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FHA-Insured Home Loans: An Overview

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Summary

The Federal Housing Administration (FHA) was created by the Housing Act of 1934 in order to broaden homeownership, protect lending institutions, and stimulate the building industry. This report discusses the features of the FHA program to insure loans on single-family homes and will be updated to reflect changes in law or regulation.

A Brief History of the FHA Home Loan Insurance Program

The Federal Housing Administration (FHA) was created by the National Housing Act of 1934 during the height of the Great Depression.[1] The act had three objectives: (1) to broaden homeownership, (2) to shore up and protect home financing institutions, and (3) to stimulate employment in the building industry.

Prior to the creation of FHA, few mortgages exceeded 50% of the property's value and most mortgages were written for terms of five years or less. At the end of the five-year term, the remaining loan balance had to be repaid or the mortgage had to be renegotiated. Borrowers generally had little trouble in obtaining new mortgages. During the Great Depression, however, lenders were unable or unwilling to refinance many of the loans that became due. Thus, many borrowers lost their homes through foreclosure, and lenders lost money because property values were falling. Lenders became wary of the mortgage market.

FHA institutionalized a revolutionary idea: 20-year mortgages on which the loan would be completely repaid at the loan term. If borrowers defaulted, FHA insured that the lender would be fully repaid. Mortgage instruments were standardized, and a new confidence was instilled in the mortgage market. Investment in housing was stimulated, and its ripple effects were felt throughout the economy. Eventually, lenders began to make long-term mortgages without FHA insurance if borrowers made significant downpayments. Over time, 25- and 30-year mortgages have become standard mortgage products.

When the Department of Housing and Urban Development (HUD) was created in 1965, FHA became an agency of HUD. This report discusses the features of the FHA program to insure loans on single-family homes. Single family homes are defined as properties containing from one to four dwelling units.[2] As will be noted below, P.L. 110-289, the Housing and Economic Recovery Act of 2008 (HERA), has made several changes to the program.

Features of the Program

Eligibility and Underwriting Guidelines

FHA-insured loans are available to owner/occupants who can demonstrate the ability to repay the loans according to the terms of the contract. In general, parties who have previously defaulted may not be eligible for FHA-insured loans. FHA-insured loans must be underwritten in accordance with accepted practices of prudent lending institutions and FHA requirements. The FHA credit analysis worksheet is used to examine the applicant's personal and financial status, monthly shelter expenses, funds required for closing expenses, effective monthly income, and debts and obligations. As a general rule, the applicant's prospective housing expenses should not exceed 29% of gross effective monthly income. The applicant's total obligations, including the proposed housing expenses, should not exceed 41% of gross effective monthly income. If these ratios are not met, the borrower should present compensating factors, such as savings history and past credit management.

[1] The National Housing Act, P.L. 73-479, 12 U.S.C. 1701 et seq.

[2] FHA also insures loans on multifamily properties, manufactured homes, nursing homes, and hospitals, but these insurance programs are not discussed in this report.

Maximum Mortgage

The maximum mortgages for FHA-insured loans are set area-by-area, and different limits are in effect for one-family , two-family, three-family, and four-family properties. Limits for high- and low-cost areas are subject to a statutory floor and ceiling. Under prior law, the FHA mortgage limit for a one-family home in an area was set at the lesser of (1) 95% of the median home price for a one-family home in the area or (2) 87% of the Federal Home Loan Mortgage Corporation (Freddie Mac)[3] conforming loan limit, but the limit for an area could be no lower than 48% of the Freddie Mac conforming loan limit. Through December 31, 2008, the Economic Stimulus Act of 2008, P.L. 110-185, increased these mortgage limits to the lesser of (1) 125% of area median home price or (2) 175% of the Freddie Mac conforming loan limit, but the loan limit for an area may not be lower than 65% of the Freddie Mac conforming loan limit. As of January 1, 2009, HERA provides that the FHA loan limit for a one-family home in an area will be the lesser of (1) 115% of the area median home price for a one-family home or (2) 150% of the Freddie Mac conforming loan limit, but the limit for an area may not be lower than 65% of the Freddie Mac conforming loan limit. FHA loan limits through December 1, 2008, are summarized in **Table 1**.

Table 1. FHA Maximum Loan Limits, through December 31, 2008

Property Size	High-Cost Area[a] (Upper Limit)	All Other Areas	Low-Cost Area[b] (Lower Limit)
1-family	$729,750	125% of area median home price	$271,050
2-family	$934,200	125% of area median home price	$347,000
3-family	$1,129,250	125% of area median home price	$419,400
4-family	$1,403,400	125% of area median home price	$521,250

Source: Department of Housing and Urban Development, Mortgagee Letter 2008-06, "Temporary Loan Limit Increase for FHA."

Note: FHA mortgage limits by state, county, and MSA are available at https://entp.hud.gov/idapp/html/hicostlook.cfm.

a. Areas where 125% of median home price exceeds 175% of the Freddie Mac limit. The National Housing Act provides that mortgage limits for loans in Alaska, Guam, Hawaii, and the Virgin Islands may be adjusted up to 150% higher than the statutory ceiling.

b. Areas where 125% of median home price is lower than 65% of the Freddie Mac limit.

Loan Term

FHA-insured loans may be obtained for mortgages with terms of up to 30 years. In special cases, low-income borrowers may be eligible for 35-year loans to make the mortgage more affordable.

Downpayment

HERA has amended the National Housing Act to increase the borrower's required cash contribution from 3% to 3.5% of the appraised value of the property. HUD has interpreted this as

[3] Freddie Mac is a stockholder-owned corporation chartered by Congress in 1970 to create a secondary market for mortgages. The size of loan Freddie Mac may purchase is set by statute and the limit may be adjusted on January 1st of each year, based on changes in the national average home prices.

a 3.5% downpayment requirement and has specified that contributions toward closing costs cannot be counted toward the 3.5% cash contribution.[4] HUD provides that this requirement will take effect on January 1, 2009, instead of October 1, 2008, as specified in HERA. Presumably, the current downpayment rules will apply until January 1, 2009. Through December 31, 2008, the minimum downpayment a borrower must provide is as follows:

- 1.25% of the value of the property for a property appraised at $50,000 or less;
- 2.35% of the value of the property for a property valued in excess of $50,000 but less than $125,000;
- 2.85% of the value of the property for a property valued at $125,000 or more;
- 2.25% of the value of the property for a property valued in excess of $50,000 that is located in an area of the state for which the average closing costs exceed 2.1% of the average closing costs for the state.

Owner Occupancy

Generally, for loans closed on or after December 15, 1989, borrowers must intend to occupy the property as a principal residence. Property that has been acquired by FHA as a result of default or foreclosure may be sold to owner-occupants or investors, and in some cases the borrowers may obtain FHA-insured loans.

Eligible Loan Purposes

FHA-insured loans may be used to purchase one-family detached homes, townhomes, rowhouses, two- to four-family buildings, manufactured homes and lots, and condominiums in developments approved by FHA. The loans may also be used to build a home; to repair, alter, or improve a home; to refinance an existing home loan; to simultaneously purchase and improve a home; or to install a solar heating and cooling system or other weatherization improvements.

Mortgage Insurance Fees

Borrowers pay an up-front mortgage insurance premium and an annual mortgage insurance premium. The amount and duration of the annual premium is determined by the size of the downpayment: (1) if the downpayment is over 10%, the annual premium is 0.5% of the loan balance for the first 11 years of the loan, (2) if the downpayment is 5% to 10%, the annual premium is 0.5% for the first 30 years of the loan, (3) if the downpayment is less than 5%, the annual premium is 0.55% of the loan balance for 30 years.

HERA increases the FHA upfront mortgage insurance premium for a borrower who has not received homeownership counseling from 2.5% to 3% of the mortgage amount, and for a borrower that has received homeownership counseling, the upfront mortgage insurance premium is increased from 2% to 2.75% of the mortgage amount. This is the maximum premium, and HUD has the discretion to set the premium at a lower level. For example, even though prior law permitted a premium of up to 2.5%, administratively HUD set the up-front premium at 1.5% of

[4] U.S. Department of Housing and Urban Development Mortgagee Letter 2008-23.

the loan amount for all loans insured on or after January 1, 2001.[5] Although the new maximums are effective upon enactment of HERA, any increases in premiums for borrowers will only take effect if HUD issues a Mortgagee Letter announcing such increases.

If borrowers prepay their loans, they may be due refunds of the up-front insurance premium that was not "earned" by FHA. The refund amount depends on when the mortgage closed and declines as the loans mature (see **Table 2**). The Consolidated Appropriations Act 2005 (P.L. 108-447) amended the National Housing Act to provide that, for mortgages insured on or after December 8, 2004, borrowers will not be eligible for refunds of up-front mortgage insurance except when borrowers are refinancing existing FHA-insured loans with new FHA-insured loans. After three years, all of the up-front insurance will be considered as "earned" by FHA, and these borrowers will not be eligible for any refunds. Borrowers whose mortgages were insured prior to December 8, 2004, will continue to be eligible for refunds according to rules in effect at the time the mortgages were closed. For mortgages insured on or after January 1, 2001, but prior to December 8, 2004, borrowers are eligible for refunds for up to five years after the mortgages are originated.

The annual insurance premiums are not refundable. For loans closed on or after January 1, 2001, the annual mortgage insurance premium will be automatically cancelled when, based on the initial amortization schedule, the loan balance reaches 78% of the initial property value. Borrowers may also request cancellation of the mortgage insurance when the 78% loan-to-value ratio is reached due to advance payments by the borrower.

Table 2. Up-Front Mortgage Insurance Premium Refunds

Date of Closing	Refund Amount If Mortgage Paid After:					
	6 Months	1 Year	3 Years	4 Years	5 Years	7 Years
On or after Dec. 8, 2004[a]	70%	58%	no refund 3 years after mortgage closed			
Jan. 1, 2001, to Dec. 7, 2004[b]	85%	75%	35%	17%	no refund after Dec. 7, 2009	

Source: Department of Housing and Urban Development Mortgagee Letters 2005-03, 00-46, and 94-1.

a. Only borrowers that refinance an existing FHA-insured loans with new FHA-insured loans are eligible for refunds.

b. All borrowers who prepay their loans are eligible for refunds.

Interest Rates

The interest rate on FHA-insured loans is negotiated by the borrower, seller and lender. The borrower has the option of selecting a loan with an interest rate that is fixed for the life of the loan or one on which the rate may be adjusted annually.

Defaults

A mortgage is considered delinquent any time a payment is due and not paid. Once the borrower is 30 days late in making a payment, the mortgage is considered to be in default. In general,

[5] HUD Mortgagee Letter 2000-38.

foreclosure may be initiated when three monthly installments are due and unpaid and must be initiated when six monthly installments are due and unpaid, except when prohibited by law.[6] A program of loss mitigation strategies (summarized in **Table 3**) was authorized by Congress in 1996 to minimize the number of FHA loans entering foreclosure.[7]

Additional loss mitigation options are available for certain populations of borrowers. By written agreement with the lender, a borrower in military service may suspend the principal portion of monthly payments and pay interest only for the period of military service, plus three months.[8] On resumption of payment, loan payments are adjusted so that the loan will be paid in full according to the original amortization.[9] FHA also has relaxed rules on the use of partial claims and loan modifications.[10]

Table 3. Loss Mitigation Strategies

Possible Remedies for FHA Loans in Default	
Special forbearance	Lender/servicer works out a repayment plan that may include partial or suspended payments for a specified period of time.
Partial claim	FHA provides an interest-free loan to the borrower to pay the arrearage. The borrower must repay FHA at the end of the original loan term or when the property is sold.
Loan modification	The original mortgage is modified to include the total unpaid amount due. Changes may be made to the term, interest rate or type of loan.
Pre-foreclosure sale	Borrower sells the property and uses the proceeds to satisfy the mortgage debt. FHA pays a partial claim to the lender to make up the difference if the property is sold for less than the mortgage amount.
Deed-in-lieu-of-foreclosure	Borrower deeds the property to FHA and is released from the mortgage.

Sources: 24 CFR 203, Subparts B and C; *An Assessment of FHA's Single-Family Mortgage Insurance Loss Mitigation Program Final Report* (Abt Associates, 2000).

Program Funding

The FHA home mortgage insurance program is funded by the FHA Mutual Mortgage Insurance Fund (MMIF), which has been sufficient to fund all operations of the FHA home mortgage insurance program without appropriations from Congress. MMIF income comes from insurance premiums, interest earnings, and proceeds from the sale of foreclosed homes; and from cash flows out of the MMIF to cover administrative costs, claims on foreclosed mortgages, and refunds of mortgage insurance premiums. In recent years, FHA has faced increased competition from conventional mortgage lenders; the resulting decrease in FHA loan volume coupled with the poor performance of FHA loans has reduced the income traditionally generated by the program.

[6] 24 *CFR* 203.355. State law may prohibit the start of foreclosure proceedings within the time frame specified by HUD. Also, military service of the borrower may delay foreclosure proceedings (24 *CFR* 203.346).

[7] P.L. 104-99, the Balanced Budget Downpayment Act, I.

[8] In addition, as amended by HERA, the Servicemembers Civil Relief Act, P.L. 108-189, provides that individuals called into military service may apply to have any legal action against their homes stayed until nine months after the release from military service, and foreclosure can be prevented until one year after release from military service.

[9] 24 *CFR* 203.345 and 203.346.

[10] HUD Mortgagee Letter 2005-46.

The President's FY2009 budget proposed reforming the FHA program to make it more competitive. Some of these reforms have been included in HERA.[11]

Program Activity

FHA wrote $56.5 billion in insurance to insure the purchase or refinancing of 402,140 housing units during FY2007. At the end of FY2007, FHA had $342.6 billion of insurance in force on about 3.7 million homes. From 1934 through the end of FY2007, FHA insured about 34.6 million home loans at a mortgage volume of about $2 trillion.

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[11] For additional information on FHA reform proposals, see CRS Report RL33879, *Housing Issues in the 110th Congress*, by Libby Perl et al.