MarketWatch

AMY HOAK'S HOME ECONOMICS

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Higher costs ahead for FHA-insured mortgages

Why FHA is so popular and what these loans could cost

By Amy Hoak, MarketWatch

CHICAGO (MarketWatch) — As one of the few backers of low-down-payment mortgages in a time of stringent lender underwriting, the Federal Housing Administration has become a primary means of financing for U.S. home buyers.

But as the government moves to reform the mortgage market, the FHA is heading for some changes that could limit borrowers' access to the loans — or at least make them more expensive.

Homes that help as you age

More houses are being built with "universal design" features that will help boomers stay in their homes as they get older. But these features no longer evoke a hospital room -- and they're appealing to a younger demographic, too. Amy Hoak reports.

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About 56% of mortgages for a home purchase were FHA-insured in 2009, up from 6% in 2007, according to a report from the George Washington University School of Business. Many FHA borrowers are first-time buyers drawn by a down-payment requirement of just 3.5% of a home's purchase price.

The FHA currently can insure loans of up to $729,750 in high-cost markets, but the Obama administration recently recommended that those higher limits, which vary by market, expire in October. That would push the top limit down to $625,500, shrinking the pool of eligible borrowers. And those limits may be reduced even further.

Meanwhile, on April 18, the annual mortgage insurance premium on new FHA loans is set to rise by a quarter of a percentage point on 30- and 15-year mortgages, a move that will "bolster the FHA's capital reserves and help private capital return to the housing market," said David H. Stevens, the FHA's commissioner, in a news release. That change will mean an average increase of $30 to a borrower's payment each month.

There could be more changes on the way, too. "A lot of people think it's just a matter of time before they increase the down payment from 3.5% to 5%," said Guy Cecala, publisher of Inside Mortgage Finance.

U.S. Department of Housing and Urban Development spokesman Lemar Wooley said there are no plans underway to increase the down payment requirement, a move that would require Congressional approval. But, he added, some members of Congress have suggested the increase.

"It's tough for the government to be saying, 'We want to help underwater borrowers; we think there should be principal forgiveness.'

At the same time they are creating a whole new wave of underwater borrowers by offering 3.5% [down-payment mortgages],” Cecala said. If a borrower puts 3.5% down on a mortgage and home prices fall by 5% over their first year in the home, they’re already underwater, he said.

A role in the recovery

FHA played a major role in assisting the housing market during the economic collapse in 2008 and 2009, said Robert Van Order, professor of finance and co-author of the George Washington University School of Business report. Loan limits were raised to help people gain access to credit in the country’s high-cost markets.

Since then, the FHA has remained a popular mortgage source for borrowers who don’t have a large down payment. “FHA has certainly been the predominant way of doing low-down-payment mortgages in the past couple of years by far,” Van Order said.

Conforming mortgages, or those that can be bought by Fannie Mae or Freddie Mac, commonly require higher down payments than FHA loans require. The catch to an FHA-insured loan is that you’ll pay more in fees.

On an FHA mortgage, borrowers pay a 1% upfront premium that can be rolled into the loan amount, said Scott Sheldon, a loan officer for First California Mortgage Company in Petaluma, Calif. Borrowers also pay an annual premium, spread out over monthly payments. Those with a 3.5% down payment now pay a 0.9% annual premium, but that will go up to 1.15% in April, he said.

Borrowers don’t face those costs on a conforming mortgage with 20% down.

But Sheldon said some borrowers are going the FHA route regardless of the costs — even those who can afford a larger down payment — because they’d rather keep their cash liquid and invest it in other ways. FHA mortgages now make up about 75% of his business; a few years ago, he wasn’t doing any FHA loans.

The desire for low-down-payment mortgages is so attractive for some Americans that higher FHA monthly premiums might not have much of an effect on demand. “There’s very strong use by first-time home buyers, who are most challenged in coming up with a down payment,” Cecala said. “That’s not going to change even with the higher fees.”

According to the Mortgage Bankers Association, 75% to 80% of FHA purchase loans are for first-time home buyers, said Michael Fratantoni, vice president of research and economics for the MBA.

Winding down FHA financing

While some in the industry say FHA loan limits should remain elevated until the housing market has stabilized completely, most agree that for the FHA to stay true to its mission of helping low- and moderate-income Americans, the limit must come down over time.

“Someone getting a $662,500 mortgage [the loan limit for Sonoma County, Calif.] clearly is not a low-income person,” Sheldon said. FHA’s role is to help families that otherwise wouldn’t be able to buy a home, he said.

Reducing the loan limits could have a favorable effect on the FHA’s finances. FHA mortgages traditionally perform worse than Fannie Mae and Freddie Mac mortgages — meaning a greater share of FHA mortgages end up delinquent, Cecala said. But bigger FHA mortgages on the books aren’t performing as well as smaller FHA mortgages, according to the George Washington University report.

The loans valued at the highest levels, or more than $350,000, are performing about 20% worse than smaller loans that are representative of more traditional FHA loan amounts, the report found. “Serious delinquencies went up as the balance went up,” Van Order said.