A Storm on the Horizon

Today's low interest rates may mean a future rise in mortgage assumptions

By Christopher L. Gardner

To become a successful originator, it's generally important to cultivate relationships with real estate agents and originate purchase mortgages. Without purchase deals, one has to rely on the boom-and-bust cycles of the refinance market.

A danger to the purchase market and a threat to future commissions could come from assumable mortgages, whereby a homebuyer agrees to take over the seller's mortgage. Assumable mortgages are attractive when terms that were given to the seller are more desirable than the terms currently available for the buyer.

Currently, there are about 11.4 million Federal Housing Administration (FHA), U.S. Department of Veterans Affairs (VA) and U.S. Department of Agriculture (USDA) loans outstanding with a market capitalization of hundreds of billions of dollars, according to 2018 data compiled by the Urban Institute. This amounts to about 24% of outstanding mortgages. These government-backed loans are fully assumable.

A qualified buyer for a home with an existing government mortgage can step into the shoes of the seller and take it over. As a result, this completely eliminates the need for (and the cost of) originating a new loan. Assumptions aren't a well-known option in the marketplace since interest rates have been declining. Once rates start going up, however, there will be more awareness about this financing mechanism.

Appealing advantages

The advantages of mortgage assumption are many. Many of the fees charged for government loans are waived. The original lender that has to approve the arrangement can charge an assumption fee, but the government agencies impose limits on these fees.

In states that place a tax on new mortgages, no tax is levied based on an existing loan. There are no origination fees that can be charged to the borrower since there is no origination. There also is no appraisal required for an assumption.

The real driver of assumptions is interest rate savings. Although rates are expected to remain low through this year, eventually they will rise. Borrowers and originators alike have long enjoyed low rates and cheap money, an historic anomaly unlikely to continue unabated. It may come as a surprise, but the average rate for a 30-year mortgage since 1971 is 7.9%, according to the Federal Reserve.

Assumptions are not a current threat to originator commissions because rates generally have done one thing for the past 25 years — go down. Imagine the scenario when rates rise and the historical rate graph starts to resemble a V.

Envision interest rates at 6% (they were at 4.94% in November 2018), then consider that many government mortgages have been streamline refinanced to rates below 3%. Under these conditions, in addition to the savings already identified, the interest rate savings for every $100,000 of mortgage debt for an assumed loan versus a new loan would be hundreds of dollars a month — for the life of the loan.

The assumed loan will have less than 30 years remaining, potentially saving years of mortgage payments. Since the mortgage is seasoned, more of the monthly payment on an assumed loan will go toward principal than it will for a newly amortized loan.

Additionally, if mortgage insurance premiums rise in the future — which is likely given the number of pandemic-induced forbearances — there will be a corresponding savings on the monthly premiums attached to FHA and USDA loans (VA loans have no mortgage insurance). Simply put, the aggregate savings and benefits of assumption will obliterate the need to originate a new mortgage.

Significant bite

You can be sure that other stakeholders in the industry are going to do everything in their power to facilitate and ensure conversion of these assumptions. Besides the benefits to buyers (lower costs and payments), a seller benefits from an assumption because more buyers qualify for the lower payment, thereby increasing demand for their property and translating to a higher sales price.

Listing and selling agents benefit from the same scenario and will be able to shorten the contract period for sales. An assumption allows for an easier and quicker transaction, with no need to set up funding, obtain an appraisal or other delays.

Additionally, servicers will do everything they can to facilitate assumptions and ensure their continued servicing of the mortgage. If they had it their way, every loan would reach its 360-month maturity. Servicers lose out when a loan is refinanced or paid off, forcing these companies to buy servicing rights on new loans. With an assumed loan, however, servicers will continue to collect the same fee even if someone new is in the home. When rates rise, the value of government loan servicing should skyrocket.

Even the U.S. Department of Housing and Urban Development (HUD) has a dog in the assumption fight. Putting aside HUD's altruistic and admirable goals of increasing affordable homeownership, FHA mortgage insurance premiums are often for the life of a loan. These fees will continue filling the agency's coffers for years on loans that, were it not for an assumption, would have been extinguished by a new conventional loan or cash purchase.

And if you don't think this will affect you, consider this: Once assumed, the new homeowner can offer a subsequent buyer his or her assumed loan, affecting originations for decades. Finally, there are hundreds of thousands of FHA mortgages being added to the outstanding total every year, ensuring that assumptions are going to take a significant bite out of origination fees for a long time.

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When rates go up, prepare to lose a significant portion of your purchase mortgage deals to loans that have already been originated. If this becomes a popular way to finance home purchases, there's not much an originator can do except to work with buyers on nongovernment loans. Assumptions are not going to help originators earn more commissions. •

DEFINITION

Assumable mortgage

An assumable mortgage is a home loan that can be transferred from the original borrower to the subsequent homeowner. The interest rate and the terms of the original loan stay the same. This can be an attractive option for both buyers and sellers in a rising interest rate environment.

Source: NerdWallet

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