	-15	0.2	0.3
95% LTV					
760+	132	44	51	23.3	0.8
740-759	118	30	37	10.1	0.5
720-739	118	30	37	8.8	0.7
700-719	56	-32	-17	6.5	1.1
680-699	56	-32	-17	5.3	1.5
660-679	-20	-108	-78	2.6	1.6
640-659	-35	-124	-85	1.0	1.6
620-639	-51	-139	-93	0.4	0.7
97% LTV					
760+	44	-46	-38	0.5	5.8
740-759	35	-55	-47	0.3	4.3
720-739	35	-55	-47	0.3	5.9
700-719	-17	-108	-92	0.3	9.3
680-699	-17	-108	-92	0.2	13.5
660-679	-79	-169	-138	0.1	16.8
640-659	-95	-185	-145	0.1	17.9
620-639	-194	-285	-237	0.0	7.5

Assumes a $220,000, 30-yr fixed rate mortgage loan.

Sources: Goldman Sachs Global Investment Research, Moody's Analytics

A 2% capitalization is also inappropriately low for the insurance fund longer run. Indeed, to protect taxpayers, it is reasonable to require that the FHA has financial resources sufficient to withstand losses on defaults if another cataclysmic economic event like the Great Recession were to occur.

The FHA suffered losses due to that downturn of closer to 8.5%.[17] The losses overwhelmed the FHA's financial resources, which include the Mutual Mortgage Insurance Fund and insurance premiums paid by borrowers. As a result, in 2013, for the first time in its 80-year history, the FHA needed financial help from the Treasury.

For the FHA to be prepared for the next Great Recession-like crisis, it thus needs financial resources of at least 8.5%. Under conservative assumptions, the ongoing insurance premiums paid by borrowers will provide claims-paying resources of approximately 4% over a five-year period, requiring the insurance fund to be capitalized to 4.5%.[18]

The fund doesn't need to reach this capitalization soon. The Great Recession was the proverbial 100-year financial flood, and the next one is surely many decades away—especially since house prices, the principal driver of default, appear low relative to household incomes and rents. There is no sign that the housing market is even overvalued, except perhaps in a handful of hot metro areas such as San Francisco and Miami.[19] The FHA should not take decades to fully fund the Mutual Mortgage Insurance Fund, but there is no rush to recapitalize overnight either. Given the negative consequences that can arise from increasing premiums too soon, it would be perfectly reasonable if the FHA took as long as a decade to fully capitalize the fund.

To fully protect taxpayers, the FHA's mortgage insurance premiums should be set so that the insurance fund achieves a 4.5% capitalization rate within the next decade.

Economic impact

Reducing FHA insurance premiums by 50 basis points will not be a panacea for the housing market and economy, but it will provide a meaningful boost to both.[20]

Only a group made up primarily of first-time and lower-income homebuyers will benefit from the lower FHA premiums, but their home purchases are more sensitive to changes in mortgage rates than those of trade-up and high-income homebuyers. Their ability to purchase a home is often constrained by the size of their mortgage payments, so small changes in affordability prompt disproportionate changes in housing demand.

To assess the impact of the FHA's premium changes on the housing market and economy, the Moody's Analytics macroeconomic model was simulated. The housing sector in the macro model includes equations for new- and existing-home sales, single- and multifamily housing starts and completions, new- and existing-home prices, vacancy rates, and rents. The simulation accounts for differences in the mortgage rate elasticity of borrowers across various credit score bands.

Based on the simulation, the lower FHA premiums result in 45,000 more new- and existing-home sales in 2015 and almost 20,000 more single-family housing starts. At the peak of the housing market impact in mid-2016, annualized home sales are close to 100,000 units higher, and there are 40,000 more annualized single-family housing starts.

The increased housing activity supports 140,000 more jobs at its peak impact in mid-2016, which lowers the unemployment rate by about 0.1 percentage point. Approximately one-tenth of the current labor market gap is closed by lowering FHA premiums.

The lower FHA premiums also provide an added, albeit small, economic benefit from increased refinancing activity. This may be especially potent now with the recent sharp decline in long-term interest rates. Mortgage rates broadly have declined by nearly a percentage point since this time last year and are low enough that hundreds of thousands of FHA borrowers are in the money. That is, current FHA loan rates are low enough that it makes financial sense for these homeowners to refinance, particularly with the lower insurance premiums.

Insurance fund impact

The lower FHA insurance premiums will delay when the Mutual Mortgage Insurance Fund reaches its 2% and 4.5% target capitalizations, but the delay will be modest.

Under the current record high mortgage insurance premiums, the insurance fund would reach a 2% capital ratio by 2017, and a 4.5% ratio by 2021. This is more pessimistic than what the FHA's actuary expects because of lower long-term interest rate assumptions and their negative impact on Home Equity Conversion Mortgage financial results. It also incorporates the impact of the GSEs' new 3% down payment program, which was not in place when the actuary did its projections for the insurance fund.

Under the new lower mortgage insurance premiums, the insurance fund will reach a 2% capital ratio by 2018, only one year later, and a 4.5% ratio by 2024, three years later.

Helping to shorten the delay in building the insurance fund under the lower mortgage insurance premiums is the stronger and better-quality FHA lending that the lower premiums would support. The sensitivity of FHA loan volumes and quality to the insurance premiums it charges is evident from the sharp decline in FHA lending last year. Refinancing activity dried up as the higher-quality borrowers who did refinance moved to cheaper Fannie/Freddie loans. The surge in long-term interest rates in late 2013 contributed to this, but the record high mortgage insurance premiums were also a major factor. Lower lending volumes and adverse selection significantly reduced the insurance fund's economic value and capital ratio in 2014.[21]

Budget impact

Lower FHA premiums will cost U.S. taxpayers approximately $3 billion over the next decade. This is based on traditional FHA accounting rules, which include Federal Credit Reform Act accounting and static scoring. That accounting uses Treasury yields to discount future FHA cash flows.

The cost to taxpayers would be measurably higher under fair value accounting rules, which discount future cash flows with the higher discount rate that the private sector would charge for providing mortgage insurance for FHA borrowers. The Congressional Budget Office has begun to use fair value accounting more often for evaluating subsidized credit programs, but for the FHA, by law the official budgetary impacts are determined using Federal Credit Reform Act accounting.

The cost to taxpayers would be measurably lower under dynamic scoring, which uses models such as the Moody's Analytics macro model to determine the full macroeconomic, and thus budgetary, impacts of a change in fiscal policy. Since the lower FHA premiums support a stronger economy, broader tax revenues are lifted and government spending is reduced. This largely offsets the direct costs of the lower FHA premiums.

While dynamic scoring presents its own set of challenges when it comes to evaluating policy that are beyond the scope of this study, we note that the cost to taxpayers of the change in FHA premiums is likely to be small—even in Federal Credit Reform Act terms—relative to the benefits from reigniting the housing market.

FHA market share impact

The FHA's lower insurance premium will stabilize its share of the mortgage market. Its share would have meaningfully declined otherwise as Fannie and Freddie's 3% down payment programs geared up.

To see this, consider if the GSEs' 3% down payment programs had been in place in 2014. Approximately 80% of FHA loans used to purchase a home last year, equal to about $75 billion, went to borrowers with down payments of 3% to 5%. Of these loans, approximately $22 billion would have qualified for Fannie and Freddie's new low down payment programs, and most of these would have gone to the GSEs because of their lower costs and mortgage rates. FHA volumes would have been reduced by an estimated 20%.

It is also important to note that most of the lending the FHA would have lost to the GSEs would have been to borrowers with higher credit scores and thus lower expected losses. The lower volumes and adverse selection would have meaningfully weakened the FHA's financial position.

The FHA's market share in coming months will depend on a pending FHFA decision regarding Fannie's and Freddie's guarantee fees. The FHFA is considering whether to reduce the loan level pricing adjustments the GSEs charge borrowers with lower credit scores and higher loan-to-value ratios. If the FHFA decides to cut the loan level pricing adjustments in half, for example, then FHA loans are clearly a better deal only for borrowers who put 5% or less down with scores of less than 680 (see Table 2).[22]

Conclusions

After nearly a decade of financial pain and suffering, the U.S. economy is back within striking distance of full employment. Job growth is strong and unemployment is quickly declining. The only remaining significant impediment to full employment is the still-fragile housing market.

Policymakers have worked hard to support the housing market since it crashed. The Federal Reserve has purchased nearly $2 trillion worth of mortgage securities to bring down mortgage rates as part of its quantitative easing programs. Fiscal policymakers have tried many things, ranging from temporary tax credits for first-time homebuyers during the recession to recently allowing the GSEs to make loans with as little as a 3% down payment.

Partly because of policymakers' efforts, housing is on the mend. However, housing remains far from normal, and policymakers should continue to support it. While there is no magic policy bullet, allowing the FHA to reduce its insurance premiums for first-time and lower-income homebuyers will provide a meaningful boost. It will also protect taxpayers, as the premiums are high enough to put the FHA on solid financial ground.

Endnotes

1 The labor market gap includes long-term unemployed, discouraged workers who are not looking for work and thus not in the labor force but say they want a job, and part-time workers who would prefer to work full time.
2 Under reasonable assumptions regarding the pace of household formation, obsolescence of the stock of homes, second- and vacation-home demand, and the homeownership rate.
3 This includes construction output and the multiplier impacts on output in other industries.
4 An estimated 7 million homeowners are still under water on their homes. For context, underwater homeowners peaked close to 15 million in early 2011.
5 This is from July 2013 to June 2014.
6 This cohort will begin to grow next year as the leading edge of the large millennial generation turns 35.
7 When a lender originates a loan that is guaranteed by Fannie Mae or Freddie Mac or insured by the FHA, it makes a set of commitments, called reps and warranties in the industry, affirming that it has complied with the underwriting guidelines established by the government guarantors. If it is later determined that the loan did not comply with these reps and warranties, the guarantors can put the credit risk back to the lender. With Fannie and Freddie, this means forcing the lender to buy back the loan; with the FHA, it means forcing the lender to indemnify the agency for any insurance claim made on the loan. Since the Great Recession, mortgage lenders have been required to buy back and indemnify hundreds of thousands of loans, resulting in massive losses to lenders. This is described in more detail in "Opening the Credit Box", Jim Parrott and Mark Zandi, Moody's Analytics and Urban Institute white paper, September 2013.
8 For example, many lenders believe that they should be indemnified after a borrower makes timely payments for some prespecified time such as 36 months. They argue that if such a loan subsequently defaults, it is more likely to be because of a credit event such as a job loss than an underwriting from three years earlier.
9 The guarantee fees charged by Fannie Mae and Freddie Mac rose from 20 basis points prior to the recession to an average of closer to 60 bps currently.
10 This accounts for private mortgage insurance and lower GNMA security yields.
11 See "The FHA Admirably Fills the Void", Mark Zandi, Moody's Analytics white paper, January 2014.
12 This is capital equal to 2% of the FHA's insurance in force.
13 The FHA's 2014 actuarial report was more pessimistic regarding the MMIF than the 2013 report. In 2013, the actuary projected that the MMIF would achieve a 2% capital ratio by this fiscal year.
14 Forecasts for long-term interest rates have declined for a range of reasons, including prospects for quantitative easing by the European Central Bank and the decline in oil prices, which is reducing inflation and inflation expectations. Moody's Analytics provides the FHA's actuary with forecasts of house prices and long-term interest rates.
15 Moody's Analytics provides the economic forecasts, including the forecast for long-term interest rates.
16 This occurred as part of the Housing and Economic Recovery Act.
17 More precisely, this is expected lifetime losses on the FHA's portfolio of loans outstanding during the financial crisis. Losses on loans insured during the height of the housing bubble will ultimately rise to more than 15%, while loans insured when underwriting was more staid, such as in the 1990s and in recent years, will come in well below 5%.
18 The 4% in insurance premiums is based on the assumption that future MIPs will average closer to 100 bps and that the average duration is five to six years. It also assumes the FHA's 78% rule remains in place.
19 Even this may be overstated given strong housing demand from foreign buyers.
20 Despite the 50-bps reduction in FHA insurance premiums, mortgage rates on FHA loans are assumed to decline by only 45 basis points. The loan rate is equal to the sum of the insurance premium, lender's profits, and the yield on Ginnie Mae securities, which will rise by an assumed 5 bps to compensate investors for the increase in prepayment rates on FHA loans due to the lower rate.
21 The increase in MIPs in 2013 reduced the MMIF's economic value in 2014 by an estimated $3.5 billion and the MMIF's capital ratio by 35 basis points.
22 A discussion of the GSEs' appropriate guarantee fees is provided in "A General Theory of G-Fees", Mark Zandi and Cris DeRitis, Moody's Analytics white paper, October 2014.

About the Authors

Mark Zandi

Mark M. Zandi is chief economist of Moody's Analytics, where he directs economic research. Moody's Analytics, a subsidiary of Moody's Corp., is a leading provider of economic research, data and analytical tools. Dr. Zandi is a cofounder of Economy.com, which Moody's purchased in 2005.

Dr. Zandi's broad research interests encompass macroeconomics, financial markets and public policy. His recent research has focused on mortgage finance reform and the determinants of mortgage foreclosure and personal bankruptcy. He has analyzed the economic impact of various tax and government spending policies and assessed the appropriate monetary policy response to bubbles in asset markets.

A trusted adviser to policymakers and an influential source of economic analysis for businesses, journalists and the public, Dr. Zandi frequently testifies before Congress on topics including the economic outlook, the nation's daunting fiscal challenges, the merits of fiscal stimulus, financial regulatory reform, and foreclosure mitigation.

Dr. Zandi conducts regular briefings on the economy for corporate boards, trade associations and policymakers at all levels. He is on the board of directors of MGIC, the nation's largest private mortgage insurance company, and The Reinvestment Fund, a large CDFI that makes investments in disadvantaged neighborhoods. He is often quoted in national and global publications and interviewed by major news media outlets, and is a frequent guest on CNBC, NPR, Meet the Press, CNN, and various other national networks and news programs.

Dr. Zandi is the author of *Paying the Price: Ending the Great Recession and Beginning a New American Century*, which provides an assessment of the monetary and fiscal policy response to the Great Recession. His other book, *Financial Shock: A 360º Look at the Subprime Mortgage Implosion, and How to Avoid the Next Financial Crisis*, is described by the New York Times as the "clearest guide" to the financial crisis.

Dr. Zandi earned his B.S. from the Wharton School at the University of Pennsylvania and his PhD at the University of Pennsylvania. He lives with his wife and three children in the suburbs of Philadelphia.

Cristian deRitis

Cristian deRitis is a director in the Credit Analytics group at Moody's Analytics, where he develops probability of default, loss given default, and loss forecasting models for firms and industries; contributes to forecasts and analysis for CreditForecast.com; and writes periodic summaries of the consumer credit industry. His commentary on housing and mortgage markets, securitization, and financial regulatory reform often appears on the Dismal Scientist web site and in the Regional Financial Review.

Dr. deRitis' recent consulting work has included an evaluation of the efficacy and cost of the federal government's Home Affordable Modification Plan, and he is frequently consulted on credit risk modeling and measurement as well as housing policy. He helped develop the company's models to forecast the Case-Shiller and FHFA metropolitan house price indexes and is a regular contributor to the firm's Housing Market Monitor. Dr. deRitis also gives frequent presentations and interviews on the state of the U.S. housing, mortgage and credit markets.

In his previous work at Fannie Mae, Dr. deRitis supervised a team of economists who developed models of borrower default and prepayment behavior. He has published research on consumer credit and credit modeling as well as on the costs and benefits of community mediation. He received a PhD in economics from Johns Hopkins University, where he focused on the impact of technology on labor markets and income inequality. His bachelor's degree in economics is from the Honors College at Michigan State University.

About Moody's Analytics
Economic & Consumer Credit Analytics

Moody's Analytics helps capital markets and credit risk management professionals worldwide respond to an evolving marketplace with confidence. Through its team of economists, Moody's Analytics is a leading independent provider of data, analysis, modeling and forecasts on national and regional economies, financial markets, and credit risk.

Moody's Analytics tracks and analyzes trends in consumer credit and spending, output and income, mortgage activity, population, central bank behavior, and prices. Our customized models, concise and timely reports, and one of the largest assembled financial, economic and demographic databases support firms and policymakers in strategic planning, product and sales forecasting, credit risk and sensitivity management, and investment research. Our customers include multinational corporations, governments at all levels, central banks and financial regulators, retailers, mutual funds, financial institutions, utilities, residential and commercial real estate firms, insurance companies, and professional investors.

Our web periodicals and special publications cover every U.S. state and metropolitan area; countries throughout Europe, Asia and the Americas; the world's major cities; and the U.S. housing market and other industries. From our offices in the U.S., the United Kingdom, the Czech Republic and Australia, we provide up-to-the-minute reporting and analysis on the world's major economies.

Moody's Analytics added Economy.com to its portfolio in 2005. Now called Economic & Consumer Credit Analytics, this arm is based in West Chester PA, a suburb of Philadelphia, with offices in London, Prague and Sydney. More information is available at www.economy.com.

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