The Baker Group

What the MIP Cut Means to MBS Investors

The Federal Housing Administration (FHA) recently announced a decrease to the annual premium charged to borrowers with FHA-backed loans. The reduction goes into effect for newly-originated purchase or refi loans endorsed on or after March 20, 2023. This annual premium, called the mortgage insurance premium (MIP), is a monthly fee that FHA borrowers pay into the fund that insures FHA-backed mortgages, the Mutual Mortgage Insurance Fund (MMIF).

This fund exists to guarantee lenders against loss for loans made under the FHA mortgage program. FHA mortgages are considered higher-risk because the program permits low down-payments and less stringent credit qualifications than conventional home loans backed by Fannie Mae and Freddie Mac. The guarantee gives lending institutions comfort extending credit to borrowers who might not otherwise qualify for a home loan and enables them to offer these borrowers better terms.

In order to fund the MMIF, FHA borrowers pay a monthly fee: the Annual MIP * their loan amount (divided by 12 to arrive at a monthly amount). Prior to the recent cut, the annual premium was between 80-105 bps, based on the size of the loan and the Loan-To-Value (LTV) ratio. The new premium is 50-75 bps, a 30 bp decrease across the board. For most borrowers the fee is either 50 or 55 bps. These fees amass in the MMIF and in the event of default by an FHA borrower, MMIF capital is used to cover any losses.

This was especially important when a wave of mortgage defaults associated with the Great Financial Crisis hit the fund beginning in 2008. By 2009, the fund's capital ratio fell below its statutory minimum of 2.0% and stayed below that level until 2014. Since then, the MMIF has grown substantially, especially over the last few years when record home price appreciation, a housing boom, and significant refinance activity drove more funds into the system. By November 2022, the MMIF reported a record 11.11% capital ratio, significantly above the 2.0% threshold mandated by Congress.

Speculation about a cut to the MIP had been swirling for more than a year as the fund got larger and larger. By late-February 2023 when the cut was announced, the move had been well telegraphed to the market and the cut largely priced in. Given how well advertised the cut was and how little of the mortgage universe is in-the-money to refinance, the cut may not mean much to Mortgage-Backed-Securities (MBS) investors in the near term.

In a more normal interest rate environment, the effect of reducing the MIP would be faster prepayment speeds on Ginnie Mae MBS (FHA mortgages are securitized into Ginnie Mae MBS). This is because borrowers would be incentivized to lower their monthly mortgage payment by taking out a new FHA mortgage tied to the lower MIP and using the proceeds to pay off their existing mortgage tied to the old/higher MIP (aka refinancing). However, today's prevailing mortgage rates are so much higher than most existing mortgages, which were originated with historically low rates over the last few years, that this exercise will not save most borrowers money. A 30 bp cut to the MIP simply is not enough to offset 300+ bps higher mortgage rates. Further, in order to qualify for a streamlined refinance of an FHA loan, a borrower's new all-in payment rate (mortgage rate + MIP) must be at least 50 bps below their current level. That simply is not possible for most FHA mortgages in existence today.

As a result, the impact on prepayment speeds for Ginnie Mae MBS will be minimal, at least for now. The landscape will certainly change if rates fall materially in the future but we should not expect to see a significant impact on prepayment speeds in the near term. Instead, the most consequential outcome of the MIP cut may be a marginal shift in production from conventional loans to FHA loans.

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In January, Fannie Mae and Freddie Mac announced a range of pricing changes applicable for conventional loans that will become effective in May 2023. Some borrowers' costs will be reduced while others will go up. The MIP cut, which reduces monthly payments for all FHA borrowers across the board, combined with the pricing changes on conventional loans will make FHA loans comparatively less costly than conventional loans for a swath of borrowers, those with FICO scores between 680-760 and LTVs below 95. As a result, we could see some loans that would have otherwise been securitized into Fannie or Freddie MBS shift into Ginnie MBS. That would translate into a marginal increase in the supply of Ginnie MBS at the expense of Fannie and Freddie MBS.

This should not have a material effect on valuations or demand but would swing the supply needle further towards Ginnie Mae production at a time when their market share is already rising. As persistently high home prices and rising mortgage rates have eroded affordability, many borrowers have fallen out of conventional loan eligibility and sought refuge in the looser credit qualifications of FHA loans, a trend which may only be exacerbated by the MIP cut. The upside for investors is slightly faster prepayment speeds if rates fall and potential for increased supply of loans available for pooling into attractive Ginnie CMO structures with 0% risk weighting.

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