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"Who Pays FHA-VA Discount Points?"

By Donald Guy

Dr. Guy is an assistant professor of real estate and land use economics in the College of Business Administration at the University of Nebraska at Omaha.

The purpose of this study was to measure empirically the extent to which FHA and VA discount points are passed on to residential buyers in Omaha, Nebraska, and to compare the results with previous studies in Columbus, Ohio, and Lubbock, Texas.

A controversy exists as to who actually pays discount points on FHA and VA mortgages. These mortgage programs were established by federal law and have interest rate ceilings set by the federal government. The ceiling rate can be adjusted up or down but has traditionally been kept below the market interest rate on comparable conventional mortgages. Federal officials intentionally keep the ceiling below the market rate. The justification given is that this will assist moderate income families to purchase homes and will help restrain interest rates on conventional mortgages. Private lending institutions that originate these mortgages require that discount points be paid at closing in order to raise the yield on the mortgages up to the yield on conventional mortgages. Since the lenders are prohibited by law from charging discounts to the buyer, the seller must pay these charges to the lending institution in order for the buyer to receive the loan and complete the sales transaction.

FHA/VA Buyer Pays More

Since the requirement to pay discounts reduces the net return on the sale, a rational seller would be expected to charge a higher price to an FHA or VA buyer. For example, if the seller anticipated that lenders would require four discount points (where one point equals 1 percent of the loan amount) and the seller wanted to net $50,000 on the sale, he might list the house at $52,000. If the seller accepted an offer at $52,000 which required a $52,000 VA loan, he would have to pay the lender $2,080 in discounts in order for the buyer to get the loan (at four discount points). In effect, the seller would reduce the net amount received by $80 while the buyer would really be paying $2,000 of the discount in the form of a higher purchase price. The seller would be as well off with a contract requiring conventional financing at a selling price of $49,920.

Ideally, the seller would like to raise the price to the FHA/VA buyer by the amount of the discount in order to receive the same net sale price as would be received from a conventional buyer. This would require that the seller be aware of the amount of the discount prior to accepting an offer (and thus prior to the buyer making a loan application to the mortgage lender). The seller is further constrained in passing on the discount by the requirement that the property must be appraised at the contract price or higher for the buyer to obtain FHA or VA financing. (If the appraised value is less than the contract price, the buyer has the option of making a larger down payment and completing the transaction or of voiding the purchase agreement.) Even if the seller knows how much would have to be added in order to pass on all of the discount, the seller must be concerned about what price could be justified by an appraisal or risk having the contract voided after the appraisal.

Thus, the controversy arises as to what portion of the discount points will actually be passed on to the buyer in the form of a higher selling price. A knowledge of what portion of the discounts are added to the selling price would obviously be of interest to potential buyers and sellers as well as to real estate brokers, salespersons, and appraisers. While the controversy is of long standing, only recently have empirical studies been undertaken to determine whether or not discounts are passed on to the buyer.

Ohio Study

The first empirical study was done by Zerbst and Brueggeman (1978, 1978). They collected cross section data based on a sample of 276 sales through the multiple listing service in Columbus, Ohio, in June 1973. They ran a regression analysis using a ratio of sale price to asking price as the dependent variable but did not explain their decision to do this. The rationale would seem to be that most buyers build points into their asking price. If a potential buyer is going to make an offer which included conventional financing, a knowledgeable buyer would offer less than the asking price. An offer that reduced the asking price by more than the amount of points built into that price should be readily acceptable to the seller.

To the extent that this model focuses on the pricing expectations of the seller, this is a reasonable way to approach the
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This methodology requires a series of steps. The regression coefficient times the average asking price equals the dollars passed through. The average selling price times the average FHA (or VA) loan to value ratio equals the average loan. The average loan times the average discount equals the amount of the discount. The dollars passed through divided by the amount of the discount equals the proportion of the discount points passed through to the buyer.

REFERENCES

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