POLICY PERSPECTIVES

FHA/VA MORTGAGE ASSUMABILITY: MAKING IT WORK

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BACKGROUND

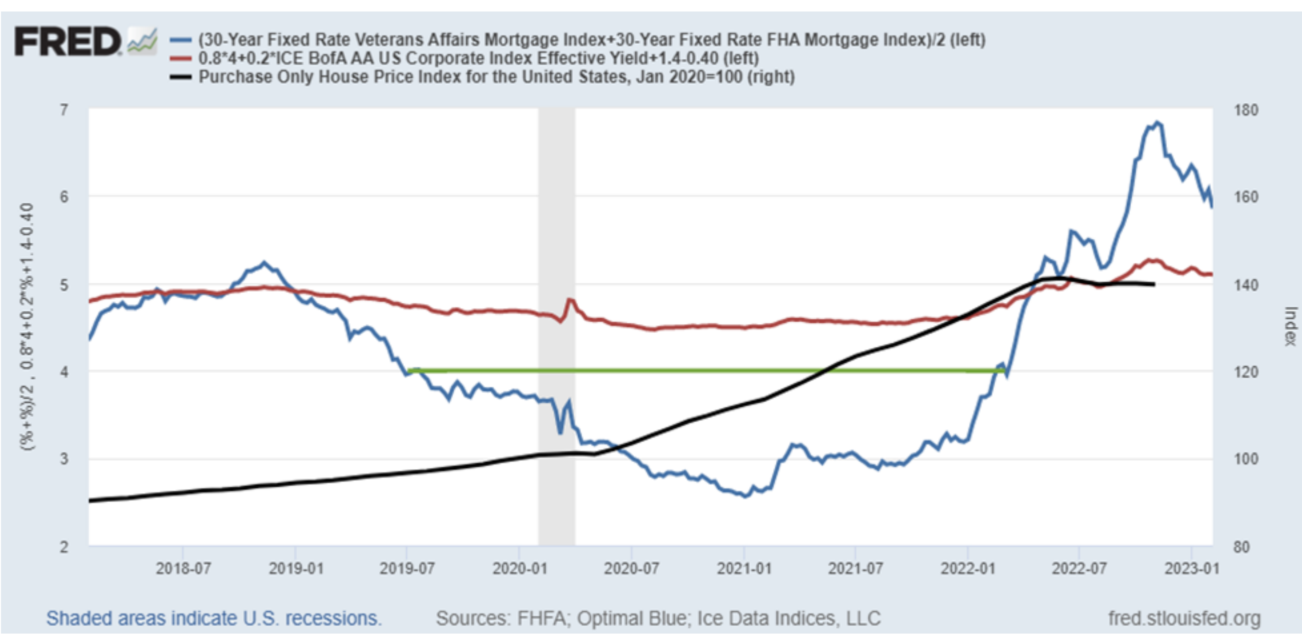
In this commentary, we use Andrew Davidson & Co., Inc. (AD&Co) analytics to determine, How can the financing gap be filled so that FHA/VA's valuable mortgage assumability provision can be widely effective?

The market for standardized mortgages is fairly efficient, with financing available from the GSEs, Ginnie Mae, and the banking system. In comparison, the market for 2nd liens is not as standardized or liquid, since (among other things) 2nds concentrate risk and inherently carry high capital weights. In markets when most mortgages are discount, a more liquid 2nds market can improve access to liquidity for owner populations who need it, such as first-time buyers and minorities who have less access to wealth. This option could help owners avoid using cash-out refis at higher rates that could, for example, cost them $20,000 in the value of the discount mortgage they pay off just to gain $20,000 in cash. The current combination of discount mortgages and increased housing prices makes this market opportunity quite large.

Mortgage rates rose 3% in 2022, and, for the first time in three decades, mortgage assumability options are valuable if they can be exercised. While not widely appreciated, loans in the $2 trillion Ginnie Mae securities market are insured by FHA, VA, and USDA, and are assumable. Rather than getting new loans at higher market rates, this option allows buyers to assume low-rate government mortgages when they buy houses from FHA/VA borrowers. GNMA bond market prices reflect the expected present value of the lower payment stream, so 4% FHA/VA mortgages provide roughly an extra 6 points of value to borrowers. This value can cover incremental risk and can be shared between buyers and sellers, expanding homeownership access without subsidy.

Figure 1 shows some key metrics. Current FHA mortgage rates are about 6% (blue line) now, but vast amounts of GNMA mortgages have recently been originated below 4%, with housing prices rising 20% or more. The red line reflects our estimate of the all-in cost of assumable FHA/VA loans combined with the private cost of gap financing. When this cost (red line) is below the government market rate, assumable 4% loans create value that can be shared by sellers and buyers.

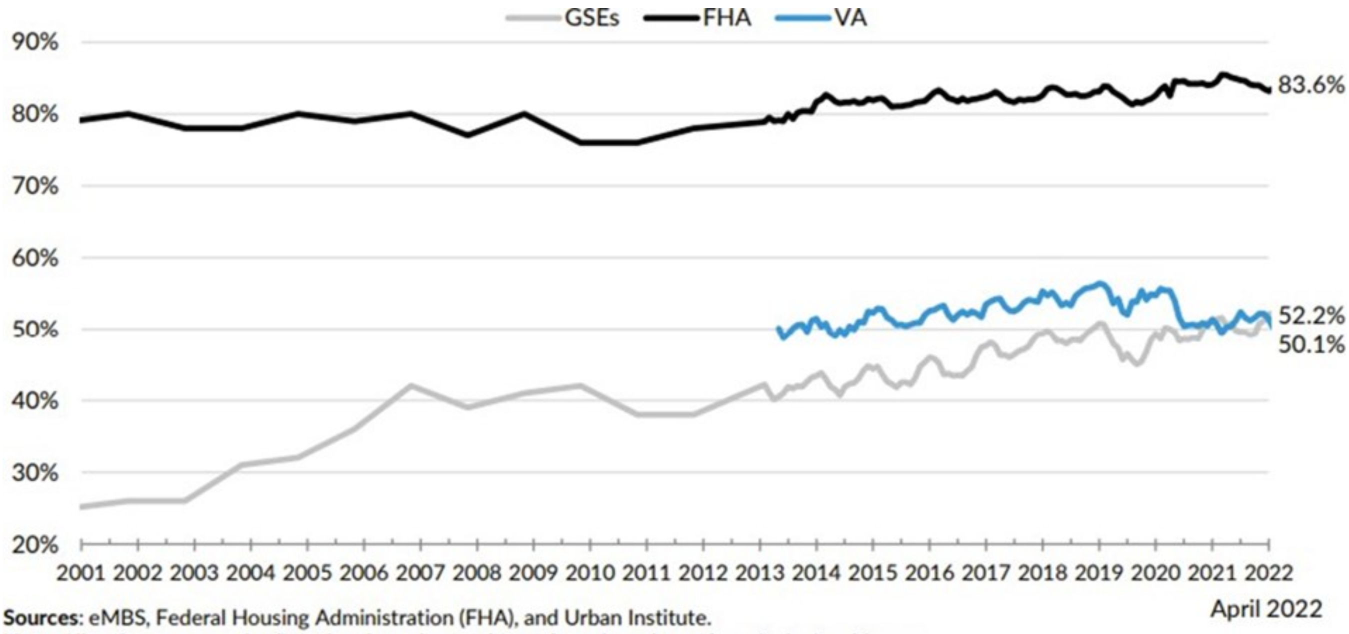
Figure 1. FHA Mortgage Rates and Housing Price Appreciation



BACKGROUND

An additional obstacle to FHA/VA assumability is that federal loans with low down payments are generally used by first-time homebuyers and also have much higher concentrations of minority borrowers. Because housing prices have risen in the past few years, additional financing will be needed to fill the gap between the current market value of the house, the small down payments of typical FHA/VA borrowers, and the remaining balance of assumable mortgages. A private market solution is needed because FHA/VA lack authority to insure 2nd liens. Is it viable?

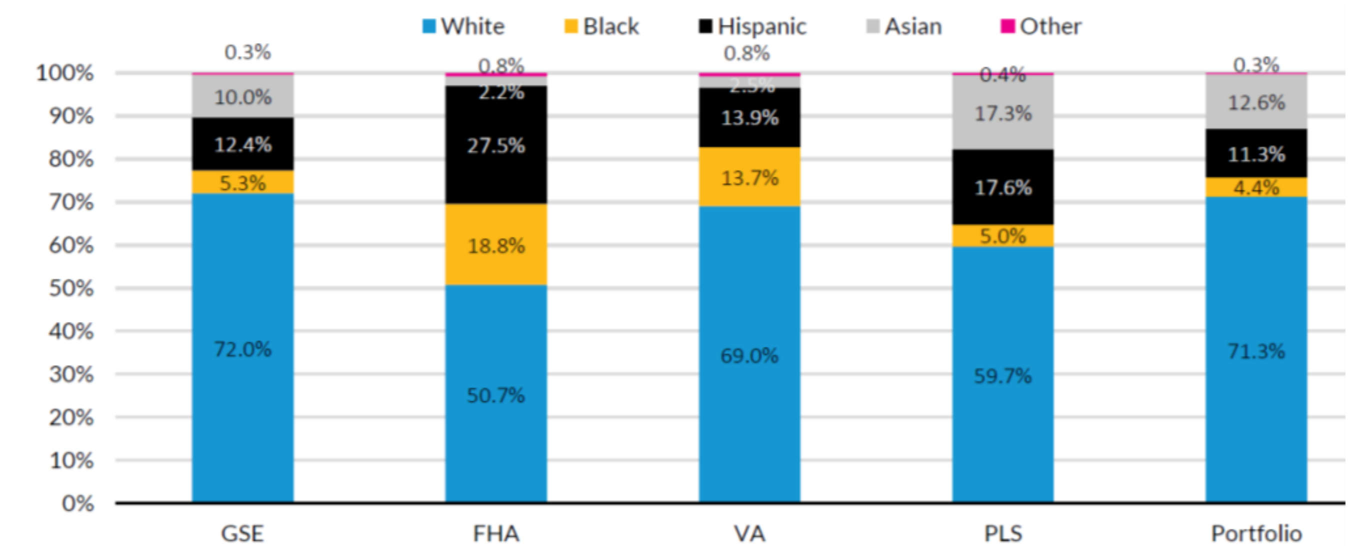
Figure 2. First-Time Homebuyer Share



Sources: eMBS, Federal Housing Administration (FHA), and Urban Institute.
Note: All series measure the first-time homebuyer share of purchase loans for principal residences.

FHA has long insured the highest percentage of minority loans. Nearly 20% of its record 2021 volume was composed of minority borrowers, which is several times higher than the conventional market. Considering the size of the government mortgage portfolio with rates under 4%, an insurable second mortgage product that serves low wealth FHA/VA borrowers and that is also attractive to investors could measurably advance minority and veteran homeownership and wealth creation. This solution could provide housing counselors, civil rights organizations, and minority real estate professionals with the ability to match targeted homebuyers with assumable loans that are below current market rates. Further, financial institutions could make progress on their CRA obligations by investing in these second mortgages.

Figure 3. 2021 Purchase Loan Channel Shares by Race



Source: 1997 to 2021 Home Mortgage Disclosure Act (HMDA).
Note: Includes purchase loans only. Shares based on loan counts

THE VALUE OF ASSUMABLE MORTAGES

The market value of borrower equity is the difference between the market value of the house and the market value of the mortgage. Premium mortgages at above market rates reduce borrower equity; discount mortgages with below market rates add to it. The size of the premium or discount is reflected in the GNMA bond market as the difference between the expected present value of mortgage payments at market rates compared to those at mortgage note rates. The incremental value to existing borrowers ranges from 3 to 20 points as measured by the market prices of GNMA MBS. Recent ultra-low mortgage rates helped raise homeownership rates for underserved populations. However, if these borrowers move, they pay off their discount mortgages at par and transfer the value to bond investors. This loss of value impedes the incentive to move (which is especially valuable for first-time homebuyers) and contributes to housing consumption disequilibrium by locking up entry-level housing supply. Finally, it eliminates the potential for gain—which could be retained by a gap financing solution—for new buyers.

Table 1 shows the market value and other key indicators of the Ginnie Mae MBS coupon stack for January 2023 settlement. GWAC is the mortgage rate, Coupon is the GNMA pass-through rate, and Price is the value of the bond relative to par. Nearly $1.5 trillion of FHA/VA mortgages were originated in the last few years at 4% or below. If 3% of these borrowers were to move annually, they and the new buyers could retain value on up to $45 billion of discount mortgages per year.

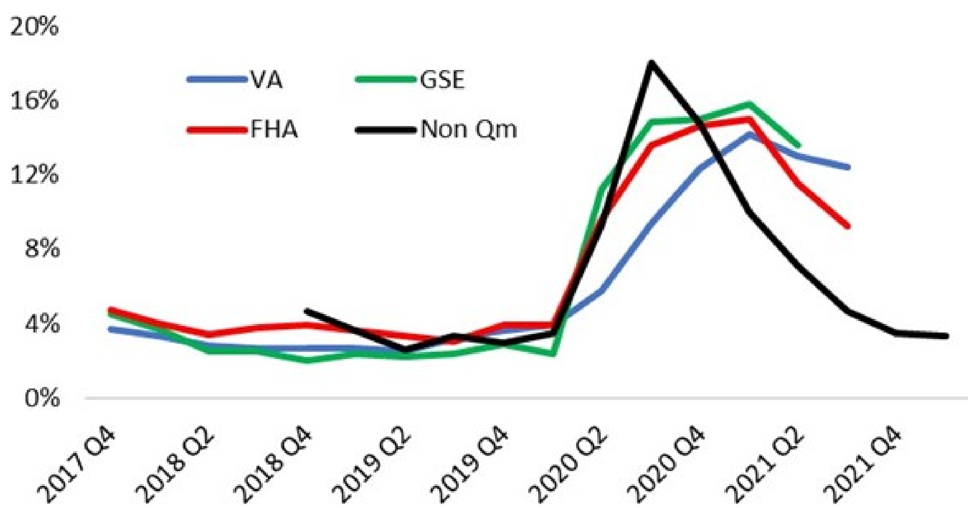
Table 1. Value of Assumable Mortgages by Coupon

GWAC	Coupon	Orig Bal	OLTV	Age	Price
1.98	1.5	$379	83	20	$ 80.20
2.51	2.0	$411	86	10	$ 83.62
3.01	2.5	$351	90	10	$ 86.41
3.46	3.0	$356	92	10	$ 88.89
3.95	3.5	$361	92	9	$ 91.73
4.52	4.0	$391	92	6	$ 94.56
5.02	4.5	$378	93	5	$ 96.95
5.52	5.0	$345	94	4	$ 98.98
5.98	5.5	$332	94	3	$100.47
6.50	6.0	$329	95	2	$101.55

For this proposed solution to work, the first requirement is that the assumable mortgages be significantly discount. Additionally, the risk embedded in the 2nd lien must be both priceable and investable. This means that the risk of 2nd liens can be quantified, and that institutions will are willing to finance them. It is well known that FHA and VA loans have higher delinquency and loss rates (FHA higher than VA) than GSE loans. FHA loans have higher risk drivers, such as credit score, LTV, and DTI that, in fact, account for the differences in performance. Comparing performance across these mortgage segments while controlling for the key risk drivers, Figure 3 shows that FHA loans perform similarly to other mortgage segments.

Figure 4 compares the "FHA Average" cohort for each of the three federal segments: GSE, VA, FHA, and non-QM (non-qualified mortgage). The FHA Average cohort is roughly 95 LTV, 680 FICO, 40 DTI for government lending, and about 90 LTV, 680 FICO for non-QM. The results illustrate that when adjusted for risk, mortgages perform similarly across market segments, even during the period of the pandemic economic shock. This implies that models using risk drivers that fit for one segment could fit for others. Default rates could be similar when controlling for risk, and the price of risk may vary more by segment fund cost than nominal losses. These results address the crucial requirement of priceability: FHA standards and borrowers are not "worse" than other mortgage segments, and their risk can be quantified like risk in other mortgage segments.

Figure 4. Delinquency Rates for FHA Average



However, there is essentially no market for high LTV 2nd liens for moderate credit score borrowers. We therefore propose insuring the 2nd lien up to investment grade risk, and then determining if this lower risk mortgage tranche that is rich in CRA credits is a more attractive investment. In today's frothy credit markets, such investors are likely to be those with federally connected balance sheets and fair lending obligations, like depositories.

Given housing price appreciation on recent 97% LTV government mortgages, current LTVs on such houses might easily be 80%. So as an example, we analyze a 4% assumable 1st lien accounting for 78% of house value and a 19% 2nd lien with a 3% downpayment. This neatly makes the financing 80% 1st and 20% 2nd. We analyzed this risk using AD&Co's Capital Charge Method at 12% ROE. We estimate that raising the investment quality of the 2nd lien roughly to AA (98% confidence) requires an insurance fee of about 1.4% across total financing (10% in PV), or about 7% annual risk premium on the 2nd lien alone. This fee, combined with 6% capital, provides about 16% protection divided across total financing, or 80% of the 2nd lien. Finally, we compare the risk of this structure to a new loan that FHA would insure at a market rate if this assumability product were not available. The risk to FHA when gap financing is included is about half the risk of a typical new FHA loan. We calculated the execution based on reducing the old 85 bps annual MIP to 45 bps. Since the standard fee is now 30 bps, the MIP could probably be further lowered to 25 bps on the assumed FHA loan protected by gap financing.

Table 2. Net Value of an Assumable Loan

Balance	Rate	Payment	Savings
$290,000	6.0%	$1739	
$240,000	4.0%	$1146	
$50,000	11.0%	$476	
$240,000	-0.4%	-$80	
$290,000	4.9%	$1542	$197

Now we can calculate the buyer's total financing cost: 80% @ 4% + 20% @ AA effective yield + 1.4% – 0.4%. The total cost of the second lien might be about 11%, representing about 20% of the new debt. The blended cost—including the FHA MIP reduction—is about 5%, compared with market rates around 6%. This 100 bps reduction in financing rate is worth 5–7 points in value to be shared by the seller and buyer.

CONCLUSION

Today's FHA/VA mortgage market offers the largest opportunity ever to reap the value of the assumability option included in government mortgages. Existing FHA/VA borrowers, with a high concentration of minority and first-time homebuyer households, currently own the value embedded in the large volume of low-rate mortgages originated in the last few years. Current and new FHA/VA borrowers can retain and share this value if they can exercise the assumability option. However, due to recent housing price appreciation, these generally low wealth households can only realize this value with effective gap financing through 2nd mortgages.

There is little demand for investment in high LTV 2nd liens of typical FHA/VA borrowers. However, the credit risk in government mortgages is fairly well understood and priceable. In the hope that lower risk mortgage assets that are rich in affordable housing credits may be sufficiently investable to catalyze the assumability option, we therefore propose insuring these 2nd liens up to investment grade. We find that assumable mortgages with coupons at least 2% below market rates have enough embedded value to not only pay for the cost of insuring the 2nd liens but also provide at least 5% of the value of the combined financing, a sum which would be shared between the sellers and buyers of homes financed with FHA/VA mortgages.

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