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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 sellers 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 no more than the amount of points built into that price would be readily acceptable to the seller.

If the potential buyer will require FHA or VA financing, the buyer has less bargaining leverage and must offer the asking price or, at least, closer to the asking price than the conventional buyer. Many other circumstances would also affect the relative bargaining position of the buyer and the seller.

To the extent that this model focuses on the pricing expectations of the seller, this is a reasonable way to approach the
The value of R^2, while quite low, is statistically significant. While the regression equation explains only a small part of the variation in the ratio of selling price to asking price, the analysis does indicate that the ratio decreases systematically depending on how the transaction was financed.

Another sample could be taken when discounting requirements were higher than those in the Columbus study. Such a study could include a larger proportion of FHA loans. The higher quality house will sell at closer to the listing price, but the discount to value ratio which was not statistically significant. While the regression indicates that the ratio decreases systematically depending on how the transaction was financed.

Regression Analysis

The results of the regression analysis indicated that 42.5 percent of FHA points and 56 percent of VA points are passed on to the buyer in the form of a higher selling price. This is consistent with the hypothesis that sellers build discount points into the asking price of the house they are selling, and that the discount points are reflected in the selling price.

Gunterman extended the analysis in a similar manner. Since the data was collected over a five year period and discounts charged vary over time, he added a series of dummy variables representing different numbers of points depending on the quarter in which the sale was closed and the number of points not charged at the end of the quarter. This analysis indicated that the seller's decision to charge higher discount points was dependent on the discount the buyer is willing to accept.

Gunterman also divided the data into two price categories and repeated the regression analysis with each group.

He concluded that FHA points were not passed through in the lowest price category and that a greater proportion of the discounts were passed through in the higher price category. This suggests that sellers are more willing to pass discounts through on homes in the higher price range.

Omaha Study

In order to estimate the extent to which FHA and VA discounts were charged, Gunterman examined only FHA sales. He collected sales data on 2,408 houses that were sold during the period 1970-1975. He ran a regression analysis using sale price as the dependent variable, and the results are shown below:

SP = 97.94 + 0.16 Se - 0.013 Age
R^2 = 0.12

The t statistics are shown in parentheses below each term. These results are consistent with the hypothesis that sellers build discount points into the asking price of the house they are selling, and that the discount points are reflected in the selling price.

The mean ratio of selling price to the asking price was 1.00, which is consistent with the hypothesis that the discount points are reflected in the selling price.

FOOTNOTES

The term point equals one percent of the mortgage amount. The number of points charged for a particular mortgage depends primarily on the spread between the ceiling rate and the market interest rate. Discounting requirements vary from loan to loan. The yield to the lender is determined by the spread between the mortgage rate and the market interest rate. The percentage of the mortgage rate that is passed on to the loan buyer is called the pass through. This pass through is determined by the loan terms and the loan to value ratio.

1) At the time of the study, local lenders charged an average of 0.79 discount points for FHA and VA loans. Using mean asking price, mean selling price, and FHA and VA mean loan to value ratios from the sample data, Zerbst and Brueggeman estimated that, on the average, 42.5 percent of FHA and VA points and 56 percent of VA discounts were passed on to buyers in the form of a higher selling price. The low value of this statistic for the L/V term indicates that the probable range of values for the coefficient is between zero and -13.4. Therefore, whether this variable should have been included in the analysis is questionable. The second study used a regression of selling price to asking price which would seem more appropriate for the problem of seller expectation. The Zerbst and Brueggeman study also included loan to value and discount points as variables in the model, and was not statistically significant. Zerbst and Brueggeman found that in order to market, it was statistically significant, and was dropped from the analysis.

The results of the analysis were consistent with the hypothesis that sellers build discount points into the asking price of the house they are selling, and that the discount points are reflected in the selling price.

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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


TABLE 4

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<thead>
<tr>
<th>Method Financing</th>
<th>Mean Selling Price</th>
<th>Mean Sale Price</th>
<th>Mean Asking Price</th>
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<tbody>
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<td>VA</td>
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<tr>
<td>CONV</td>
<td>$32,263.95</td>
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</table>

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