CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

June 21, 2004

H.R. 3755
Zero Downpayment Act of 2004

As ordered reported by the House Committee on Financial Services on June 3, 2004

SUMMARY

H.R. 3755 would authorize a new loan guarantee program under the Federal Housing Administration (FHA) that would allow first-time home buyers to purchase a home without a down payment. Currently, FHA's single-family loan guarantee program requires home buyers to make a down payment of at least 3 percent of the sales price. The new loan guarantees would be available to home buyers purchasing various types of one-to-three family residences, such as single-family homes and condominiums, through September 30, 2009. The number of zero down-payment loans insured by FHA each year could not exceed 10 percent of its total number of single-family loan guarantees made during the preceding year. This legislation also would allow FHA to charge up-front and annual fees up to the levels set under current law for the existing single-family program.

CBO estimates that implementing this legislation would have a net cost of about $500 million over the 2006-2009 period, assuming future appropriation actions consistent with the bill. (We expect that it would take FHA about one year to implement the new program.) FHA's loan guarantee programs are discretionary federal credit programs that require appropriation action each year to establish a dollar limitation on the value of loans that may be guaranteed and to provide a credit subsidy appropriation for those FHA programs estimated to have a positive subsidy rate.

Included in this net cost is $59 million in offsetting collections that would be generated because we estimate that about half of the new loan guarantees under the zero down-payment program would be included in the Government National Mortgage Association's (GNMA's) single-family Mortgage-Backed Securities (MBS) program. (GNMA is responsible for guaranteeing securities backed by pools of mortgages insured by the federal government and, like FHA, requires appropriation action to establish its dollar limitation for the securities program.)

Enacting this bill could affect direct spending and receipts because the bill would provide the Secretary of the Office of Housing and Urban Development (HUD) with the authority to establish penalties against borrowers who fail to meet certain requirements under the bill. CBO estimates that any increase in civil or criminal penalties would not be significant.

H.R. 755 contains no intergovernmental or private-sector mandates as defined in the Unfunded Mandates Reform Act (UMRA) and would not affect the budgets of state, local, or tribal governments.

ESTIMATED COST TO THE FEDERAL GOVERNMENT

The estimated budgetary impact of H.R. 3755 is shown in the following table. The costs of this legislation fall within budget function 370 (mortgage and housing credit). For this estimate, we assume the bill will be enacted near the beginning of fiscal year 2005.

BASIS OF ESTIMATE

The budgetary impact of the zero down-payment loan program would depend on how many households would use this provision to help them become homeowners and the likelihood that such borrowers would default on their mortgages. CBO estimates that FHA would need appropriations of $143 million in 2006 and $562 million over the 2006-2009 period to cover the estimated subsidy cost of the zero down-payment program. We also estimate that about 50 percent of the loan guarantees made each year under the zero down-payment program would be included in GNMA's MBS program, resulting in the collection of additional negative subsidy receipts of $59 million over the 2006-2009 period. There also would be a cost associated with the GAO studies that are required under this bill. However, CBO estimates that those costs would be less than $500,000 each year. Each of these budgetary effects are discussed below.

	By Fiscal Year, in Millions of Dollars					
	2004	2005	2006	2007	2008	2009
SPENDING SUBJECT TO APPROPRIATION						
FHA and GNMA Spending Under Current Law [a]						
Estimated Authorization Level	-3,860	-2,611	-2,444	-2,383	-2,424	-2,478
Estimated Outlays	-3,860	-2,611	-2,444	-2,383	-2,424	-2,478
Proposed Changes						
Net Subsidy Cost for Zero Down-Payment Loans						
Estimated Authorization Level	0	0	143	140	138	141
Estimated Outlays	0	0	143	140	138	141
GNMA Offsetting Collections						
Estimated Authorization Level	0	0	-16	-15	-14	-14
Estimated Outlays	0	0	-16	-15	-14	-14
Total Changes						
Estimated Authorization Level	0	0	127	125	124	127
Estimated Outlays	0	0	127	125	124	127
Total FHA and GNMA Spending Under H.R. 3755 [b]						
Estimated Authorization Level	-3,860	-2,611	-2,317	-2,158	-2,300	-2,351
Estimated Outlays	-3,860	-2,611	-2,317	-2,158	-2,300	-2,351

a. The figures for 2004 are CBO's current estimates of budget authority and outlays for these programs under the enacted appropriation levels for this year. The 2005-2009 levels are CBO's baseline estimates of the amount of offsetting collections generated by FHA's single-family program and GNMA's single-family MBS program.

b. Enacting H.R. 3755 also would require an annual appropriation of less than $500,000 beginning in 2007 for the General Accounting Office (GAO) to prepare the studies required under the bill.

Demand for the Zero Down-Payment Program

According to FHA, mortgage banking associations, and industry experts, the number of private entities supporting down-payment assistance programs in recent years has grown, indicating a growing demand for programs that help home buyers who cannot afford down payments. For example, the Nehemiah Corporation, which is the oldest and largest nonprofit provider of down-payment assistance in the country, provided assistance to over 5,500 home buyers in 1998 compared to 33,000 home buyers in 2003.

CBO believes that demand for a zero down-payment program would be strong and, based on information from FHA, expects that about 150,000 loans with a face value of about $20 billion (known as the loan volume) could be guaranteed beginning in 2006. CBO does not estimate that any new loan guarantees would be issued in 2005 because we expect that it would take FHA one year to implement the new program following enactment of this legislation. This bill would limit the loan volume for the zero down-payment program to no more than 10 percent of FHA's total number of single-family loan guarantees made in the preceding year. CBO's estimates of total loan volume over the next five years average about $126 billion each year. Consequently, CBO estimates that volume for the new program would be limited to about $13 billion each year for around 100,000 borrowers.

According to FHA, an increasing number of its borrowers who are first-time home buyers making low down payments are using some form of down-payment assistance (e.g., gifts from relatives or grants from nonprofit entities). On average, these borrowers represent about 26 percent of all first-time home buyers making the minimum 3 percent down payment. CBO estimates that about 80,000 FHA borrowers who are first-time home buyers will use some form of down-payment assistance each year. CBO estimates that at least 50 percent of such borrowers would migrate to the new zero down-payment program. Under that assumption, about 40,000 FHA borrowers would use the new zero down-payment program instead of the existing single-family program. CBO estimates that this shift of about $5 billion worth of loan guarantees from the existing single-family program to the new zero down-payment program each year would affect the subsidy cost of the FHA program, as discussed below.

Credit Risk Associated with the Zero Down-Payment Program

Zero down-payment loans are viewed by private-sector lenders as having a higher risk of default than traditional mortgages with down payments according to several industry experts, such as people involved with the secondary-mortgage market, trade associations, and down-payment assistance programs. For private lenders, the borrower's loan-to-value (LTV) ratio indicates how much equity a borrower initially has in the home and serves as one of the predictors of the likelihood of default. On average, borrowers with less equity (that is, higher LTV ratios) have higher default rates than borrowers with more equity. Such borrowers are more vulnerable to adverse events, such as job loss and falling house prices. Under the proposed zero down-payment program, borrowers would enter home ownership with zero or even negative equity because borrowers could finance their up-front premiums and closing costs, resulting in LTV ratios of 103 percent or more.

To compensate for this risk of default, FHA has indicated that it would not change the credit standards (e.g., debt-to-income ratios and payment-to-income ratios) it applies to these new borrowers, but it would charge such borrowers higher loan-guarantee fees than those charged to borrowers under FHA's current single-family program. We expect that FHA would implement the fees at the maximum levels established under current law. That is, the up-front fees for the new program would be 2.25 percent of the loan value and annual fees would be 0.55 percent of the loan value for the first five years and 0.5 percent thereafter. (In comparison, borrowers in the existing program pay an up-front premium of a 1.5 percent and annual premiums of 0.5 percent.) Despite these higher fees, however, CBO expects that default costs could still exceed the value of the higher fees.

This bill would require FHA to suspend the zero down-payment program if more than 3.5 percent of the loans in the program are foreclosed in one year. CBO estimates that defaults for the new program would average about 1 percent each year and that the cumulative default rate over a 30-year period would exceed 30 percent. This restriction on the number of defaults could limit the number of loans FHA insures each year if the number of foreclosures is greater than we estimate. But other factors, such as changing consumer demand for the program due to higher interest rates, could also lead to a smaller loan volume in the program. The zero down-payment program would be considered a discretionary program that could be suspended by FHA at any time. For this estimate, CBO assumes that the necessary subsidies are provided each year through the appropriation process and that the subsidies are spent each year.

Subsidy Cost

Under credit reform procedures, funds must be appropriated in advance to cover the subsidy cost of the loan guarantees, as estimated on a present-value basis. CBO estimates that the new program would have a subsidy rate of about 1.21 percent, compared to our estimate of the subsidy rate in 2006 of negative 1.78 percent for FHA's existing single-family program. With a subsidy rate of 1.21 percent, CBO estimates that the zero down-payment program would cost $618 million over the 2006-2009 period.

This estimated subsidy cost would be slightly offset by some expected savings associated with the $5 billion in business that would shift from the existing single-family program to the zero down-payment program. Because the loans that would shift to the new program would most likely represent some of the riskier loans, CBO estimates that the migration of these borrowers to the new program would leave the larger remaining portfolio of single-family loan guarantees with an overall slightly more negative subsidy rate. CBO estimates that the negative subsidy associated with the existing single-family program would become more negative by about 0.1 percent beginning in 2006, resulting in additional offsetting collections of $57 million over the 2006-2009 period.

CBO estimates that implementing the zero down-payment program would result in a net cost of $143 million in 2006 and a net cost of $562 million over the 2006-2009 period. The estimated loan subsidy costs—which are treated as discretionary spending—would be recorded in the budget each year when the subsidy appropriation is provided. Under this legislation, the Secretary of HUD would have the ability to make certain programmatic adjustments, such as changing the guarantee fees, to ensure that the Mutual Mortgage Insurance Fund (MMIF) continues to realize offsetting collections. While CBO estimates that the zero down-payment program would require an appropriation to cover its estimated costs, such costs would not preclude the MMIF from generating net offsetting collections, albeit fewer collections than would be expected under current law.

GNMA Subsidy Receipts

GNMA is responsible for guaranteeing securities backed by pools of mortgages insured by the federal government. In exchange for a fee charged to lenders or issuers of the securities, GNMA guarantees the timely payments of scheduled principal and interest due on the pooled mortgages that back these securities. Because the value of the fees collected are estimated to exceed the cost of loan defaults in each year, the GNMA MBS program is estimated to have a negative subsidy rate of 0.23 percent in 2006, resulting in the net collection of receipts to the federal government.

Because over 90 percent of FHA-insured loans are eventually included in GNMA's MBS program, CBO estimates that implementing the zero down-payment program would result in additional collections to GNMA. Based on information from GNMA, CBO assumes that only the zero down-payment loans with the lowest credit risk would be included in GNMA's MBS program and that consequently such loans would not have any significant effect on GNMA's negative subsidy rate. We estimate that about 50 percent of the loan guarantees made under this new program would be included in GNMA's MBS program, resulting in the collection of $16 million in 2006 and $59 million over the 2006-2009 period.

GAO Studies

This legislation also would require GAO to prepare a report on loan performance under the zero down-payment program no later than two years following enactment of the bill and annually thereafter. CBO estimates that GAO would require less than $500,000 annually beginning in 2007 for such reports.

INTERGOVERNMENTAL AND PRIVATE-SECTOR IMPACT

H.R. 3755 contains no intergovernmental or private-sector mandates as defined in UMRA and would not affect the budgets of state, local, or tribal governments.

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