



CONGRESSIONAL BUDGET OFFICE  
U.S. Congress  
Washington, DC 20515

July 19, 2006

Honorable Jeb Hensarling  
U.S. House of Representatives  
Washington, DC 20515

Dear Congressman:

According to the federal budget, the subsidy cost of the Federal Housing Administration's (FHA's) Mutual Mortgage Insurance (MMI) program is negative. That is, under the budget accounting rules specified in the Federal Credit Reform Act of 1990 (FCRA), the program's activities are estimated to produce a net gain to the government, excluding its administrative costs. The President's budget for fiscal year 2007, for example, projects net income of 37 cents for each \$100 of guaranteed loans originated that year. However, studies by the Congressional Budget Office (CBO) indicate that the current budget rules tend to understate the cost of federal credit programs.

In response to your request of June 14, 2006, CBO has compared the cost of single-family mortgage insurance offered by FHA as reported in the budget with the cost of comparable insurance in private markets. The competitiveness of the market for private mortgage insurance suggests that quoted prices are good approximations of the minimum cost of providing such insurance. Therefore, the differences between market prices and premiums charged by FHA indicate the actual cost to the government of federal mortgage insurance. That comparison yields the following conclusions:

- Budget accounting understates the subsidy cost of credit programs by excluding the cost of market risk and displaying administrative expenses separately. (Subsidy costs are recognized up front as loans are originated; administrative expenses are included in the budget as they are paid each year.) The result is a budgetary bias in favor of credit programs relative to other types of spending programs.
- FHA's Mutual Mortgage Insurance program imposes costs on the government and taxpayers. On the basis of market prices for private mortgage insurance, the subsidy cost of the FHA insurance is between 2 percent and 5 percent of the amount of insured loans, CBO estimates. (However, the accounting rules specified in FCRA, which indicate a net gain to the government from providing such insurance, govern federal budget estimates.)
- Some current proposals for increasing the volume of FHA insurance would increase the government's costs for that program.

Honorable Jeb Hensarling  
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The details of CBO's analysis are contained in the attachment to this letter. I hope that you find the analysis useful. The staff contacts for this work are Marvin Phaup and Susanne Mehlman, who can be reached at (202) 226-2640 and (202) 226-2860, respectively.

Sincerely,



Donald B. Marron  
Acting Director

Attachment

cc: Honorable Jim Nussle, Chairman  
Honorable John M. Spratt Jr., Ranking Member  
House Committee on the Budget

Honorable Michael G. Oxley, Chairman  
Honorable Barney Frank, Ranking Member  
House Committee on Financial Services

Honorable Robert W. Ney, Chairman  
Honorable Maxine Waters, Ranking Minority Member  
Subcommittee on Housing and Community Opportunity  
House Committee on Financial Services

Honorable Judd Gregg, Chairman  
Honorable Kent Conrad, Ranking Member  
Senate Committee on the Budget

Honorable Richard C. Shelby, Chairman  
Honorable Paul S. Sarbanes, Ranking Member  
Senate Committee on Banking, Housing, and Urban Affairs

Honorable Wayne Allard, Chairman  
Honorable Jack Reed, Ranking Member  
Subcommittee on Housing and Transportation  
Senate Committee on Banking, Housing, and Urban Affairs

# **Assessing the Government's Costs for Mortgage Insurance Provided by the Federal Housing Administration**

July 19, 2006

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## Note

The Congressional Budget Office's (CBO's) analysis was prepared by Marvin Phaup and Susanne Mehlman under the supervision of Robert Dennis of the Macroeconomic Analysis Division and Robert Sunshine of the Budget Analysis Division. Deborah Lucas of Northwestern University provided helpful comments and suggestions. (The assistance of an external reviewer implies no responsibility for the final product, which rests solely with CBO.)

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- Some current proposals for increasing the volume of FHA insurance would increase the government's costs for that program.

## **FHA Single-Family Mortgage Insurance: An Overview**

Since its inception in 1934, FHA has provided mortgage insurance for single-family and multifamily homes and now also provides it for manufactured homes and hospitals. The insurance affords lenders with protection against losses from defaults and increases the availability of funds for higher-risk borrowers. In particular, FHA's Mutual Mortgage Insurance program, the federal government's largest mortgage insurance program, is aimed at extending access to home

ownership to those who lack the savings, credit history, or income to qualify for an unguaranteed, or conventional, mortgage. Under that program, FHA provides insurance on 30-year and 15-year fixed- and adjustable-rate amortizing mortgages for home purchases or refinancing.

FHA charges borrowers both up-front and annual fees for the service. Current law authorizes an initial fee of up to 2.25 percent of the loan amount and an annual fee of up to 0.55 percent of the unpaid balance. At present, the premium is a one-time fee of 1.5 percent and an annual fee of 0.5 percent. (The annual fee ceases when the loan balance is reduced to 78 percent of the initial amount.) FHA also requires a down payment of at least 3 percent of the purchase price.<sup>1</sup>

To target the program to low- and moderate-income borrowers, authorizing legislation limits the dollar value of the mortgages that may be insured. Those limits vary by geographic region, depending on the ceilings that the government-sponsored enterprises for housing—Fannie Mae and Freddie Mac—set for conforming mortgages; appreciation in house prices; and the cost of living for an area. Currently, the limit in most areas is \$200,160, but in some high-cost areas, FHA can insure loans up to \$362,790.

In fiscal year 2005, FHA guaranteed about \$58 billion in new loans, which is down sharply from the \$147 billion extended in 2003 (see Figure 1). Although that drop seems precipitous, FHA has seen a long-term decline in its share of single-family mortgages since the mid-1990s, when the agency insured about 15 percent of all such mortgages. Its current share is about 5 percent (see Figure 2).

The decline in the volume of new business, combined with increases in losses from defaults, has significantly reduced the net gains shown in the federal budget from new business. Insurance issued in fiscal year 2003, for example, is now estimated to have a net negative subsidy (that is, net income in the budget) of \$1.5 billion. For loans guaranteed in fiscal year 2005, the estimated net income is \$123 million.

FHA's basic insurance is directed at a segment of the market that is shrinking and becoming less dependent on the government for access to mortgage financing. In part, that situation has arisen because private lenders have increased their offerings for low-down-payment and higher-risk mortgages. In addition, FHA is restricted in the range of mortgage types that it can insure: 30- and 15-year amortizing mortgages of limited size with a minimum down payment of 3 percent of the purchase price. Private mortgage insurers, by contrast, have recorded especially rapid growth in coverage for loans with down payments of less than 3 percent; mortgages of amounts higher than FHA's limits; deferred principal/

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1. The ratio of the loan amount to house value may exceed 97 percent, however, because the up-front fee and first-year premium can be financed as part of the insured loan.

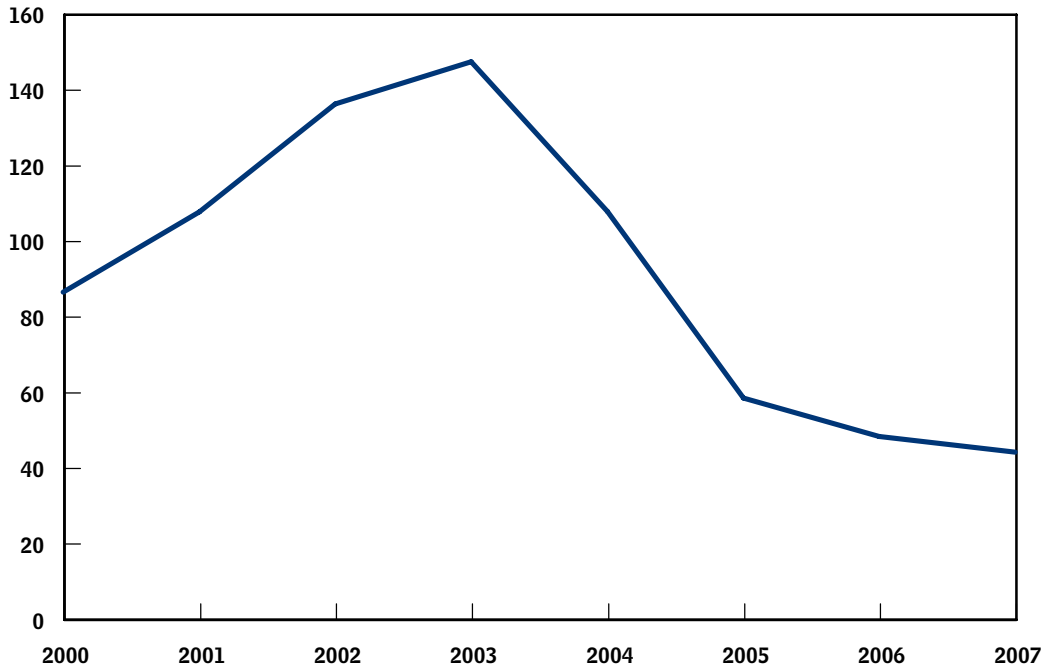
**Figure 1.**

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**FHA's Guarantees of New Mortgages, 2000 to 2007**

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(Billions of dollars)



Source: Congressional Budget Office based on data from the Federal Housing Administration.

Note: The amount for 2006 is estimated; the amount for 2007 is projected.

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payment or interest-only mortgages; and adjustable-rate mortgages in which the borrower has an option to pay only a portion of the amount due each month. FHA may also suffer from a perception that the quality of its service is uneven.<sup>2</sup>

## **Limitations of the Current Budgetary Treatment of FHA Mortgage Insurance**

In the federal budget, FHA's loan guarantee programs are considered discretionary and thus require appropriation action each year to establish a dollar-volume limit for each program and to provide an appropriation of subsidy costs for those programs whose estimated subsidy is positive. Subsidy costs are the present value of the government's projected cash flows from guaranteed loans disbursed in a fiscal year. Administrative expenses for the programs are separately subject to appropriation; such expenses are recorded each year as they are paid, rather than up front as loans are originated. They are not counted against the appropriation for subsidy costs.

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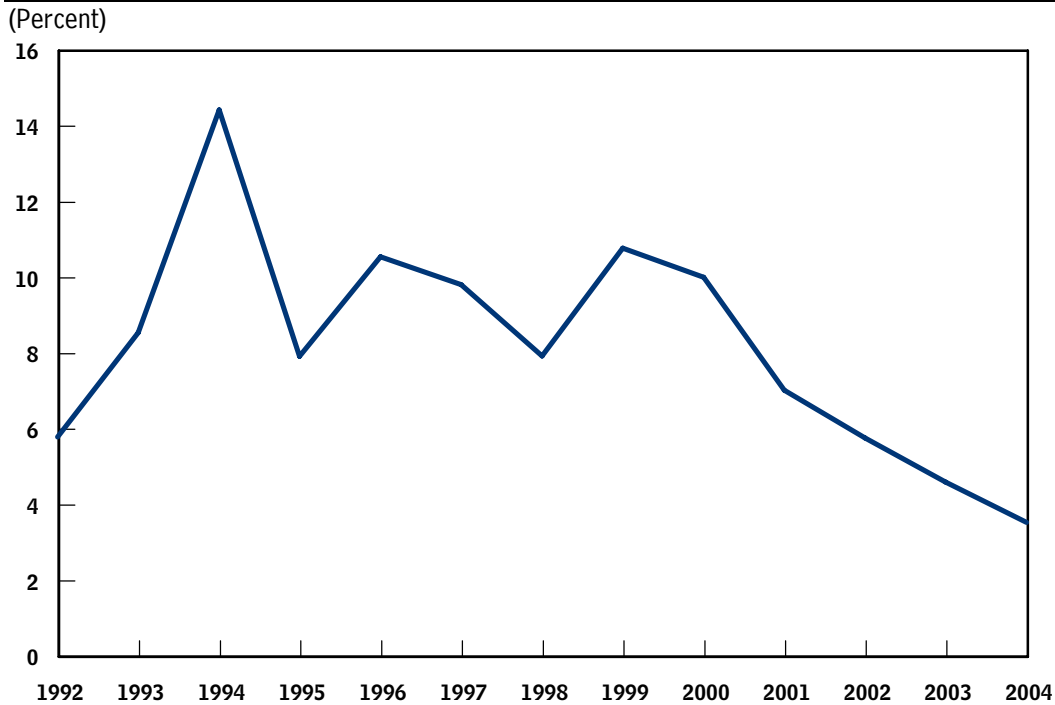
2. See the statements of Regina M. Lowrie, Mortgage Bankers Association, and Jerry Howard, National Association of Home Builders, before the Subcommittee on Housing and Community Opportunity, House Committee on Financial Services (April 5, 2006).

**Figure 2.**

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**FHA's Share of the Market for Single-Family Mortgages,  
1992 to 2004**

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Source: Congressional Budget Office based on data from Forrest Pafenberg, Office of Federal Housing Enterprise Oversight.

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The primary effect of loans and guarantees on the federal budget is the subsidy costs (or savings) calculated according to the requirements of the Federal Credit Reform Act of 1990.<sup>3</sup> That law specifies the rules for estimating the cost of direct loans and loan guarantees, including mortgage insurance. It defines the subsidy cost of guarantees as the net present value of the government's cash flows from fees and defaults, net of recoveries. FCRA's specified method of calculating subsidies for federal credit, however, omits some costs even though they can be major contributors to the total cost of credit.

The FCRA rules for calculating subsidies include the cost of expected losses from defaults, but they do not value those losses the way markets do—by including a cost for uncertainty and risk. The budget measures expected, or average, losses. In doing so, it assigns the same cost to an expected loss of 25 percent of principal that is certain to occur as it does to a loss with the same expected value but for which the realized loss can range from zero to 100 percent. If markets were indifferent to whether losses in any particular year were above or below the expected value, the budget measure would be adequate. But losses on FHA loans

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3. In the case of FHA, administrative expenses for fiscal year 2007 are projected to outweigh subsidy costs—owing to a low projected volume of new insurance, a low negative subsidy rate, and a large volume of existing guarantees that must be serviced.



(and loans under other federal credit programs) are more likely to occur in years when most other asset prices are low—such as during recessions. In the market, losses in such years get more weight than those that might occur when other asset prices are high, so lenders require additional compensation for taking on those risks. The budget measure of cost does not recognize any compensation to taxpayers for taking on those risks.<sup>4</sup> As a consequence, the cost of credit programs shown in the federal budget is understated relative to the burden that their activities impose on taxpayers.<sup>5</sup>

## **The Subsidy Cost of FHA Insurance Based on Market Prices**

When available, market prices can provide a good indication of the economic cost of government credit programs. In the case of FHA's basic home mortgage insurance, prices are available because private insurers provide comparable coverage and quote their prices for such insurance publicly. If the market for private mortgage insurance is sufficiently competitive, the quoted price will approximate the minimum cost of providing that insurance for an efficient provider. In that case, the difference between the premium charged by FHA and that charged by private insurers would provide a measure of the subsidy cost of FHA insurance.

In fact, the market for private mortgage insurance is by all indications highly competitive. Eight insurers are currently providing coverage in the United States. In addition, and perhaps more important, a large number of mortgage lenders compete not by selling mortgage insurance directly but by providing equivalent services through second mortgages and home-equity loans. Because first mortgages for no more than 80 percent of the purchase price generally do not require mortgage insurance, borrowers may take out a second mortgage that will finance the remaining 20 percent and that will cover the risk of default, thereby providing the insurance.

Private mortgage insurance is usually limited to covering 35 percent or 40 percent of the unpaid mortgage balance, whereas FHA coverage is for nearly 100 percent of the mortgage amount. However, for the lender, that difference is not significant because the collateral value of the house provides a buffer to actual losses from defaults. Consequently, unless the market price of the house falls to a level below the mortgage insurance coverage, the lender will be protected from loss by the proceeds from the sale of the foreclosed property. The very low loss experience of

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4. See the statement of Douglas Holtz-Eakin, Director, Congressional Budget Office, *The Economic Costs of Long-Term Federal Obligations*, before the House Committee on the Budget (July 24, 2003), available at [www.cbo.gov](http://www.cbo.gov).

5. Congressional Budget Office, *Estimating the Value of Subsidies for Federal Loans and Loan Guarantees* (August 2004), available at [www.cbo.gov](http://www.cbo.gov).

the government-sponsored enterprises, which hold large portfolios of mortgages with fractional private mortgage insurance coverage, illustrates the protection provided by the collateral value of the house. To the extent that coverage by private mortgage insurance is less comprehensive than that offered by FHA, the premiums charged by private insurers will provide a low estimate of the cost of FHA guarantees.

Premium rates for private mortgage insurance are quoted as a fixed annual percentage of the amount of the loan and vary with the borrower's down payment and credit rating, as commonly measured by Fair Isaac & Co. (thus, the borrower's FICO score).<sup>6</sup> Other variables, including what the term of the loan is and whether the interest rate is fixed or adjustable, also affect the premium for private mortgage insurance.

For CBO's analysis, the comparison of premiums is for 30-year fixed-rate amortizing mortgages for owner-occupied houses with loan-to-value ratios above 0.95—FHA's standard product. FHA borrowers, on average, make down payments of less than 5 percent.<sup>7</sup> (Premiums for private insurance do not vary among mortgages with loan-to-value ratios of 0.95 to 1.0.)

FHA fees are the same for all qualified borrowers: 1.5 percent of the loan amount at origination (this fee can be financed in the mortgage) and an annual fee, including one for the first year, of 0.5 percent of the unpaid balance. To facilitate a comparison of private and FHA premiums, CBO converted FHA's up-front fee (using a 6 percent interest rate) to a fixed annual rate paid over eight years. Stated as an annual fixed rate, FHA's fees total 0.73 percent of the unpaid balance, or 73 basis points.<sup>8</sup>

For borrowers who have FICO scores of 620 and above, currently quoted private insurance premiums for 40 percent coverage of 30-year fixed-rate mortgages of owner-occupied single-family homes are 1.09 percent, or 109 basis points, per year (see Table 1). Lower FICO scores require a higher premium.<sup>9</sup>

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6. Fair Isaac is a private company that developed the system now widely used by lenders to assess the credit quality of borrowers. For details, see [www.FICO.com](http://www.FICO.com).

7. In 2005, loan-to-value ratios for FHA-insured mortgages ranged from less than 0.75 to more than 1.0, with 81 percent above 0.95. The median for values below 0.95 fell between that value and 0.80. See Federal Housing Administration, *Actuarial Review of the Mutual Mortgage Insurance Fund FY 2005*, "Characteristics of the FY 2005 Book of Business" (November 2, 2005), available at [www.hud.gov/offices/hsg/comp/rpts/actr/2005sec4.pdf](http://www.hud.gov/offices/hsg/comp/rpts/actr/2005sec4.pdf).

8. A basis point is one-hundredth of a percentage point.

9. When this report was prepared, the quoted national premiums for private mortgage insurance were the same on various major firms' Web sites.

**Table 1.**

**Private and FHA Insurance Premiums for 30-Year Fixed-Rate Amortizing Mortgages for Owner-Occupied Single-Family Homes**

(Basis points)

<b>FICO Score<sup>a</sup></b>	<b>Premium for Private Insurance<sup>b</sup></b>	<b>FHA Premium<sup>c</sup></b>	<b>Estimated Percentage of FHA Loans</b>
620 and Higher	109	73	63
600 to 619	210	73	16 <sup>d</sup>
575 to 599	287	73	12 <sup>d</sup>
Lower Than 575	467	73	9
Weighted Average	179 <sup>e</sup>	73	100

Source: Congressional Budget Office.

Note: A basis point is one-hundredth of a percentage point.

- a. FICO scores are credit quality measures for borrowers calculated by Fair Isaac & Co.
- b. Under an assumption that the loan-to-value ratio is 0.95 or higher and that FICO scores of 620 and higher are accompanied by a rating of A and scores of 619 and lower, a rating of A-.
- c. FHA charges fees of 1.5 percent of the loan amount at origination and 0.5 percent of the unpaid balance per year. CBO has assumed that the average life of the mortgages and of the annual fee is eight years. Discounted at 6 percent, the FHA premium is the equivalent of an annual fee of 0.73 percent, or 73 basis points.
- d. FHA reports that the distribution of its home buyers for 2004 and 2005 by FICO score was as follows: 620 and higher, 63 percent; 560 to 619, 28 percent; and less than 560, 9 percent. To allocate the middle group to the two subgroups distinguished by private insurers for pricing, CBO has assumed that 16 percent had FICO scores of 600 to 619 and that 12 percent had scores of 575 to 599.
- e. The weighted average annual premium that FHA borrowers would pay in the private mortgage insurance market.

According to FHA, in 2004 and 2005, 63 percent of its insured borrowers had FICO scores above 620, and 9 percent had scores less than 560.<sup>10</sup> CBO distributed the remaining borrowers (those with intermediate credit quality) into two standard categories recognized by private insurers. Using those assumptions, CBO estimates that the weighted average of insurance premiums that private insurers would charge FHA borrowers would be 179 basis points. That charge compares with FHA's premium of 73 basis points.

However, testimony by industry experts and the relative success of private mortgage insurance suggest the possibility that private insurers offer superior service and thus incur greater costs than FHA. For example, private insurers

10. Although FHA collects the FICO scores of borrowers, it is not required to use that proprietary system to qualify borrowers.

appear to provide more convenient, timely, and responsive service. They also actively market their products to lenders.

To adjust for that possibility, CBO estimates—on the basis of reported expense ratios of a sample of private mortgage insurers—that the cost to the government of FHA insurance is 50 basis points per year less than the total cost of private insurance. With that adjustment, FHA is offering insurance that costs 129 basis points but is charging purchasers only 73 basis points for it. Thus, FHA’s subsidy cost for the MMI program is 56 basis points per year, equivalent to about 3.5 percent of the amount of the insured mortgages, CBO estimates.<sup>11</sup> Because that adjustment is uncertain, CBO has also calculated FHA’s subsidy rate under the alternative assumptions that its annual net cost is 36 and 76 basis points less than the cost of private insurance. With those adjustments, the subsidy costs translate to between 2 percent and 5 percent of the amount of the insured mortgages. If FHA insures \$60 billion in new single-family mortgages each year, a subsidy rate of 3.5 percent would mean that the cost of the program is about \$2 billion annually. That amount is the cost that U.S. taxpayers incur, mostly in the form of bearing risk, to maintain the program’s activities.

Thus, in the case of FHA’s basic insurance of fixed-rate mortgages in the Mutual Mortgage Insurance program, a comprehensive, market-based measure shows a subsidy cost, whereas the estimates currently used in the budget show a gain. That is, under the budgetary accounting rules mandated by FCRA, the MMI program (its administrative costs excluded) appears to make money for the government. For fiscal year 2007, for example, the Administration estimates that each \$100 of insurance sold will produce estimated net income to the government of 37 cents. Administrative costs would add about 70 cents to that figure, resulting in a net cost of about 33 cents per \$100 of insurance, which is still far below the costs indicated by market prices.<sup>12</sup>

## Proposed Changes in Policy

The declining market share of FHA has prompted calls for restructuring the MMI program. One proposal now under consideration by the Congress (H.R. 5121) would give FHA the authority to be more like a commercial mortgage insurer in operating the single-family mortgage program. That legislation would authorize the agency to insure larger mortgages for terms of up to 40 years and would abolish the requirement for borrowers to make a down payment to qualify for

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11 . The private insurance premium (179 basis points) minus an adjustment for a difference in operating costs (50 basis points) minus FHA’s fees (73 basis points). The annual subsidy of 56 basis points is capitalized at 6 percent interest over eight years to obtain the up-front cost at origination of 3.5 percent.

12. That estimate of FHA’s annual administrative costs is obtained by expressing them as a percentage of the total amount of outstanding insurance, or 0.10 percent (10 basis points) per year and assuming that those costs are incurred for eight years on average. Using rates on Treasury securities to discount that annual cost for eight years produces a net present value of about 70 basis points.

FHA insurance. It would also have FHA adopt a risk-based premium schedule so that higher-risk borrowers would pay higher insurance premiums. In addition, the bill would remove the current cap on the number of home-equity conversion mortgages, a form of reverse mortgage provided to homeowners who are age 62 or older. The proposal would also widen the range of purposes for which such mortgages could be used and potentially increase the demand for them.<sup>13</sup>

FHA has indicated that if it is granted authority to charge risk-adjusted premiums, it would probably cut fees to the lowest-risk borrowers to an annual rate of 50 basis points per year and increase the rates to the highest-risk borrowers to an up-front fee of 3.0 percent and an annual fee of 0.75 percent, or the equivalent of 121 basis points per year for eight years.<sup>14</sup> A fee of 50 basis points for low-risk borrowers would be competitive with that offered by private insurers, who quote a rate of 60 basis points per year for a borrower with a FICO score of 620 or higher who is making a 10 percent down payment. However, a premium of 121 basis points for high-risk borrowers would continue to provide a substantial subsidy to them. For example, the private insurance rate for a borrower with a FICO score of 600 who is making a down payment of less than 5 percent is 210 basis points.

The proposal to make FHA more like a commercial insurer is not the only one under consideration. Others include increasing the premium in the basic single-family mortgage insurance program to the maximum authorized levels of 2.25 percent up front and 0.55 percent annually; expanding the range of mortgages eligible for insurance; adopting risk-based pricing; and using more-targeted policies to assist low-income first-time homebuyers.<sup>15</sup>

Each of those proposals has advantages and disadvantages. However, an important feature of current and proposed federal policy has been obscured by the budget costs estimated under the FCRA accounting rules: insurance provided under the MMI program by FHA, when evaluated at market prices, is subsidized by the government. It is a use of taxpayer resources, and many of the alternatives under consideration for expanding it entail higher costs to taxpayers.

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13. For details and the estimated budgetary effects, see the Congressional Budget Office's cost estimate for H.R. 5121, the Expanding American Homeownership Act of 2006, June 14, 2006. The bill was ordered reported by the House Committee on Financial Services on May 23, 2006.

14. Statement of Brian D. Montgomery, Assistant Secretary for Housing-Federal Housing Commissioner, Department of Housing and Urban Development, before the Subcommittee on Housing and Community Opportunity, House Committee on Financial Services (April 5, 2006).

15. H.R. 1999 and S. 771, for example, would expand the use of vouchers for down payment assistance.

## **Implications of Cost Measures for Alternative Policies**

One implication of a comprehensive, market-based measure of costs is that the current policy does not reduce the fiscal burden on taxpayers, as suggested by the current entries in the budget. The Federal Housing Administration's Mutual Mortgage Insurance program costs taxpayers the equivalent of \$2 billion annually.

A second implication is that expanding the current program by enlarging the type, size, and volume of mortgages eligible for insurance would increase total costs. Increasing premiums to high-risk borrowers would limit the increase in costs, but a premium of 121 basis points would cover only a share of the cost of insurance for FHA's high-risk borrowers. Total costs to taxpayers would increase under current proposals that expand FHA's program and therefore increase risk.

The FCRA subsidy estimates understate the cost of FHA guarantees relative to that of other federal spending programs. Thus, a third implication is that the current budgetary treatment results in a bias in favor of federal credit programs and against other programs. For example, a proposal to spend \$2 billion per year for vouchers to permit high-risk first-time home buyers to purchase private mortgage insurance would have a budget cost of \$10 billion over a five-year period, whereas the fiscally equivalent alternative of operating the MMI program under current policy would be shown in the budget as having net savings of \$1.8 billion for that same period.<sup>16</sup>

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16. Direct assistance to qualified borrowers for down payments, closing costs, and rehabilitation is currently provided through the American Dream Down Payment Initiative. The American Dream Act authorized spending of \$200 million annually for 2004 to 2007, and the program has received appropriations of \$167 million for the first three of those four years. Mortgage service assistance is available from the Department of Housing and Urban Development's Housing Choice/Housing Certificate Fund.