

# VA Loans Outperform FHA Loans. Why? And What Can We Learn?

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While Veterans Administration (VA) mortgages and Federal Housing Administration (FHA) mortgages are often lumped together as “government mortgages,” the programs have significant differences, as do the borrowers who use them. In addition, delinquency rates on VA loans have consistently been much lower than on FHA mortgages, even after correcting for borrower characteristics. In this commentary, we look at the programs, the profiles of the borrowers, and default rates to identify lessons from the favorable VA experience that can be incorporated into FHA or other programs.

There are two critical differences in the design of FHA and VA lending programs:

1. **Skin in the game.** In the VA program, the lender has a stake in how the borrower performs. The VA provides insurance in the form of a first-loss guaranty, but the lender is at risk if losses exceed that amount.
2. **Additional affordability test.** The VA also has a residual income test as well as debt-to-income (DTI) guidelines, whereas the FHA and conventional lenders rely exclusively on DTI guidelines to measure affordability.

We believe both differences have been important in containing default rates on lower-credit-score, lower-income borrowers. Making the FHA more like the VA by adopting the first difference and insuring less than 100 percent of FHA’s single family first-lien loans will be a long process, if it is possible at all. But the second idea, using residual income as at least a supplement to DTI, might be feasible and worth pursuing in the short term.

In the next section, we look at differences in the programs and profiles of the borrowers. We then control for differences in borrower characteristics, and look at differences in default rates. Finally, we suggest some reasons for the consistently better performance of VA loans and make suggestions for expanding the residual income test to other programs.

## Comparison of VA and FHA Programs

1. **Borrower eligibility.** To be eligible for a VA loan, the borrower must be a veteran, or currently on active duty, and satisfy certain length and character of service criteria. Members of the National Guard or Selected Reserve who have six years of service are also eligible, as are certain surviving spouses of veterans. There are no borrower eligibility restrictions for an FHA loan.
2. **Loan limitations.** Both FHA and VA loans are limited to owner-occupied properties and both have loan limits. For the FHA, the loan limits are governed by the Housing and Economic Reform Act of 2008. For single-family homes, the limit is set at 115 percent of an area’s median home price, with a floor and ceiling, currently at \$271,500 and \$625,000, respectively.<sup>1</sup>

The VA has a maximum guaranty amount for each county, which effectively serves as a loan limit. The maximum is \$417,000 for most of the country, and much higher in certain high-cost areas. For example, the limit is \$1,050,000 in San Francisco and \$978,750 for most of the New York metropolitan area.

3. **Low down payments allowed.** Both the FHA and the VA are low-down payment lending programs. The FHA permits purchase loans with up to a 96.5 percent loan-to-value (LTV) ratio. The limit for refinance loans is 97.75 LTV (2.25 percent down). In addition, the 1.75 percent up-front mortgage insurance premium may be financed.

The VA allows for 100 percent LTV financing (no down payment). However, the VA charges a fee for funding the mortgage. This fee, which is usually 2.15 percent of the sales price the first time a borrower uses the VA guaranty and 3.3 percent for subsequent uses, can also be financed.<sup>2</sup> Borrowers who receive disability compensation (about 33 percent of all borrowers) are exempt from the fee.

Thus, under the VA program, a borrower may finance 102.15 percent of the sales price or reasonable value of the home for first-time uses or 103.3 percent for subsequent uses. The VA also permits up to \$6,000 in financing for energy improvements.

4. **Fees.** In addition to the up-front mortgage insurance premium, the FHA charges an annual fee. This fee is now 135 basis points for a typical borrower taking out a 30-year loan at the maximum permissible level. Unlike the FHA, the VA does not have an annual insurance fee.
5. **Lender responsibility.** A major difference between the two programs is the extent of continuing lender responsibility for the loan's performance. The FHA is responsible for 100 percent of the principal and interest payments for its loans. In contrast, the VA guaranty is much more modest, leaving the VA lender at some financial risk if the loan defaults.<sup>3</sup> The maximum VA guaranty is 25 percent of the loan amount, up to the county loan limit, with a minimum guaranty of \$36,000. The lender is responsible for any loss above the VA guaranty.

It is important to realize that veterans have an available "entitlement" to a VA guaranty equal to 25 percent of the county limit for the home being mortgaged. This county loan limit determines the maximum amount a veteran can borrow without

making a down payment. A borrower can have more than one VA-guaranteed home loan. However, if a borrower still owns a home and rents it out, or has sold it to a nonveteran who assumed the loan, the amount of the remaining entitlement will be reduced by the entitlement used for the existing loan. The full entitlement would be restored if the loans were assumed by a veteran with his or her own entitlement.

Several examples will make the responsibilities of the lender clearer:

**Example 1:** 25 percent of the loan amount is less than VA minimum guaranty (\$36,000)

A veteran who has no other VA mortgage purchases a home for its market value of \$75,000. The borrower takes out a VA mortgage for \$75,000 plus funding costs. In this example, the loan is small enough that the VA will guarantee \$36,000, which is more than 25 percent of the loan amount. The lender is at risk for the remaining balance.

**Example 2:** 25 percent of the loan amount is greater than VA minimum guaranty (\$36,000)

An active duty service member with no other VA mortgage purchases a home for a market value of \$280,000, in a county with a \$417,000 limit. The maximum guaranty available in the county is 25 percent of \$417,000, or \$104,250. The borrower takes out a VA mortgage for \$280,000. The VA guarantees the first 25 percent, or \$70,000. The lender is at risk for the balance.

**Example 3:** A borrower has multiple mortgages

A veteran purchases a home for its market value of \$280,000. The borrower has used \$50,000 of her entitlement on a prior loan, and because that loan is still outstanding, that portion of her entitlement is not available for this purchase. The county limit is \$417,000, generating a maximum guaranty amount of \$104,250. The entitlement available to this borrower for the current mortgage is \$104,250 less \$50,000, or \$54,250. The lender will most likely require the borrower to make a higher down payment, in order to cover the difference between the available entitlement (\$54,250) and the normal VA guaranty on the loan of \$70,000, as in example 2. Thus, the borrower would be required to put

\$15,750 down and the loan amount would be \$264,250. The VA will guarantee \$54,250 and the lender will be at risk for \$210,000.

## Understanding the Residual Income Test

The FHA and the VA look at most of the same factors when deciding to insure a mortgage: both compare the value of the loan with the value of the collateral; both look at a borrower's credit score as an indication of his willingness to pay a loan; and both look at a borrower's DTI ratio as an indication of the borrower's ability to repay a loan. But currently only the VA also conducts a residual income test.

The residual income test looks at the borrower's ability to pay for food, clothing, transportation, medical expenses, and other day-to-day living expenses after paying for the expenses related to the home on which the VA loan is to be made. The calculation begins with a borrower's after-tax income, subtracts the monthly payment on debt and other obligations, as well as the mortgage payment and estimated property taxes, hazard insurance, flood insurance if applicable, maintenance and utilities, and any homeowner association dues or condo fees. The result of this calculation is the amount available for family support. For a family of four in the Northeast, the residual income guideline is \$888 for loans up to \$79,999, and \$1,025 for loans of \$80,000 and above. The residual income test is based on 1997 prices. Even though the required residual income amounts have not been raised since 1997, we believe this test can be a powerful indication that the borrower will find the mortgage payments sustainable.

The difference between DTI and residual income is important. DTI provides some indication of ability to repay. But because it is a ratio, it does not measure whether the borrower has sufficient income to cover living expenses after paying the mortgage and related costs.

Consider two borrowers, one earning \$30,000 a year and the other earning \$60,000. The first borrower proposes to spend \$12,000 a year (\$1,000 a month) on a mortgage and related payments; the second proposes to spend \$24,000 a year (\$2,000 a month). Thus both have a DTI of 40. The borrower earning

\$30,000 (assume \$25,000 after taxes), or \$2,083 a month, would be left with \$1,083 a month. While this is just above the VA standard for a family of four in the Northeast, any unanticipated expenses may well cause the borrower to default. The loan would be eligible for a VA guaranty, but both lender and borrower may pause before proceeding.

By contrast, the borrower earning \$60,000 year (assume \$51,000 after taxes), or \$4,250 a month, would be left with a more comfortable \$2,250 for all other expenses, and would be less likely to default even if challenged with unexpected expenses. The way the residual income test works suggests that lower-income borrowers may have difficulty qualifying for VA loans.

<b>Annual Income</b>	\$30,000	\$60,000
<b>Annual Mortgage</b>	\$12,000	\$24,000
<b>DTI</b>	12/30 = 40%	24/60 = 40%
<b>Monthly Residual</b>	\$1,083	\$2,250

## Comparing Borrower Profiles

We compare below the profiles of FHA and VA borrowers along three dimensions to determine if the programs attract different types of borrowers. Our analysis reveals that the VA has always had more higher-FICO and higher-income borrowers than the FHA, although this difference has been much smaller since the 2009 vintage. We also find that DTI distribution is quite similar for FHA and VA borrowers across most vintage years. Note that we did not compare LTV. Both the FHA and VA programs are high-LTV products, hence the variability in LTV is relatively small.

To compare both sets of borrowers by their credit scores (FICO), income, and DTI, we married two data sets:

1. **Home Mortgage Disclosure Act (HMDA) data** include characteristics of the borrowers, such as income, and the amount of the loan, but do not include borrower credit scores or information about loan performance.
2. **CoreLogic's Prime Servicing Data** have borrower credit scores and information about the performance of the loan, but no income information.

By tying these data sets together, a process that involved matching at the loan level, our analysis is more robust than it would be using either data set alone.

### Credit Scores

Figure 1 compares the distribution of credit scores of FHA and VA borrowers, using FICO scores as the measure, divided into five FICO buckets:

1. Less than 620
2. 620–650
3. 650–700
4. 700–750
5. Greater than 750

Note that while FICO scores have on average been drifting up over time for both programs, the VA has always had more higher-FICO borrowers than the FHA. For example, for mortgages originated in 2001 (referred to as the 2001 vintage), 35 percent of FHA borrowers had FICOs less than 620, compared with VA's 23 percent. At the other end of the spectrum, 21 percent of FHA borrowers had FICOs greater than 700, compared with VA's 36 percent. While the FICO differential is quite persistent over time—for each and every vintage year, the VA has a slightly more favorable distribution—since the 2009 vintage, those differences are much smaller. This reflects muted increases in VA FICO scores and very dramatic increases in FHA FICO scores since 2008.

### Income Distribution

Figure 2 compares the profiles of FHA and VA borrowers by income distribution, divided into four income buckets:

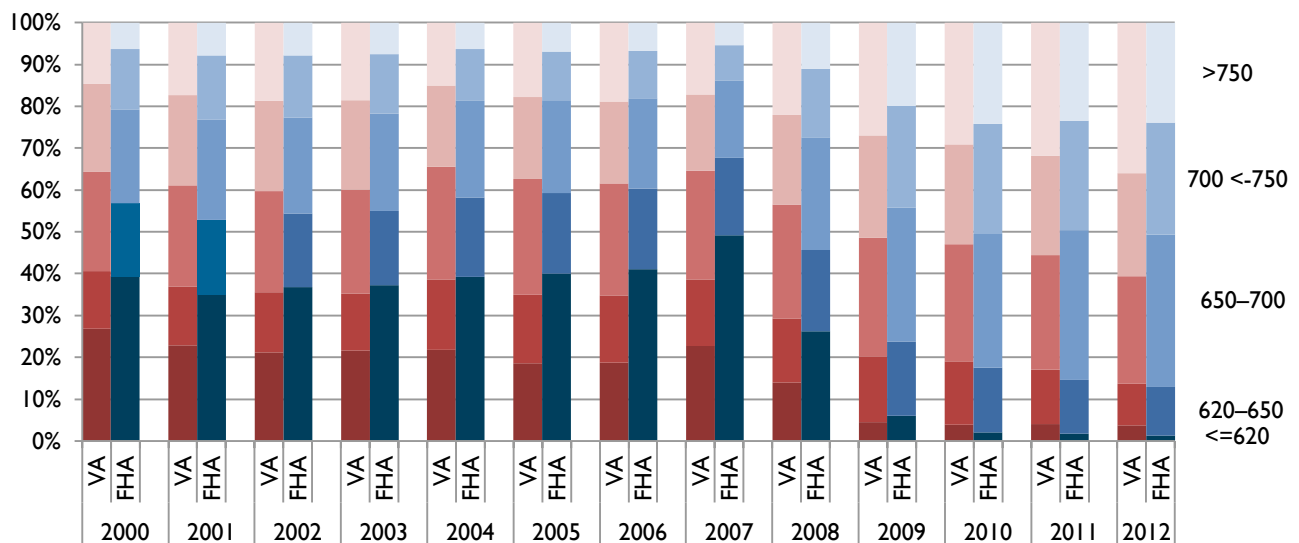
1. Less than \$50,000
2. \$50,000–\$75,000
3. \$75,000–\$100,000
4. Greater than \$100,000

Note that the income of the borrower(s) is consistently higher on VA loans. A \$5,000 to \$10,000 average difference in incomes has been persistent through each of the vintage years.

### DTI

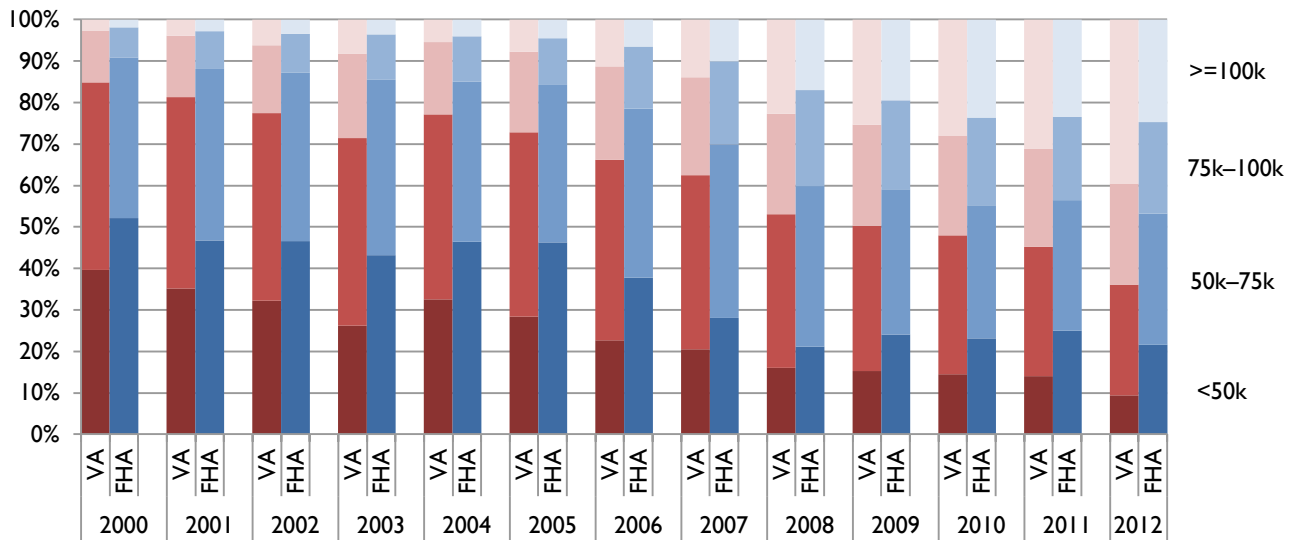
We also hypothesized that there may be differences in the DTI distribution, but did not have adequate DTI information in our database. Many loans in the CoreLogic database do not include DTI information. Moreover, even when lenders report DTIs, they report the “back-end” DTI. This is the total of all the borrower's fixed payments as a percentage of the borrower's income, arising from all forms of debt, including not only mortgage payments and taxes and insurance on the house, but also credit card, auto, and student loan payments. When these data are missing, we cannot extract them from other fields. On the other hand, we almost always have data on the mortgage payment. To complete our analysis, we needed to develop a DTI proxy, which

**Figure 1: FICO Distribution at Origination**



Source: Corelogic Prime Servicing Data as of month 303 March 2004, HMDA, and Urban Institute calculation.

**Figure 2: Income Distribution at Origination**



Source: Corelogic Prime Servicing Data as of month 303 March 2004, HMDA, and Urban Institute calculation.

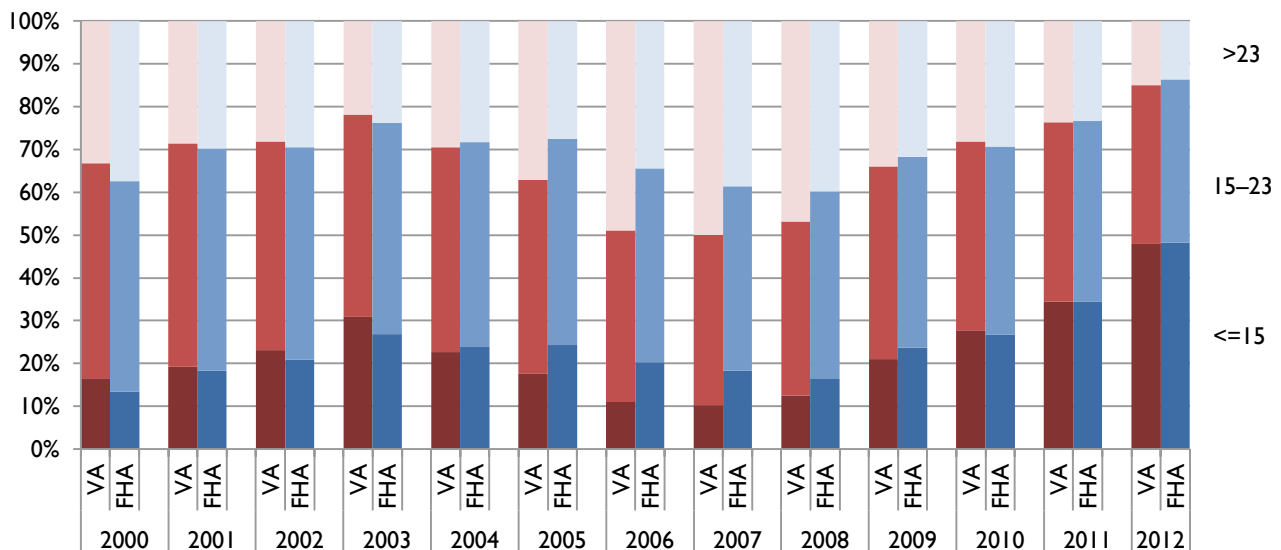
we created with a simplified mortgage-payment-to-income ratio, or MPI. This is reasonably close to a “front-end” DTI, although front-end ratios usually include taxes and insurance payments on the home.

Figure 3 compares the distribution of FHA and VA borrowers in each of three MPI categories.

1. MPI greater than 23
2. MPI 16–23
3. MPI less than or equal to 15

Note that the percent of borrowers in each MPI category is similar for FHA and VA borrowers from 2000 through 2004 and from 2009 through 2012. In 2005, the percent of borrowers in the highest MPI category—arguably those most burdened by their mortgages—increases for VA borrowers. It remains higher until 2008. This spike occurs between 2006 and 2008 for FHA borrowers. During this spike, there was a higher percentage of VA borrowers in the heavily burdened category than FHA borrowers.

**Figure 3: Mortgage Payment to Income (MPI) Distribution**



Source: Corelogic Prime Servicing Data as of month 303 March 2004, HMDA, and Urban Institute calculation.

Figure 2 demonstrates that VA borrowers have higher incomes, while Figure 3 shows the MPIs are similar across most vintage years (except in 2005–2008 when FHA was stronger.)

Figure 4 confirms that VA homebuyers have higher incomes and larger loan amounts than FHA borrowers, but their MPIs are similar or even less favorable. The relatively small proportion of lower-income VA borrowers (shown in Figure 2) is consistent with the hypothesis that the residual income test makes it more difficult for lower-income homebuyers to qualify for a VA mortgage, driving at least some of them to the FHA route.

**Even when income, credit, and mortgage burden are comparable, VA loans perform better than FHA loans.**

We showed above that the FICO and income characteristics of VA borrowers are slightly stronger than those of FHA borrowers. We show below, however, that this difference does not explain the difference in default rates.

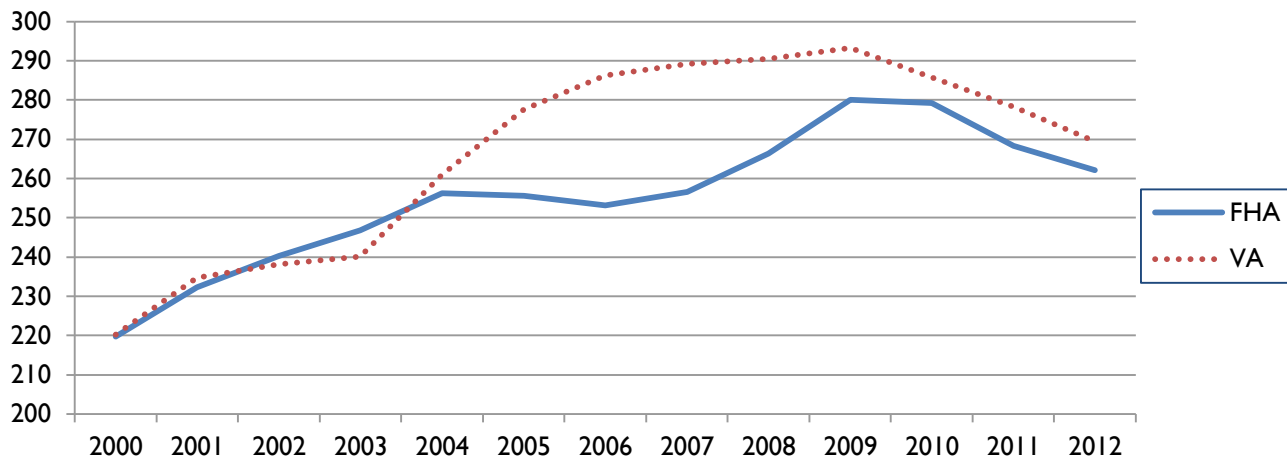
Figure 5 shows cumulative lifetime-to-date default rates by vintage year for FHA and VA borrowers. For the purpose of this analysis, a loan is considered to be in default if it goes 90+ days delinquent; so for the worst origination year, 2007, 36 percent of the FHA loans have gone at least 90 days delinquent; for VA loans the comparable number is 16 percent. The chart shows both balance-weighted and loan count-weighted default numbers and reveals little

difference in the two weighting methods.<sup>4</sup> What is immediately striking is that VA borrowers experienced much lower default rates than their FHA counterparts even when the loans represent a comparable fraction of income.

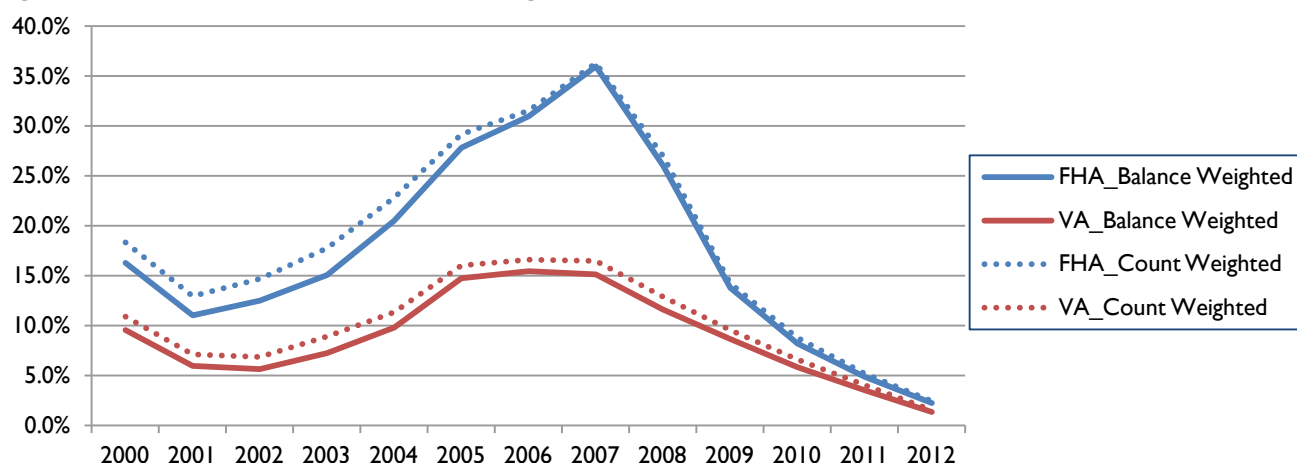
Table 1 shows that for 2001 originations, VA borrowers have experienced a lifetime-to-date default rate of 6.0 percent, compared with FHA's 11.1 percent. The table also shows the FICO, income, and MPI for each year. Note that part of the 2001 default differential can be explained by the higher average FICO of VA borrowers (670 versus 643) and the slightly higher income (\$56,510 versus \$52,323); MPIs, however, are similar. Likewise in 2008, the VA default rate was 11.6 percent, compared with FHA's 26.1 percent. Again, some of the difference can be explained by the difference in FICO score (686 versus 660), and average income (\$71,125 versus \$65,731). But our MPI calculation shows that FHA was actually slightly stronger than VA for 2008.

There is also some difference in geography. For example, for the 2007 vintage, the top five states for FHA loans were Texas, Georgia, Ohio, Illinois, and Florida, while the top five for VA loans were Texas, North Carolina, Virginia, Florida, and Georgia. California, Arizona, and Nevada are not in the top 10 states for either program. In fact, as we will see below, geography makes almost no difference in the results.

**Figure 4: Average Loan Balance/Income over Time**



Source: Corelogic Prime Servicing Data as of month 303 March 2004, HMDA, and Urban Institute calculation.

**Figure 5: FHA and VA Default Rates through Time**

Source: Corelogic Prime Servicing Data as of month 303 March 2004, HMDA, and Urban Institute calculation.

Note: Default is defined as ever D90+.

To determine how much of the difference in default rates is due to differences in borrower or geographic characteristics, we created a table of FHA loans, with columns for each FICO bucket/income bucket/MPI bucket and state. The overall default rate is calculated by multiplying the default rate for each cell times the percent of the balance in that cell. We then change the distribution of cells in the FHA table to mirror the VA distribution to compute the FHA default rate using the VA composition.

The results of this analysis are shown on the right side of table 1. For the 2001 vintage, we noted above that the actual FHA default rate was 11.1 percent. If we conform the FHA distribution to the VA distribution for FICO and income, we drop the default rate to 8.3 percent. Doing the same for FICO, income, and MPI, the default rate is also 8.3 percent. If we add geography, the default rate is 8.2 percent. Compare this to a much lower 6.0 percent for the VA.

**Table 1: Characteristic Corrected Default Rates**

Year	Count	FICO		Income		Mortgage Payment to Income		Actual Default Rates		Hypothetical Default Rates For FHA			
		VA	FHA	VA	FHA	VA	FHA	VA	FHA	FICO and Income	FICO, Income, and MPI	FICO, Income, and State	FICO, Income, MPI, and State
2000	189768	666	640	52912	47517	19	20	9.5%	16.3%	12.4%	12.4%	12.4%	12.2%
2001	429242	670	643	56510	52323	19	19	6.0%	11.1%	8.4%	8.3%	8.3%	8.2%
2002	480209	670	637	66888	54023	19	19	5.6%	12.5%	9.0%	9.0%	9.0%	8.9%
2003	665428	662	630	63283	53240	17	18	7.2%	15.1%	11.2%	11.0%	10.4%	10.3%
2004	277428	663	637	58097	51306	19	18	9.8%	20.5%	15.9%	15.9%	14.6%	14.5%
2005	155025	676	638	59831	51583	20	18	14.7%	27.8%	21.0%	22.0%	19.6%	19.7%
2006	159093	678	639	63298	55270	21	19	15.4%	31.0%	23.0%	24.6%	22.9%	23.4%
2007	234723	670	627	65480	61243	22	20	15.2%	36.0%	26.6%	27.7%	26.5%	26.2%
2008	690441	686	660	71125	65731	21	20	11.6%	26.1%	20.9%	21.1%	20.2%	20.1%
2009	1086124	701	692	73590	67007	19	19	8.6%	13.8%	12.5%	12.7%	11.8%	11.8%
2010	887084	703	701	75456	69172	18	18	5.8%	8.2%	8.1%	8.1%	7.6%	7.5%
2011	550209	708	703	78036	66633	17	17	3.5%	4.9%	4.7%	4.7%	4.4%	4.4%
2012	644206	715	706	86570	69710	15	15	1.4%	2.3%	2.0%	2.1%	2.0%	2.0%

Source: Corelogic Prime Servicing Data as of Month 303, March, 2014, HMDA, and Urban Institute calculation.

Note: Hypothetical default rates are based on FHA default rates using VA's composition. MPI is calculated as monthly payment/income.

For the 2008 vintage, we can perform a similar analysis. Note that the actual FHA default rate was 26.1 percent. After correcting for FICO and income, it was 20.9 percent; after correcting for FICO, income, and MPI, it was 20.2 percent; and after correcting for FICO, income, MPI, and state, it was 20.1 percent. Compare this to the VA default rate for 2008 of 11.6 percent.

So even after theoretically correcting for credit score, income, MPI, and geography, we still find that FHA default rates are higher than VA default rates.

### The VA performs better across the years.

We also analyzed whether the differences between the FHA and the VA were consistent in different years and across different FICO and income buckets. (We determined that the differences in MPI are small, and inconsistent across years, so we dropped the variable for this stage of our analysis. Doing so allows us to focus more easily on the FICO/income cross tabulation.)

**Table 2 Panel A: FICO and Income Composition for VA**

Year	FICO/Income	<50K	50K–75K	75K–100K	>=100K	All
2001	<=620	8.6%	10.2%	3.1%	1.0%	22.8%
	620–650	5.3%	6.3%	2.1%	0.5%	14.1%
	650–700	8.7%	11.1%	3.5%	0.9%	24.2%
	700–750	7.0%	10.3%	3.4%	0.8%	21.5%
	>750	5.6%	8.4%	2.7%	0.7%	17.4%
	All	35.1%	46.2%	14.7%	3.9%	100.0%
2007	<=620	5.7%	9.4%	4.9%	2.6%	22.6%
	620–650	3.6%	7.0%	3.6%	1.9%	16.0%
	650–700	5.4%	11.1%	6.0%	3.5%	26.0%
	700–750	3.4%	7.6%	4.6%	2.7%	18.2%
	>750	2.4%	7.0%	4.6%	3.1%	17.1%
	All	20.4%	42.0%	23.7%	13.8%	100.0%
2008	<=620	2.9%	5.7%	3.1%	2.3%	14.0%
	620–650	3.1%	6.1%	3.5%	2.7%	15.3%
	650–700	4.6%	10.3%	6.4%	5.8%	27.1%
	700–750	3.0%	7.9%	5.4%	5.3%	21.6%
	>750	2.4%	7.1%	5.8%	6.6%	22.0%
	All	16.1%	37.0%	24.3%	22.7%	100.0%
2012	<=620	0.6%	1.2%	0.9%	1.1%	3.8%
	620–650	1.2%	3.4%	2.5%	2.7%	9.9%
	650–700	2.8%	7.8%	6.5%	8.7%	25.7%
	700–750	2.1%	6.4%	6.1%	10.0%	24.7%
	>750	2.8%	7.9%	8.4%	16.9%	36.0%
	All	9.4%	26.7%	24.4%	39.5%	100.0%

Source: Corelogic Prime Servicing Data as of month 303 March 2014, HMDA, and Urban Institute calculation.

Table 2 shows the composition of FHA and VA loans for four issue years, 2001, 2007, 2008, and 2012, by FICO and income buckets. Note that we have used the same five FICO and the same four income buckets that we used for the earlier analysis. This table reveals again the slightly more favorable characteristics of the VA loans.

Table 3 shows the default rate on these four issue years, for each of the 20 buckets. This analysis reveals that, after controlling for FICO and income, VA default rates are considerably lower and the largest differences occur in the lower-income/lower-credit score borrowers. This difference is pronounced across all issue years, including recent issue years.

For example, FHA (VA) borrowers with FICO scores of 620 to 650 and income less than \$50,000 had a lifetime to date default rate of:

- 13.7 percent (10.5 percent) for the 2001 vintage;
- 35.5 percent (22.4 percent) for the 2007 vintage;

**Table 2 Panel B: FICO and Income Composition for FHA**

Year	FICO/Income	<50K	50K–75K	75K–100K	>=100K	All
2001	<=620	16.6%	14.3%	3.3%	1.0%	35.2%
	620–650	8.3%	7.4%	1.6%	0.5%	17.8%
	650–700	11.1%	10.1%	2.2%	0.7%	24.0%
	700–750	7.1%	6.5%	1.3%	0.4%	15.3%
	>750	3.6%	3.2%	0.7%	0.2%	7.8%
	All	46.7%	41.5%	9.0%	2.8%	100.0%
2007	<=620	13.7%	20.2%	10.2%	5.1%	49.2%
	620–650	5.2%	7.8%	3.8%	1.8%	18.5%
	650–700	5.2%	7.8%	3.7%	1.8%	18.5%
	700–750	2.5%	3.6%	1.6%	0.8%	8.4%
	>750	1.6%	2.3%	1.0%	0.5%	5.4%
	All	28.1%	41.7%	20.2%	10.0%	100.0%
2008	<=620	6.2%	10.4%	6.0%	3.6%	26.2%
	620–650	4.4%	7.6%	4.4%	3.0%	19.4%
	650–700	5.5%	10.4%	6.3%	4.9%	27.1%
	700–750	3.1%	6.1%	3.9%	3.2%	16.3%
	>750	2.0%	4.1%	2.6%	2.3%	11.0%
	All	21.2%	38.7%	23.2%	17.0%	100.0%
2012	<=620	0.4%	0.4%	0.3%	0.2%	1.2%
	620–650	3.1%	3.9%	2.4%	2.2%	11.7%
	650–700	8.4%	11.8%	7.9%	8.3%	36.4%
	700–750	5.4%	8.4%	6.0%	7.0%	26.7%
	>750	4.3%	7.2%	5.4%	7.0%	23.9%
	All	21.6%	31.7%	22.0%	24.7%	100.0%

Source: Corelogic Prime Servicing Data as of month 303 March 2014, HMDA, and Urban Institute calculation.



- 32.8 percent (22.6 percent) for the 2008 vintage; and
- 6.5 percent (5.4 percent) for the 2012 vintage.

FHA (VA) borrowers with FICO scores of less than 620 and incomes between \$50,000 and \$75,000 had a lifetime to date default rate of:

- 17.2 percent (12.2 percent) for the 2001 vintage;
- 47.9 percent (29.5 percent) for the 2007 vintage;
- 43.2 percent (27.3 percent) for the 2008 vintage; and
- 11.4 percent (5.0 percent) for the 2012 vintage.

Although there were differences in the higher FICO/income buckets, those differences were (and remain) less pronounced in absolute terms.

## Why Do VA Loans Default Less Often? Lessons to Be Learned

It's clear that VA loans perform better than FHA loans and that the generally higher incomes and better credit of the VA borrowers are not the reason. There are several possible reasons for the difference in performance of FHA and VA loans.

### Military Culture

Some have suggested that members of the military could be inherently more disciplined and responsible, and hence less apt to default on their loans. This has never been proven or disproven. Moreover, if an active-duty member of the military is foreclosed upon, the borrower can lose his or her security clearance and hence his or her job, although each case is decided on its own merits. It is unlikely this stronger disincentive against default for VA borrowers explains the difference. Only 17 percent of the borrowers who took out VA loans in 2013 were on active duty when they took out the loan.

### Direct Contact

There is also a difference in how the VA and the FHA service loans. The VA has a statutory requirement to service its borrowers, and direct contact is required. The FHA does not engage in direct contact with borrowers; the servicer contacts the borrower. As a result, the VA intervenes at an earlier point in the delinquency cycle and in a more uniform fashion.

**Table 3 Panel A: Default Rates for VA**

Year	FICO/Income	<50K	50K-75K	75K-100K	>=100K	All
2001	<=620	16.2%	12.2%	11.0%	11.9%	13.6%
	620-650	10.5%	7.0%	6.1%	6.0%	8.1%
	650-700	5.9%	4.5%	3.7%	2.9%	4.8%
	700-750	2.8%	1.5%	1.0%	1.7%	1.9%
	>750	1.5%	0.7%	0.6%	0.4%	0.9%
All	7.8%	5.2%	4.4%	4.8%	6.0%	
2007	<=620	33.9%	29.5%	27.0%	28.7%	30.0%
	620-650	22.4%	20.5%	17.7%	18.7%	20.1%
	650-700	14.9%	12.6%	11.9%	8.5%	12.4%
	700-750	8.3%	7.2%	6.1%	5.0%	6.8%
	>750	5.7%	3.8%	4.0%	3.2%	4.0%
All	19.4%	15.3%	13.3%	11.8%	15.2%	
2008	<=620	31.1%	27.3%	26.4%	23.6%	27.3%
	620-650	22.6%	19.5%	17.7%	17.8%	19.4%
	650-700	13.4%	11.7%	10.8%	8.8%	11.1%
	700-750	7.4%	6.0%	5.0%	3.9%	5.4%
	>750	5.4%	3.3%	2.4%	1.6%	2.8%
All	16.1%	12.5%	10.5%	8.1%	11.6%	
2012	<=620	5.7%	5.0%	5.4%	3.8%	4.9%
	620-650	5.4%	5.5%	5.1%	3.8%	4.9%
	650-700	2.7%	2.1%	1.5%	1.5%	1.8%
	700-750	0.8%	0.9%	0.7%	0.4%	0.6%
	>750	0.5%	0.3%	0.2%	0.1%	0.2%
All	2.1%	1.8%	1.4%	0.9%	1.4%	

Source: Corelogic Prime Servicing Data as of month 303 March 2014, HMDA, and Urban Institute calculation.

**Table 3 Panel B: Default Rates for FHA**

Year	FICO/Income	<50K	50K-75K	75K-100K	>=100K	All
2001	<=620	21.6%	17.2%	14.4%	13.9%	18.9%
	620-650	13.7%	9.6%	7.5%	7.0%	11.2%
	650-700	8.8%	6.0%	5.4%	5.0%	7.2%
	700-750	4.3%	2.8%	2.2%	2.1%	3.4%
	>750	2.5%	1.4%	1.6%	0.7%	1.9%
All	13.0%	9.6%	8.3%	7.9%	11.0%	
2007	<=620	49.0%	47.9%	45.7%	44.0%	47.3%
	620-650	35.5%	34.8%	34.0%	33.5%	34.7%
	650-700	25.9%	24.8%	24.4%	22.9%	24.9%
	700-750	15.0%	14.4%	13.9%	11.7%	14.2%
	>750	8.7%	8.5%	7.5%	9.0%	8.5%
All	36.9%	36.0%	35.4%	34.1%	36.0%	
2008	<=620	43.4%	43.2%	42.0%	39.4%	42.4%
	620-650	32.8%	33.0%	32.1%	29.5%	32.2%
	650-700	22.6%	22.5%	21.7%	19.1%	21.8%
	700-750	13.4%	12.9%	12.4%	10.4%	12.4%
	>750	8.3%	7.5%	7.2%	5.8%	7.2%
All	28.1%	27.0%	25.7%	21.8%	26.1%	
2012	<=620	12.6%	11.4%	9.0%	6.1%	10.3%
	620-650	6.5%	6.5%	5.7%	5.1%	6.1%
	650-700	3.1%	3.0%	2.8%	2.2%	2.8%
	700-750	1.3%	1.1%	1.2%	0.9%	1.1%
	>750	0.6%	0.6%	0.5%	0.3%	0.5%
All	2.8%	2.5%	2.2%	1.6%	2.3%	

Source: Corelogic Prime Servicing Data as of month 303 March 2014, HMDA, and Urban Institute calculation.

We attempted to assess whether these factors played a role in the lower VA default rates by looking at whether a delinquent loan is more apt to cure. In fact, we find almost no difference in cure rates. However, this evidence is less convincing than it appears. Less-affluent borrowers tend to have better cure rates once delinquent than more-affluent borrowers; for many of them, missing one or two mortgage payments and making it up later is not unusual. And FHA borrowers are less affluent than VA borrowers. Thus, it may be that the earlier, direct borrower contact provided by the VA and/or the possible greater discipline of VA borrowers offset what would otherwise be even lower cure rates for VA borrowers.

### ***Skin in the Game***

There is also a major difference in the design of the programs. In contrast to the FHA's 100 percent guarantee, VA lenders have residual risk after the VA's first-loss obligation is exhausted. How is this manifested? Is the denial rate for VA borrowers higher? Are VA loans concentrated in a smaller number of more-experienced lenders who may be better capitalized than FHA lenders? Table 4 shows that VA denial rates, as measured by HMDA data, are only about two-thirds of FHA denial rates across all years. This difference has been declining, but even in 2012, the latest year for which HMDA data are available, the denial rate for VA loans was

19.5 percent, compared with 23.9 percent for FHA loans. Although the VA lender's residual risk does not result in rejection of a higher percent of the applicants, we cannot directly compare the population of applicants. It is likely that the VA has a stronger applicant pool, and this too may play a role in the lower denial rate.

### ***Lender Concentration***

VA lending has been more concentrated than FHA lending, particularly in recent years. The top 10 lenders accounted for 54 percent of VA loan originations, and only 32 percent of FHA loan originations. Table 5 details the 2012 top 10 lender list for the FHA and the VA. While Wells Fargo is the leading VA lender, the second- and third-largest lenders are USAA and Navy Federal Credit Union, institutions that specialize in providing financial services to military personnel and veterans. In addition, Mortgage Investor's Corporation (number 4), Mortgage Research Center (number 8, formerly known as Veteran's United Home Loans), and Newday (number 10) are nonbank lenders that specialize in providing mortgages to veterans.

By contrast, the FHA list contains more diversified firms. Quicken is the number 2 FHA lender behind Wells Fargo; they are followed by Bank of America (number 3) and JP Morgan (number 4). The role of nondepository lenders is quite important for both products. Nondepository lenders comprise four of the top 10 FHA lenders, and five of the top 10 VA lenders. Our preliminary conclusion is that VA lending is a subspecialty that involves risk retention, and hence larger risks than are present in FHA lending. As a result, the lenders that offer this product do not do it casually; it is an important business line for them, and they put considerable resources behind it. Note that although we believe that risk retention produces lower default rates, we have established a correlation, not causation.

### ***Residual Income Test***

Another major difference is that VA underwriting includes a residual income guideline, in addition to a DTI test. This effectively makes it more difficult for low-income homebuyers to qualify for a mortgage, because it requires that they have sufficient excess income to meet unanticipated

**Table 4: Denial Rates and Top 10 Lender Concentration**

Year	Denial Rates		Top 10 Lenders Concentration	
	FHA	VA	FHA	VA
2000	17.5%	9.1%	38.2%	39.9%
2001	9.0%	6.5%	36.2%	49.0%
2002	10.2%	7.3%	38.0%	49.4%
2004	16.9%	13.5%	35.8%	48.0%
2005	20.0%	14.5%	34.0%	40.6%
2006	19.6%	13.8%	35.7%	41.3%
2007	27.2%	15.1%	40.7%	45.5%
2008	31.2%	16.6%	37.9%	44.2%
2009	26.2%	16.1%	36.4%	45.8%
2010	26.7%	19.9%	38.0%	50.1%
2011	26.7%	20.6%	36.2%	55.0%
2012	23.9%	19.5%	32.2%	54.4%
All	22.5%	15.4%		

Source: HMDA and Urban Institute calculation.

**Table 5: Top 10 FHA and VA Lenders, 2012**

	FHA	FHA Market Share	VA	VA Market Share
1	WELLS FARGO BK NA	12.4%	WELLS FARGO BK NA	16.1%
2	QUICKEN LOANS, INC.	4.8%	USAA FSB	8.8%
3	BANK OF AMERICA NA	2.8%	NAVY FCU	7.1%
4	JPMORGAN CHASE BK NA	2.5%	MORTGAGE INVESTORS CORPORATION	5.4%
5	SERVICE FINANCE COMPANY LLC	2.2%	QUICKEN LOANS, INC.	4.5%
6	EMBRACE HOME LOANS, INC.	2.0%	BANK OF AMERICA NA	3.0%
7	FLAGSTAR BK FSB	1.7%	FREEDOM MORTGAGE CORPORATION	2.9%
8	FREEDOM MORTGAGE CORPORATION	1.5%	MORTGAGE RESEARCH CENTER, LLC	2.7%
9	U S BK NA	1.2%	JPMORGAN CHASE BK NA	2.0%
10	FIFTH THIRD MTG CO	1.1%	NEWDAY FINANCIAL, LLC	2.0%

Source: HMDA and Urban Institute calculation.

expenses that might lead them to default. On the other hand, the residual income test may also protect borrowers from entering into mortgage transactions that have a high likelihood of failure, and instead lead them to delay purchase, purchase a less expensive house, or put down a larger down payment. This seems to make a big difference in default probabilities across all income groups. Even more telling, perhaps, is that the lower-income borrowers who do take out VA loans—those who pass the residual income screen—perform much better than their FHA counterparts.

We believe the residual income test can have applicability beyond the VA market. The most obvious question is whether the FHA should consider incorporating residual income in their underwriting guidelines. And if so, should the test be recalibrated to reflect 2014 prices? What basket of goods should be assumed? Should the methodology be changed? There is no question that if the methodology is going to be used more widely, it should be reexamined.

Residual income may also have applicability on the regulatory front. We understand that the Consumer Financial Protection Bureau (CFPB) considered using residual income rather than DTI in the Qualified Mortgage rule.<sup>5</sup> The evidence from the VA's experience suggests that when the CFPB reviews its mortgage rules in five years, residual income is worth another look.

In the meantime, lenders making higher-cost Qualified Mortgages may want to consider using

residual income tests to provide more certainty that they will not run afoul of the ability-to-repay test. For these higher-cost loans, a defaulting borrower can rebut the Qualified Mortgage presumption that he had an ability to repay most credibly by showing a lack of residual income. Adding a residual income test when underwriting a high-cost Qualified Mortgages could make lenders more willing to make loans whose risk level would, for other reasons, warrant a higher interest rate.

We often think VA and FHA loans are alike, but the programs' different parameters have yielded significantly different results for many years, with better performance from the VA. Our analysis provides strong evidence that the residual income test may be a critical differentiating factor. Although the details of the VA's test should be reexamined before the test is adopted by others, other programs should consider adopting a residual income test, and regulators should evaluate whether the test might produce a more realistic assessment of ability to pay.

## Endnotes

<sup>1</sup> For most of the period from February 2008 through December 2013, the limits were slightly higher than current limits for most areas, set at 125 percent of the area median home price, with a ceiling of \$729,750 and a floor of \$271,050. Prior to February 2008, the limits were generally lower than current limits. From 2006 to February 2008, for example, the limits were set at 95 percent of an area's median home price, with a ceiling of \$362,790 and a floor of \$271,050.

<sup>2</sup> The funding fee is lower if the borrower puts down 5 percent or more: it drops to 1.5 percent for a down payment of 5 percent to 9.99 percent, and 1.25 percent for a down payment of 10 percent or more. Funding fees are slightly higher for veterans of the Reserves or National Guard.

<sup>3</sup> There is a difference in how default costs are handled. The FHA reimburses only about two-thirds of foreclosure expenses, interest is not reimbursed for the first two missed payments, and interest is reimbursed at the HUD debenture rate for subsequent missed payments. The VA reimburses for all foreclosure expenses, including missed payments.

<sup>4</sup> When default rates are weighted by loan count, each loan counts equally, regardless of size. When default rates are weighted by balances, the default

rate on a \$200,000 loan counts twice as much as on a \$100,000 loan. Note that there is virtually no difference in the results as a consequence of the weighting used, demonstrating that the loan size distribution does not play a role in the results.

<sup>5</sup> The CFPB has defined a Qualified Mortgage (QM) as one in which, among other things, the borrower's DTI does not exceed 43 (12 CFR 1026.43(e)(2)(vi)). A first-lien QM with an interest rate that does not exceed the average prime offer rate plus 1.5 percent has a safe harbor from challenge to enforcement against a defaulting borrower. For first-lien QMs above that interest rate, the lender enjoys a rebuttable presumption that he has accurately assessed the borrower's ability to repay (12 CFR 1026.43(e)(1)(ii) and 12 CFR 1026.43(b)(4)).



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