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Since the 1940s, Federal Housing Administration (FHA) loans have been a key to homeownership for many Americans with modest incomes. These government-insured loans have historically offered lower down payments and easier qualifying requirements than conventional loans.

To target the program to entry-level homebuyers, FHA loans have limits on the principal amount (each county has a loan limit based on typical local prices). Limits are adjusted annually. In recent years, limits have been raised substantially.

But how important is it for the FHA loan program to expand its coverage beyond the most affordable segments of the housing market? First-time buyers are finding it easier to secure conventional loans than in the past because of more liberal qualification requirements. Is there still a need for a government-insured home loan program?

Ease in Securing Loans

Despite the easing of conventional underwriting standards, market observers consider it easier to obtain an FHA loan than a conventional loan. Conventional lenders tend to disapprove loans if the monthly payment, including principal, interest,

taxes and insurance, exceeds 25 to 28 percent of the borrower's monthly income, depending on the type of loan. The FHA allows up to 29 percent.

The FHA also allows a borrower to have a higher total debt burden than most conventional lenders would allow. Total debt payment, including existing debts running for ten months or more, can be as much as 41 percent of income, compared with 36 percent for most conventional loans.

Lenders emphasize that these payment-to-income ratios are guidelines, not hard and fast rules. For both FHA and conventional loans, "compensating factors" such as an excellent credit record may be used to justify exceeding the guidelines. FHA loan policies allow more expansive use of such factors than conventional loans do.

Despite the recent ceiling increases, FHA loan maximums remain much lower than the limits on conventional loans, except in areas with high housing costs. For most areas, the

maximum FHA loan is \$132,000. Dallas has Texas' highest FHA loan limit at \$156,750. By contrast, private mortgage insurance (PMI) on conventional loans is limited to those loans eligible for purchase by Freddie Mac and Fannie Mae, which dictate an upper limit of \$275,000.

FHA loans have traditionally required a much lower down payment than conventional loans, making them particularly appealing to first-time homebuyers. In the past, borrowers were allowed to wrap closing costs and mortgage insurance premiums into the loan, bringing the loan total to more than 100 percent of the value of the home. In 1998, the FHA introduced a simplified method of calculating maximum loan amount that requires the borrower to make a cash investment at least equal to 3 percent of the value of the home. Part of this cash investment can be payment of closing costs in cash.

The maximum loan-to-value ratio (the amount borrowed compared with the lesser of the appraised value of the home or the sales price) depends on whether the home is located in a high- or low-settlement-cost state. In Texas, a high-settlement-cost state, an FHA loan can cover as much as 97.75 percent of acquisition costs (98.75 percent if the home costs less than \$50,000).

As competition for first-time homebuyers' business has increased, more and more lenders have begun offering conventional loans with 3 percent down payments (97 percent loan-to-value). Through the support of Fannie Mae and Freddie Mac, lenders have introduced an array of conventional loans designed to appeal to this group. Consequently, borrowers have a much broader selection of loans, and the FHA program is becoming less unique.

While FHA loans generally have lower cash requirements than conventional loans, they may carry a higher interest rate. Recent national rate quotes for FHA fixed-rate loans run about 20 basis points (0.2 percentage points) higher than those for conventional fixed-rate loans.

The table compares FHA and conventional loans on a \$70,000 home. The FHA loan is calculated at maximum loan-to-value and the conventional loan with 3 percent down. Closing costs for the FHA loan in this example are lower because some of the buyer's closing costs are paid by the seller. The monthly payment is higher because the up-front mortgage premium is financed into the loan.

Both conventional and FHA lenders require an appraisal of the property prior to approving the loan. The FHA, however, now requires appraisers to inspect the homes for specific defects. The agency instituted the inspection program in 1999 to help borrowers steer clear of homes needing significant repair work. The requirement may cause sales to fall through if sellers refuse to make required repairs.

Types of Loans Available

FHA's selection of loans includes standard fixed-rate loans and adjustable rate mortgages (ARMs). FHA's ARM has more restrictive payment adjustment caps, meaning the range of percentage rates the loan is subject to is smaller than the range applied to conventional loans. FHA's annual cap is 1 percent, with a lifetime cap of 5 percent, while the most common conventional ARMs have caps of 2 and 6 percent, respectively. As a result, FHA ARM borrowers are less exposed to interest rate volatility.

Conventional lenders typically offer a variety of ARMs featuring an initial fixed interest rate period followed by annual rate adjustments for the remainder of the term. The loans differ based on the length of the fixed-rate period; the shorter the fixed-rate period, the lower the initial interest rate. FHA began offering loans of this type in 2000.

FHA offers some loan options not available from conventional lenders. The FHA 203(k) loan offers people who buy "fixer-uppers" a single loan that covers the purchase of the home and the cost of rehabilitation. The FHA also insures reverse annuity mortgages, which allow older homeowners to obtain supplemental income through the equity in their homes.

How Loans are Insured

Mortgage insurance protects lenders if the borrower defaults on a loan. Without this insurance, lenders would not be willing to finance more than 80 percent of the cost of a home. FHA loans are insured by the federal government, while conventional loans may be insured by private mortgage insurance (PMI) companies.

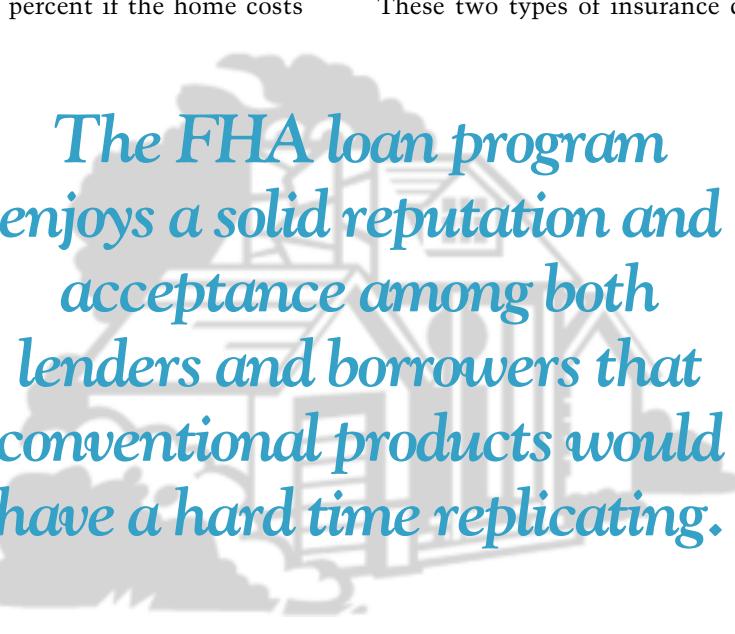
These two types of insurance coverage are fundamentally different. Insurance on FHA loans remains in effect until the loan is repaid. PMI, however, is in effect only as long as premiums are paid. Many lenders allow PMI insurance coverage to be cancelled when the value of the home is at least 20 percent higher than the outstanding mortgage principal amount. Federal legislation mandates cancellation in these circumstances on loans made since mid-1999. When PMI is cancelled, the borrower no longer has to pay the premiums.

FHA insurance cannot be cancelled. The borrower pays an initial mortgage premium when the loan is closed. Although many borrowers choose to include that premium amount in the loan, there is no provision for discontinuing payment of the premium when the loan principal is paid down. There is a provision for refunding part of the premium if the loan is repaid before it matures.

If the initial loan-to-value ratio on an FHA loan is more than 90 percent, an additional monthly premium is charged. This $\frac{1}{2}$ percentage point per year fee continues for a period that varies with the loan-to-value ratio. In the past, the monthly premium had to be paid until either the loan was paid off or the term of the fee ended. In late 2000, the Department of Housing and Urban Development allowed cancellation of monthly premiums on FHA loans when the loan-to-value ratio drops to 78 percent. Unlike PMI, insurance coverage would continue even after the payments cease.

PMI companies offer a variety of methods for paying insurance premiums. The borrower can choose from one lump sum payment, annual premiums or monthly premiums. Some lenders pay the premium if borrowers are willing to pay a higher interest rate. This allows borrowers to convert the nondeductible insurance expense into an interest expense that can be deducted from taxable income.

Freddie Mac recently reduced the amount of insurance coverage required for loans it buys, and if the borrower pays additional discount points or a higher interest rate, required coverage is reduced further. Because premiums for PMI are



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lower when the required coverage is lowered, monthly payments are reduced.

FHA Loan Program's Role in the Mortgage Market

If FHA loans are less unique in today's market, is the program still needed? Yes, reply its proponents, because the FHA loan program plays a role in the mortgage market that private insurers probably could not or would not fulfill if FHA was eliminated.

For decades, FHA has been synonymous with low-down-payment financing. Although the differences between FHA and conventional loans are disappearing, the FHA loan program is well known among lenders serving the entry-level market and has earned "brand loyalty" among many borrowers based on familiarity.

FHA loans are perceived as a "last resort" for those who cannot qualify for conventional financing. A 1995 study by the Government Accounting Office found that 66 percent of FHA borrowers would not have qualified if research disputes this, finders would qualify for conventional program may allow some buyers if they relied on conventional loans eventually be able to buy even

The FHA loan program is clearly meeting a need in inner cities, where the loans are more prevalent. According to 1998 Home Mortgage Disclosure Act data, 44 percent of FHA loans outstanding were in inner-city areas, compared with 38 percent of conventional loans. The FHA share was down from 46 percent in 1993 while the conventional share was unchanged.

Future Need for FHA Loans

To say that a segment of the housing market is totally dependent on FHA-insured loans is an exaggeration. The program does allow some borrowers to become homeowners sooner or buy a higher-priced home than would be possible with conventional financing. Each year when the FHA loan limit is increased, more people are able to take advantage of the program to become homeowners. However, many could have qualified anyway by saving a little more cash or choosing a less expensive home. The differences between FHA and conventional loans are even fewer in today's market, especially

considering Freddie Mac's and Fannie Mae's affordable housing programs.

But to say that FHA loans could be phased out of the market with little impact is an overstatement as well. The FHA loan program enjoys a solid reputation and acceptance among lenders as well as borrowers that conventional products would have a hard time replicating. Brand name recognition is important to borrowers, particularly as some unscrupulous lenders engage in predatory lending practices.

Conventional lenders' commitment to financing affordable housing is relatively new and may not survive long term. The current mood of expansiveness in lending practices stems in part from Freddie Mac's and Fannie Mae's need to demonstrate that they deserve their privileged quasigovernmental status, which allows them to borrow money at reduced interest rates. There are two other contributing factors. First, pressure is being exerted on lenders by local activists determined to see that money is being lent within the community per the Community Reinvestment Act. Second, the mortgage mar-

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ket looks safe now that delinquency and foreclosure rates are historically low.

Will the liberal terms first-time homebuyers are now able to get continue if the pressure to serve that group wanes? Will lenders be as generous if the economy slows and foreclosures rise? For the long-term health of the industry, should they

be so generous? Following the collapse of the savings and loan industry, all lenders, (FHA included, though not as much) tightened their lending practices considerably. Ultimately, the FHA may be needed as a consistent recourse for first-time buyers to access homeownership throughout the business cycle.

While risk-taking is often necessary for progress, some feel that some risks are too large for private industry and should be undertaken by the government. Making mortgage loans to borrowers without established credit ratings may be necessary to encourage homeownership in the inner cities and minority enclaves. Yet an economic recession could have dire consequences for firms taking on such risks.

Many argue that a federal agency is better suited to absorb the losses that are possible in lending to firsttime buyers. A government agency also might have the luxury of flexibility when borrowers experience short-term financial difficulty and need time to get back on track, or perhaps could restructure a loan to avoid default. The problem with these arguments is that when an entity is insulated from market risk, it tends to take on too much risk. The cost of failure then tends to be foisted on the public, as it was in the Federal Savings and Loan Deposit Insurance Corporation collapse in 1990.

All things considered, it would appear that the FHA can continue in its role of innovator, niche market server and promoter of homeownership without becoming a public liability if its programs continue to target first-time and underserved buyers. 

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Comparison of FHA and Conventional Loans on a \$70,000 Home

*FHA loan includes financed up-front mortgage insurance premium.

Source: Rocky Mountain Mortgage Company, El Paso



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