CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

June 14, 2006

H.R. 5121

Expanding American Homeownership Act of 2006

As ordered reported by the House Committee on Financial Services on May 23, 2006

SUMMARY

H.R. 5121 would amend the National Housing Act to provide the Federal Housing Administration (FHA) with new authority to offer guarantees for various types of loans within a new pricing structure. The bill is aimed at updating FHA's business operations so that it could more effectively manage its credit risks and expand homeownership opportunities.

CBO estimates that implementing H.R. 5121 would increase offsetting collections (as a credit against discretionary spending) by $247 million in 2007 and $2.3 billion over the 2007-2011 period, assuming enactment of appropriation laws necessary to implement the FHA programs. Such savings would stem from increasing the number of homeowners who could obtain loan insurance under FHA's Home Equity Conversion Mortgage (HECM) program and under FHA's single-family loan insurance program. Offsetting collections are generated by those programs because the fees paid by borrowers generally exceed the cost of expected defaults. Enacting the bill would not affect direct spending or revenues.

H.R. 5121 contains no intergovernmental or private-sector mandates as defined in the Unfunded Mandates Reform Act (UMRA) and would impose no costs on state, local, or tribal governments.

ESTIMATED COST TO THE FEDERAL GOVERNMENT

The estimated budgetary impact of H.R. 5121 is shown in the following table. The cost of this legislation falls within budget function 370 (mortgage and housing credit). For this estimate, we assume the bill will be enacted near the end of fiscal year 2006.

	By Fiscal Year, in Millions of Dollars					
	2006	2007	2008	2009	2010	2011
SPENDING SUBJECT TO APPROPRIATION						
FHA and GNMA Spending Under Current Law [a]						
Estimated Authorization Level	-1,296	-472	-327	-331	-344	-353
Estimated Outlays	-1,296	-472	-327	-331	-344	-353
Proposed Changes						
Change to HECM Loan Program						
Estimated Authorization Level	0	-230	-430	-470	-510	-550
Estimated Outlays	0	-230	-430	-470	-510	-550
Increasing Loan Limits for Single-Family Guaranteees						
Estimated Authorization Level	0	-11	-13	-14	-16	-16
Estimated Outlays	0	-11	-13	-14	-16	-16
GNMA Offsetting Collections						
Estimated Authorization Level	0	-6	-6	-7	-8	-8
Estimated Outlays	0	-6	-6	-7	-8	-8
Total Changes						
Estimated Authorization Level	0	-247	-449	-491	-534	-574
Estimated Outlays	0	-247	-449	-491	-534	-574
Total FHA and GNMA Spending Under H.R. 5121						
Estimated Authorization Level	-1,296	-719	-776	-822	-878	-927
Estimated Outlays	-1,296	-719	-776	-822	-878	-927

NOTE: GNMA = Government National Mortgage Association; HECM = Home Equity Mortgage Insurance; MBS = Mortgage-Backed Securities.

a. The figures for 2006 are CBO's current estimates of budget authority and outlays for the FHA's Single-Family and HECM programs and for GNMA's MBS program under the enacted appropriation levels for this year. The 2007-2011 levels are CBO's baseline estimates of the amount of offsetting collections generated by these programs.

BASIS OF ESTIMATE

The budgetary impact of this legislation would stem from additional offsetting collections generated by expanding the HECM loan program, raising the loan limits for FHA's single-family program, and increasing activity for the Government National Mortgage Association (GNMA). CBO expects other provisions of the bill would have no significant budgetary impact over the next five years. The major provision of the bill are discussed below.

Expanding the HECM Loan Insurance Program

HECM loans are considered to be "reverse mortgages" because they enable homeowners who are at least 62 years of age to withdraw some of the equity in their home in the form of monthly payments, in a lump sum, or through a line of credit. Under current law, FHA is permitted to guarantee up to a cumulative total of 250,000 such loans, and CBO expects that FHA will reach that cap in 2007. Loan size is tied to loan limits that vary by geographic region, and such loans cannot be used to purchase another home. Enacting this legislation would remove the statutory limitation on the number of loans that could be guaranteed, set a single nationwide loan limit for the HECM program tied to the conforming loan amount, and allow borrowers to use HECM loans to purchase a new home. Conforming loans have terms and conditions that follow the guidelines set forth by the Government Sponsored Enterprises (GSEs). Implementation of the HECM program, like all of FHA's insurance programs, is contingent on the enactment of appropriation laws that provide annual loan commitment authority. The estimated budgetary impact of this proposal is tied to the demand for HECM loans and their subsidy cost.

Demand for HECM Loans. According to the National Reverse Mortgage Lenders Association (NRMLA) and other industry experts, the HECM program has risen in popularity in recent years. As more consumers are becoming aware of the product, more households are becoming eligible for the program (e.g. currently there are over 17 million households with owners aged 65 or older, according to census data), and more seniors view the product as an alternative approach to financing home-improvement projects, medical costs, and other needs. In addition, sources in the mortgage industry have observed an increasing demand among seniors for new housing within senior communities. The number of HECM loans insured by FHA more than doubled from 2003 to 2005 (18,000 loans were insured in 2003, compared with 43,000 loans in 2005, and as of April 2006 a cumulative total of about 200,000 loans have been insured). Moreover, there is relatively little private competition for these loans, enabling FHA to dominant the marketplace. The NRMLA estimates that FHA's current market share of reverse mortgages is about 90 percent.

Based on information from FHA, NRMLA, and other industry experts, CBO estimates that these legislative changes would result in a HECM loan product that would be more attractive to borrowers and more easily marketed by lenders, resulting in increased demand for HECM loans. The market for HECM loans appears to be very robust and with limited competition, the potential for FHA to insure more than 100,000 loans annually appears likely. Whether the number of guarantees could exceed this level would depend on FHA's ability to administer and manage the program in an efficient manner on a continued basis. CBO assumes that about 20,000 loans (with a face value of $5 billion) could be insured during the first quarter of fiscal year 2007 under the current statutory cap on the number of such loans that FHA can insure. We estimate that FHA could guarantee an additional 80,000 loans (with a face value of about $20 billion) in 2007 as a result of the changes proposed in this legislation. In subsequent years, assuming demand for this product continues to grow and FHA maintains its market share, CBO estimates that 140,000 to 160,000 such loans (with a face value of $35 billion to $45 billion) could be insured annually.

Subsidy Cost. Under current law, FHA guarantees of HECM loans result in net offsetting collections to the federal government because guarantee fees for those mortgages more than offset the costs of expected defaults, resulting in net collections from the loan guarantee program. For 2007, the Administration's subsidy estimate is -2.8 percent. Under the expanded program authorized by H.R. 5121, CBO estimates that the subsidy rate for the HECM loans would be -1.2 percent. This reduction from the estimated rate for 2007 is due to the increased risk FHA would experience under the proposed nationwide loan limitation. With larger loan sizes, the "equity cushion" (i.e., the difference between the home's value and the potential cost of a claim payment) would decrease, leading to potentially more costly claims for FHA.

This estimated subsidy rate of -1.2 percent assumes that the HECM loan program would not be subject to the risk-based pricing structure authorized by the bill and described below. CBO assumes that FHA would continue to charge fixed, up-front and annual fees for all HECM borrowers, regardless of any specific evaluation of their individual risk of default. CBO estimates that enacting this legislation would result in additional offsetting collections of $230 million in 2007 and $2.2 billion over the 2007-2010 period. Such offsetting collections are contingent on enactment of appropriation bills, which establish the authority to make such loan guarantees by specifying annual loan commitment levels.

Raising Loan Limits for the Single-Family Program

Proposed Changes. Section 3 would raise FHA loan limits (i.e., the dollar amount of mortgages that FHA can insure) for its single-family program from 87 percent of the conforming loan amount—up to 100 percent of the conforming loan limit in certain geographic regions where the cost of housing is very high. Effectively, this would be a change from loans of $362,790 today to loans of $417,000. In less expensive markets, the limit would be raised from 48 percent to 65 percent of the conforming loan limit for a change from loans of $200,160 today to loans of $271,050.

Estimated Savings. CBO estimates that increasing the loan limits would increase offsetting collections (as a credit against discretionary spending) by about $11 million in 2007 and $70 million over the 2007-2011 period, assuming enactment of appropriations laws necessary to implement FHA's single-family insurance program. We expect that the subsidy rate for these loans obtaining insurance under the new limitations would be close to the estimated rate of -0.37 percent for 2007, and that demand for FHA's loan guarantees would increase by about 10 percent annually after the marketplace has fully adapted to the changes in limits.

Increase in Demand. The last significant change in FHA's loan limitation occurred in October 1998 when the limit for high cost areas was raised from 75 percent to 87 percent of the conforming loan amount; subsequently, the total volume of loans guaranteed by FHA over the next year increased by about 25 percent. While a portion of this increase could be attributed to a surge in refinancing of existing mortgages and increases in house prices, FHA estimates that about 6 percent to 8 percent of the increase resulted from borrowers obtaining FHA-insured loans that were higher in value. Based on information from FHA and several industry associations, CBO expects that the increase in the volume of loans guaranteed by FHA under the proposed limits would be slightly higher.

An estimated 7 percent to 9 percent increase would amount to about $4 billion in loan guarantees and assumes that the estimated change in volume would stem mostly from increasing the limit in the less expensive housing markets. In lower-cost areas, FHA has a stronger presence; thus, increasing the limits in those areas would build upon FHA's existing market penetration in those areas. Moreover, according to the Mortgage Brokers Association, FHA's loan limits are not sufficient to cover the cost of new construction in many areas of the country, limiting options for the type of loans homebuyers can obtain in those areas. The National Association of Homebuilders reports that the median house price for a new home in 2005 was about $240,000, an amount that would fall within the proposed limit of $271,050 for the lower-cost areas.

The proposed increase in loan limit for the higher-cost areas would, in contrast, not have a significant impact in such high-cost areas because the median-house price in many of those areas already exceeds the proposed ceiling of $417,000. For example, according to information published by the National Association of Realtors, the median-house price in most parts of California exceeds $530,000. In addition, FHA's market share in high-cost areas is very low. According to the Realtors group, in 2004, FHA's market share in California was 0.37 percent. Thus, CBO expects that in certain high-cost markets where FHA's presence is minimal, there would probably be no significant impact on FHA over the next five years.

GNMA Savings. Changes in FHA loan limits also would generate savings for GNMA. 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 Mortgage-Backed Securities (MBS) program is estimated to have a subsidy rate of -0.21 percent in 2007, resulting in the net collection of receipts to the federal government.

Because most FHA single-family loan guarantees are included in GNMA's MBS program, CBO estimates that raising the loan limit would result in additional collections to GNMA of about $35 million over the 2007-2011 period. Like FHA, GNMA requires appropriation action to establish its dollar limitation for the securities program. (HECM loans are not included in GNMA's MBS program.)

Other Amendments to FHA's Programs

H.R. 5121 would make other changes to FHA's business operations; however, CBO does not expect these changes would have a significant budgetary impact over the next five years. These provisions are discussed below.

Risk-based Pricing and Flexible Downpayment Requirements. Once considered an innovator and dominant player in housing finance, especially for those borrowers who were not adequately served by the private market, FHA is no longer a major participant in the mortgage insurance industry. According to FHA, its market share has fallen from about 8 percent in 1999 to about 2 percent in 2005. Since 2002, FHA has experienced a sharp decline in the volume of single-family loans it guarantees, with total guarantees falling 60 percent from $147 billion in 2003 to $58 billion in 2005.

Moreover, the amount of offsetting collections generated by single-family loan guarantees has decreased significantly ($3.7 billion recorded in 2003 and $169 million estimated by the Administration for 2007) because the subsidy rate for the guarantees dropped from -2.53 in 2003 to an estimated -0.37 for 2007. The primary reasons for the waning popularity of FHA's guarantees and its decreasing offsetting collections are the perception among lenders and other industry participants of FHA's services as inefficient and overly cumbersome, its flat pricing structure, and the fact that FHA guarantees a limited range of loan products compared to private insurers, who are increasingly insuring low or no-downpayment loans and other types of alternative loan products.

Currently, FHA has a flat premium structure where all borrowers pay the same 1.5 percent up-front fee and 0.5 percent annual fee, regardless of the borrower's individual risk of default. This premium structure favors the riskiest borrowers because they are usually charged premiums that are too low to cover their expected defaults. In comparison, less risky borrowers are usually charged fees that are too high; consequently, many such borrowers seek competitively priced products from the private market, which charges borrowers fees that are commensurate with their credit profiles, otherwise known as risk-based pricing. This tradeoff between high- and low-risk borrowers results in an FHA portfolio that has a high concentration of the highest risk borrowers, limiting the amount of offsetting collections generated.

Proposed Changes. Under this legislation, FHA would have the authority to match the fees it charges with the borrowers' risk of default, and to offer guarantees for loans with little or no downpayment. Based on information from FHA, CBO assumes that FHA would initially charge up-front fees ranging from 0.5 percent (for the lowest-risk borrowers) to almost 3 percent (for the highest-risk borrowers). Annual fees are expected to range from .5 percent to .75 percent. FHA estimates that the blended subsidy rate for all of the guarantees would be about -0.9 percent beginning in 2007 (compared to -0.37 percent estimated for 2007 under current law). In addition, FHA estimates that by offering guarantees for low down-payment loans and other types of alternative loan products, and by charging lower fees for less risky borrowers, the overall volume of loans guaranteed would increase from about $45 billion to $65 billion.

Budgetary Effect. While CBO recognizes that FHA could increase the amount of offsetting collections it earns from its guarantees by converting from a flat fee structure to risk-based pricing, we do not expect that its overall collections and business volume would change significantly in the next five years. Risk-based pricing is complicated, requiring much precision in the underwriting process.

A recent review of FHA's automated underwriting system by the Government Accountability Office raises concerns over the effectiveness of the system and recommends that additional improvements be made. CBO expects that developing and maintaining the appropriate systems for managing a risk-based pricing structure would take FHA several years to implement. In addition, CBO estimates that any changes in volume stemming from the changes in pricing and the availability of FHA guarantees for a wider range of loan types would, in the short term, most likely result in no significant net change to the total number of loans guaranteed. That is, while some borrowers may turn to FHA because of better pricing and the ability to obtain insurance for more attractive loan products, other borrowers may turn away from FHA because of higher pricing. Moreover, CBO expects that it would take time for FHA to overcome its negative perception in the marketplace and to regain its place as a viable competitor in the mortgage insurance industry. Thus, CBO estimates that enacting these provisions would result in no significant effect on the budget in the near term.

Participation of Mortgage Brokers and Correspondent Lenders. Under current law, mortgage brokers and correspondent lenders (i.e., entities who do not underwrite or service loans) must meet certain financial audit and net-worth requirements to originate FHA loans. According to the National Association of Mortgage Brokers, these requirements are a barrier to mortgage-broker participation in the FHA program because the requirements can be very cost prohibitive and time consuming, especially for certain small businesses. Section 15 of H.R. 5121 would permit these mortgage brokers and correspondent lenders to participate in FHA loan programs if they post a bond in the amount of $75,000.

Based on information from FHA, CBO estimates that while this section would expand the number of distribution channels for bringing FHA loans to the marketplace, we do not estimate that the total number of loans guaranteed would change significantly over the next five years, resulting in no significant budgetary effect. Currently, there exists a vast network of lenders who participate in or who have access to FHA loan programs.

Consolidating Single-Family Programs. Enacting this legislation would enable FHA to move several loan guarantee programs, including loan guarantees for condominiums and HECM loans, from the General Insurance/Special Risk Insurance Fund to the Mutual Mortgage Insurance Fund. CBO estimates that this administrative change would have no net budgetary effect.

INTERGOVERNMENTAL AND PRIVATE-SECTOR IMPACT

H.R. 5121 contains no intergovernmental or private-sector mandates as defined in UMRA and would impose no costs on state, local, or tribal governments

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