

# UCLA ECONOMIC LETTER

## REAL ESTATE AND THE MACROECONOMY



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Monthly condensed analyses of crucial real estate and economic issues offered by the UCLA Anderson Forecast and UCLA Ziman Center for Real Estate. Here, Stephen Oliner, senior fellow at the UCLA Ziman Center for Real Estate, presents research showing that cutting the FHA mortgage insurance premium would be counterproductive.

## Cutting FHA's Mortgage Insurance Premium: Not a Good Idea

*By [Stephen Oliner](#)*

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The Federal Housing Administration (FHA), a government agency that insures home mortgage loans, typically flies below the radar screen. However, since the turn of the year, it has received extensive press coverage. On January 9, less than two weeks before leaving office, the Obama administration announced that FHA would reduce the mortgage insurance premium it charges borrowers, effective January 27. Then, in a dramatic reversal only hours after the inauguration, the Trump administration indefinitely suspended the premium cut. Why this flurry of activity?

*"The median FHA buyer in 2015 paid about \$1,300 more for the exact same house due to the upward pressure on house prices from that year's premium cut. Thus, part of the benefit intended for first-time buyers ended up in the pockets of home sellers."*

First, some background. FHA was established in 1934, at the height of the Great Depression, to promote homeownership and revive the construction industry. FHA did so by insuring lenders against losses on the home mortgages they originated, a policy intended to unlock the supply of mortgage credit. Over the decades after the Depression, FHA's focus shifted toward guaranteeing mortgage loans for higher-risk borrowers – generally first-time homebuyers – who might not otherwise qualify for mortgage credit. This loosening of credit standards effectively transformed FHA into the government's own subprime lender. Today, the typical FHA first-time buyer makes a down payment of only 3.5%, has a low to middling credit score, and has a debt payment burden right at the limit set by the ability-to-repay rules under Dodd-Frank.

In exchange for its guarantee, FHA charges borrowers a two-part mortgage insurance premium. The first part is paid upfront and has been set at 1.75% of the loan amount since 2012. Borrowers almost always roll this upfront premium into the mortgage loan to avoid a cash payment at closing. The second part of the premium is paid annually while the loan is outstanding. The dueling announcements in January pertained to this annual premium. For a 30-year loan with 3.5% down, the Obama administration would have cut the annual premium from 0.85% of the mortgage balance to 0.60%. The Trump administration prevented this cut from taking effect, which left the annual premium at 0.85% of the loan balance.

Although the premium cut did not take effect, the question remains: Was it a good idea? A recent [study](#) from the American Enterprise Institute sheds light on this question by examining the outcome of a similar FHA premium cut that was implemented in January 2015. In that earlier action, FHA reduced the annual premium ½ percentage point – from 1.35% per year to 0.85%. FHA estimated that the cut would save the average homebuyer \$900 per year, spurring an additional 250,000 households to buy their first home over the next three years (an average of about 83,000 per year).

My colleagues and I analyzed the effects of the 2015 premium cut using a large dataset of home purchases during the year before and the year after the cut. Our research showed that the premium cut did not live up to its billing. It brought in many fewer first-time buyers than FHA had projected and it had unintended consequences that conflicted with the original intent of the policy change.

How many first-time buyers came into the market because of FHA's premium cut? As a starting point, note that the total number of FHA first-time buyers rose from about 480,000 in 2014 to 660,000 in 2015, an increase of 180,000 across the two years. This increase far exceeded the roughly 83,000 new buyers that FHA had hoped to bring in annually with the premium cut. So, at first glance, it might appear the 2015 premium cut worked even better than intended.

However, our research shows that the premium cut was responsible for only a small part of the additional FHA volume. Notably, FHA poached nearly half of the additional 180,000 first-time buyers from loan programs run by other government agencies, mainly Fannie Mae and Freddie Mac. As the agency with the weakest underwriting standards, FHA can expand its book of business by inducing the riskiest borrowers in Fannie and Freddie's pool to take out an FHA loan instead. The premium cut caused many homebuyers to make that switch. We estimate that another third of the 180,000 new first-time buyers would have entered the market regardless of the lower premium, because an improving economy was raising incomes and lowering unemployment across the nation. These subtractions leave only about 35,000 new FHA borrowers who entered the market in 2015 because of the premium cut, well below FHA's prediction.

The premium cut also had unintended consequences that were contrary to FHA's objectives. About half of the premium cut was consumed in two ways that did not serve the goal of promoting homeownership. First, by boosting housing demand at a time when the inventory of homes for sale was already tight, the premium cut pushed up house prices. We estimate that the median FHA buyer in 2015 paid about \$1,300 more for the exact same house due to the premium cut. Thus, part of the benefit intended for first-time buyers ended up in the pockets of home sellers. Second, FHA borrowers used part of the monthly savings from the premium cut to go "up-market" by purchasing larger or more lavish homes or by opting to live in more expensive neighborhoods. This "up-market" spending represents pure waste from the viewpoint of encouraging homeownership.

The bottom line is that FHA's premium cut in 2015 was a costly and largely ineffective way to support first-time homebuyers. Accordingly, in my view, the suspension of last month's proposed cut was appropriate.

Instead of trying to boost housing demand in an already tight market, policies to improve the housing options for renters and aspiring homeowners should focus on increasing supply. The shortage of affordable housing can only be addressed by removing regulatory barriers and thinking creatively about ways to build economical homes and apartments. This will take time and effort, but there is no quick fix.

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