FHA Streamline Refinance Program - Is Adverse Selection Getting Worse?*

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Abstract

Since the Subprime crisis and national housing market debacle, FHA has become the primary source for mortgage financing in the United States, along with the two GSEs (Fannie Mae and Freddie Mac). In 2006, FHA's market share in home sales was3.77%; in 2010, it jumped to 19.13%.

Due to the continuous housing market deterioration during 2006-2009, FHA loans have incurred significant losses. In order to replenish its economic capital, FHA has sharply increased its annual mortgage insurance premium (MIP) from 0.50% to 1.55% for its highest risk mortgage cohort.

There have been some arguments that the increased MIP has worsened the adverse selection of FHA loan refinancing: more good credit loans are leaving the FHA for the GSEs, and the results will be higher claim rates for future FHA books.

In this paper, we develop a competing risk framework, where the traditional refinancing and FHA streamline refinancing are alternative termination outcomes for an FHA loan. We identify that traditional definition of adverse selection based on home equity is very strong, but the adverse selection on other credit risk attributes are not as severe. Also based on the newly originated streamline refinance loans, we estimate that the adverse selection is not getting worse.