Fast Prepayments of VA Mortgages Are Increasing Costs to Veteran and FHA Mortgage Borrowers

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June 2019

The Government National Mortgage Association, or Ginnie Mae, promotes affordable homeownership through mortgage securitization programs that connect mortgage lenders with investors, providing liquidity and stability to the US mortgage market. Ginnie Mae's programs convert government mortgages backed by three federal agencies—the Federal Housing Administration (FHA), the US Department of Veterans Affairs (VA), and the US Department of Agriculture (USDA) Rural Housing Program—into mortgage-backed securities for investors to purchase.

Since 2016, Ginnie Mae has tried to combat the churning of VA mortgages (which results in unusually fast prepayment speeds), a potential abuse in the system by VA lenders that has made all government mortgages slightly more expensive, particularly loans made to veterans.

We quantified the additional cost that fast prepayments might impose upon all government mortgage borrowers and find that the cost in the form of higher mortgage rates is 7 basis points, or 0.07 percent. Because many of these prepayments do not benefit borrowers and represent an abuse of the program by lenders, this extra cost is concerning. Critically, the cost to all borrowers could be larger if investors lose confidence in Ginnie Mae securities because of churning.

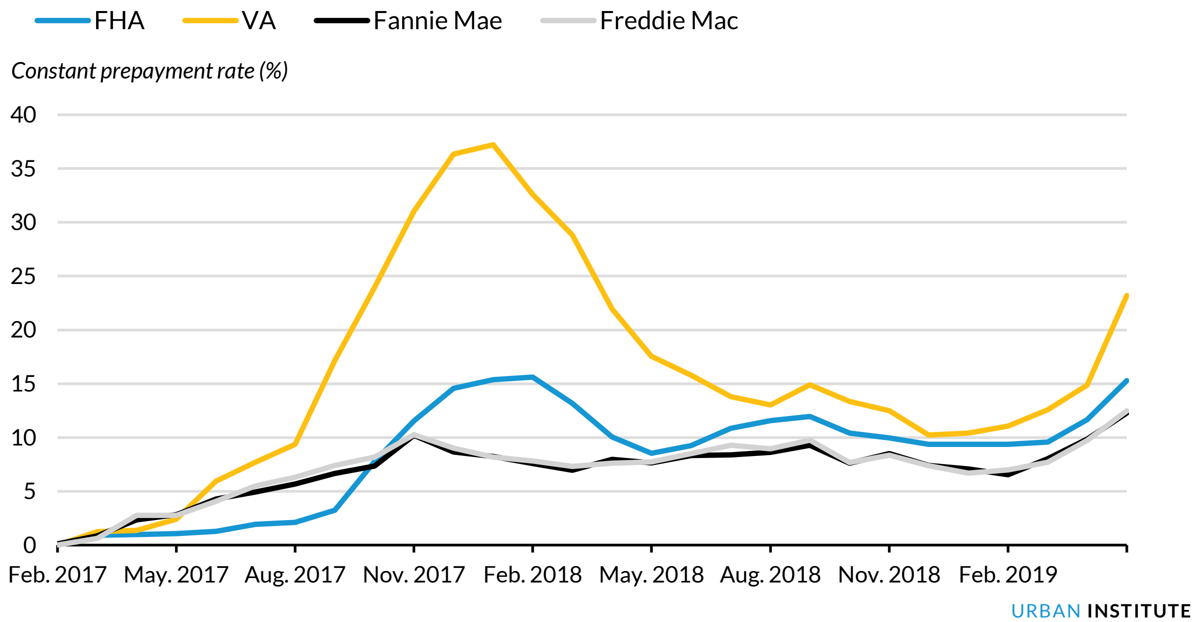
Faster Prepayment Speeds Harm Veterans and All Government Borrowers

A review of the differential prepayment rates between FHA and VA mortgages reveals that VA borrowers prepay their mortgages faster and are more responsive to interest rate declines.

Figure 1 shows the prepayment behavior of VA mortgages versus FHA and conventional mortgages pooled in 2017 with a 4 percent coupon.

FIGURE 1

Prepayment Behavior of Mortgages Originated in 2017 with a 4 Percent Coupon



Sources: Apsec and the Urban Institute.

Note: FHA = Federal Housing Administration; VA = US Department of Veterans Affairs.

Veterans. Some of the increased speeds in VA mortgages are accounted for by the nature of the program—that is, the cost of refinancing a VA mortgage is lower than for an FHA mortgage, and VA borrowers tend to have better credit scores, making refinancing easier. But some of the faster prepayments are because of churning, where the original mortgage is made with the expectation that the loan will quickly refinance (Bright 2018). Churning can cause a VA borrower to pay an above-market rate for a period of time and additional origination fees on the new mortgage. In many cases, the new mortgage is a cash-out refinance, so the increased balance includes both the fees and some equity taken out for the borrower. New cash-out refinance mortgages were 24 percent of VA originations in March 2019 but just 20 percent of Freddie Mac and 17 percent of FHA originations (Fannie Mae data are unavailable).

Borrowers using the FHA or USDA programs. Ginnie Mae originations are 57 percent FHA loans, 40 percent VA loans, and 3 percent loans from other government programs (mostly the USDA). All Ginnie Mae borrowers pay high interest rates because of high VA prepayment speeds. The impact is greater for borrowers who are less apt to refinance, typically borrowers with low credit scores and those who live in areas with low home price appreciation.

How Much Do Faster VA Prepayment Speeds Cost Ginnie Mae Borrowers?

Through calculations described below, we determined that the faster prepayment speeds, if passed through to the borrower, would require all Ginnie Mae borrowers to pay an additional 7 basis points per year in interest rates. Although not a huge number, it is significant. For example, it would increase the monthly payment on a $250,000, 30-year mortgage with a 4.25 percent interest rate by $175 per year, with no benefit to the borrower.

Faster Prepayments Could Undermine Investor Confidence

VA lenders that churn loans do so because they can make a profit with two closings. But refinancing a loan that has already been securitized is costly for investors in mortgage-backed securities. For example, if a borrower takes out an FHA mortgage with a 4.25 percent interest rate, that mortgage will be packaged in a securitization with a 4 percent coupon, the servicer will keep 19 basis points for servicing, and Ginnie Mae will receive 6 basis points. Assume the price for $100 par amount of a Ginnie Mae 4 percent mortgage is $103.50. If every mortgage were removed from the Ginnie Mae pool just after purchase and refinanced into an identical mortgage, the investor will lose $3.50 per $100 invested. The investor is compensated for this risk by receiving a rate higher than the Treasury interest rate on a guaranteed security. But the more loans are removed and refinanced, the more investor confidence in this security is undermined.

Ginnie Mae Is Combating the Problem, but It Is Not Easy to Solve

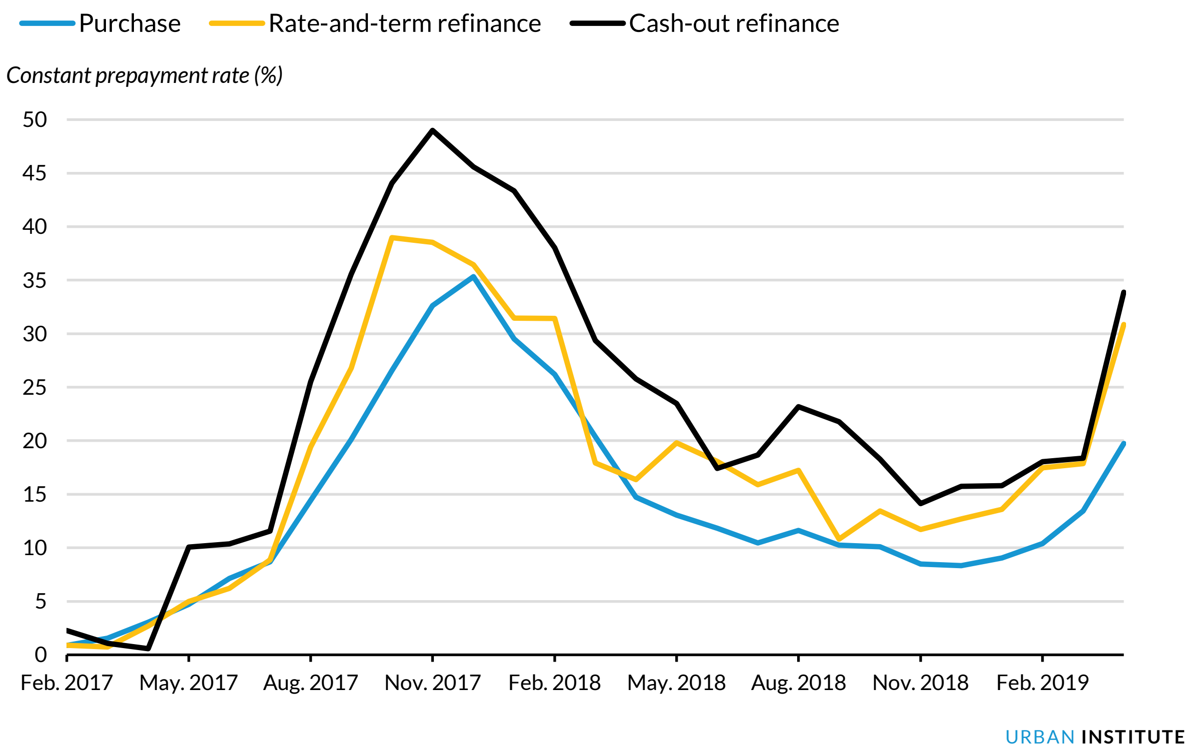
Ginnie Mae is concerned about this problem and has taken several actions to curb abuses since 2016. It implemented a six-month seasoning period for streamlined refinance loans and later extended this to cash-out refinance loans. In 2018, Ginnie Mae put lenders with fast VA speeds in a “penalty box” for various periods by prohibiting those lenders from delivering VA loans into large multi-issuer Ginnie Mae II securities. Also, in 2018, the VA implemented a net benefit test to ensure veterans receive some benefit from refinancing. Even so, VA speeds are still faster than FHA or conventional speeds.

Ginnie Mae continues to seek advice. On May 6, 2019, it issued a request for information, seeking advice on further action. The deadline was May 31, but comments are still welcome. In the request for information, Ginnie Mae suggests prohibiting or restricting the amount of VA cash-out refinances with a loan-to-value ratio of over 90 percent that can be pooled with other types of loans.

This is a difficult issue. Some servicers are faster than others, and borrowers with certain characteristics are faster at prepaying than others. And cash-out refinances are at least somewhat faster than purchase loans, but they are not a lot faster than rate-and-term refinances (figure 2).

FIGURE 2

Prepayment Behavior of VA Mortgages Originated in 2017 with a 4 Percent Coupon



Sources: Apsec and the Urban Institute.

Note: VA = US Department of Veterans Affairs.

Restricting only cash-out refinances will have a marginal effect on speeds and will not close the speed gap relative to FHA or government-sponsored enterprise mortgages. The bigger question is how much variation in prepayment speeds can be allowed in the Ginnie Mae program and how much of the variation is attributable to inappropriate practices.

We can agree that prepayment speeds on VA mortgages are considerably faster than on their FHA counterparts, and this costs all government borrowers money. And although Ginnie Mae and the VA have taken steps to curb the rapid speeds, they are looking to do more.

The next step is less clear. We anticipate this request for information will generate suggestions to exclude certain loans, which will have implications for borrowers and prepayments. Before taking any action, Ginnie Mae should understand who is using the products that will be excluded or restricted and simulate the effect on outstanding pools to understand the impact on speeds. Among the options that Ginnie Mae and the VA may want to consider are strengthening the net benefit test on refinancing, such as requiring an explicit calculation that shows material gain for the borrower (a VA action), or further restricting the ability of refinancings on recent originations to be placed into Ginnie Mae securities (a Ginnie Mae action). Dramatic changes include separate Ginnie Mae securities for the VA program. Any of these options could impose significant costs on the mortgage system and create winners and losers. Nonetheless, doing nothing is not a good option.

How We Calculated the Cost of Faster Prepayments

Borrowers prepay at different rates. Some borrowers require more of an incentive to refinance, and some require less. And these prepayment rates depend on interest rates, with lower rates generating more refinancing activity. We need to make some simplifying assumptions for our calculations. To quantify the effect of the faster VA speeds on all Ginnie Mae borrowers, we made the following assumptions:

- The Ginnie Mae pool composition is 40 percent VA loans.
- The VA prepays a 15 percent faster conditional prepayment rate in the first year, a 10 percent faster rate in the second year, and a 5 percent faster rate in the third year. These numbers are larger than the averages in figure 1. For expositional purposes, we assume FHA speeds are zero, and we do not discount our results.
- The current price of a Ginnie Mae 4 percent mortgage pool is $103.50.

If all mortgages exhibited the prepayment speeds of VA mortgages, the cost to a Ginnie Mae investor is the 15 percent extra prepayment in the first year, 10 percent in the second year on the remaining balance of 85 percent, and 5 percent in the third year on the 76.5 percent of the pool that is left: $[(0.15) + (0.85)(0.10) + (0.765)(0.05)] * 3.50 = 23.5\% * 3.5 = \$0.95$ per $100 of mortgage balance.

But the mortgages are only 40 percent of the pool, so the cost to investors would be $0.38 per $100 par value.

If this were passed through to the borrower, it would require all Ginnie Mae borrowers to pay an additional 7 basis points per year in interest rates to cover this risk. Although this is not a huge number, it is significant. For example, it would increase the monthly payment on a $250,000, 30-year mortgage by $175 a year ($250,000 * 7 basis points). Of course, the effect could be larger if investors worry that "cheapest to deliver" securities will have greater prepayment speeds and they cease investing in the Ginnie Mae program.

Reference

Bright, Michael R. 2018. Testimony before the House Committee on Veterans Affairs, Subcommittee on Economic Opportunity, Washington, DC, January 10.

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Acknowledgments

The Housing Finance Policy Center (HFPC) was launched with generous support at the leadership level from the Citi Foundation and John D. and Catherine T. MacArthur Foundation. Additional support was provided by The Ford Foundation and The Open Society Foundations.

Ongoing support for HFPC is also provided by the Housing Finance Innovation Forum, a group of organizations and individuals that support high-quality independent research that informs evidence-based policy development. Funds raised through the Forum provide flexible resources, allowing HFPC to anticipate and respond to emerging policy issues with timely analysis. This funding supports HFPC's research, outreach and engagement, and general operating activities.

This brief was funded by these combined sources. We are grateful to them and to all our funders, who make it possible for Urban to advance its mission.

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