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BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Debentures Not Serving Purposes HUD Intended--Legislative Changes Could Help Increase Effectiveness And Minimize Interest Costs

The National Housing Act of 1934 authorizes the Department of Housing and Urban Development (HUD) to use long-term, low-interest debentures instead of cash to pay mortgage insurance claims. HUD uses debentures to settle a substantial portion of its multifamily housing program claims to (1) create a disincentive for foreclosure and (2) minimize borrowing from the U.S. Treasury.

Debentures can be redeemed prior to their stated maturity, at face value, as payment of mortgage insurance premiums. GAO believes redemptions prior to maturity undermine the intended purposes for using debentures and can lead to higher interest costs if Treasury borrowing is required.

GAO recommends that the Congress change the legislation to give the Secretary of HUD authority to either redeem debentures before maturity at less than face value or reject them as payment of mortgage insurance premiums. To protect the rights of current debenture owners, such legislation should be applied prospectively.

126429

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives

This report evaluates provisions in the National Housing Act of 1934 which authorize the Department of Housing and Urban Development (HUD) to accept long-term, low-interest debentures instead of cash as payment for mortgage insurance premiums. The report shows how early redemption causes significant cash payouts and can ultimately lead to borrowing from the U.S. Treasury.

We are sending copies of this report to the Secretary, Department of Housing and Urban Development; the Director, Office of Management and Budget; and interested congressional committees, subcommittees, and individual members of Congress.

Comptroller General
of the United States

BY THE COMPTROLLER GENERAL
REPORT TO THE CONGRESS

DEBENTURES NOT SERVING PURPOSES HUD INTENDED-- LEGISLATIVE CHANGES COULD HELP INCREASE EFFECTIVENESS AND MINIMIZE INTEREST COSTS

D I G E S T

The National Housing Act of 1934 authorizes the Department of Housing and Urban Development (HUD) to insure mortgages for various types of housing. In return, the lender or mortgage holder (mortgagee) pays HUD mortgage insurance premiums to insure against default by borrowers. The act also authorizes HUD to use either cash or debentures (guaranteed obligations of the government) to pay mortgage insurance claims on defaulted mortgages. Debenture use is intended, in part, by HUD to create a disincentive for mortgagees to foreclose when facing the prospect of receiving debentures which carry interest rates lower than prevailing market rates instead of cash in settlement of claims.

Debentures are transferable from one owner to another; mature, generally, in 20 years; and carry interest rates existing for debentures at about the time HUD insured the mortgage. Debentures are redeemable at face value when they mature, if called by HUD's Secretary, or in payment of mortgage insurance premiums. (See p. 1.)

GAO made its review as part of a continuing effort to help HUD improve its management of programs and resources and to assist the Congress in deciding whether amendments to the National Housing Act, with respect to the use of debentures, are warranted. Specifically, GAO's review focused on the cost and programmatic impact of debentures being redeemed before they reach maturity as payment for mortgage insurance premiums. GAO analyzed the impact of this practice by examining debenture transactions over a 5-year period from fiscal year 1978 to 1982.

Except where data was available in HUD's fiscal year 1985 budget justification, updating data beyond GAO's review period was not practical because HUD's debenture records are maintained by a manual system and cannot be extracted and analyzed in a simplified or timely manner. Further, the substance of GAO's analysis is based on the calculated difference between costs of U.S. Treasury borrowing to pay off prematurely redeemed debentures and debenture interest costs had early redemption not occurred. Thus, while analysis of more recent transactions could yield different cost results they would not affect GAO's overall conclusions. (See p. 5.)

GAO found that the provisions in the act which allow the redemption of debentures before maturity could impact on the following "cost of money" computations through the (1) need for increased appropriations, (2) need for HUD to borrow from the Treasury, or (3) loss of any opportunity by HUD to earn interest on mortgage insurance premiums paid in cash rather than debentures.

INCENTIVE TO AVOID FORECLOSURE COMPROMISED BY REDEMPTION OF DEBENTURES PRIOR TO MATURITY

Existing statutes allow debentures to be used to pay mortgage insurance premiums before the debenture matures. This can have the effect of compromising the purpose for using debentures because it provides mortgagees receiving debentures with an outlet for returning the debentures to HUD before they mature. GAO found that:

--About $458 million in debentures, or 95 percent of all debentures redeemed during the 5 years ending September 30, 1982, were used to pay mortgage insurance premiums. (See p. 10.)

--Debentures were used to pay almost 15 percent of all premiums collected during the same 5-year period, including over one-half of the premiums collected for the General Insurance Fund--HUD's major multifamily fund which historically has not generated sufficient income to meet expenses. (See pp. 10 and 11.)

--Debentures with a 20-year maturity date are redeemed, on the average, in about 7-1/2 years. (See p. 10.)

REDEMPTIONS BEFORE MATURITY CAN LEAD TO HIGHER INTEREST COSTS

Because HUD may not have reserves available in its insurance funds at the time debentures are redeemed, early redemptions can lead to borrowing from the U.S. Treasury--something debentures are intended by HUD to help avoid. (See p. 11.)

Treasury borrowing rates have been historically higher than rates carried by debentures being redeemed. Consequently, whenever HUD has to borrow money at interest rates higher than the rates on the debentures being redeemed, higher interest costs are incurred. GAO found that:

--Debentures redeemed during fiscal year 1982 carried interest rates ranging from 2-1/2 percent to 8 percent. Treasury borrowing rates during the same period ranged between 13-3/8 percent and 15-1/8 percent. (See p. 14.)

--Debentures redeemed during a typical month in fiscal year 1982 could result in about $2 million to $13 million more in interest costs by borrowing from the Treasury than if the debentures had remained outstanding until maturity. (See p. 15.)

--Based on an average turnaround time of about 7-1/2 years, the $100 million in debentures redeemed during fiscal year 1982 could result in additional interest costs if Treasury borrowing would be required. (See p. 16.)

LEGISLATIVE CHANGES MODIFYING USE AND TERMS OF DEBENTURES

In fiscal year 1982 HUD proposed that its authorization bill include a provision to eliminate the statutory requirement allowing debentures to be redeemed at face value in exchange for mortgage insurance premium payments. HUD also, because of concerns that lender participation could be deterred if debenture redemption in exchange for premium payments was eliminated, drafted legislation to modify debentures' interest rates and maturity terms. (See p. 17.)

According to HUD, its proposals to modify interest rates and maturity terms of debentures were not adopted by the Administration and therefore not included in its 1982 authorization proposals. HUD's proposal to eliminate debenture redemptions at face value was included in its authorization proposals, but was not enacted.

Based on discussion with congressional staff and a review of the legislative history of HUD's 1982 authorization bill, GAO believes HUD's proposal may have been overlooked because of the authorization bill's size and complexity. (See p. 17.)

Most mortgage lending institutions GAO contacted said that the mortgage insurance premium redemption feature provides no particular incentive for investing in programs which pay in debentures. One of 17 mortgagees said, however, that it would not continue in the programs if the redemption feature was eliminated. (See p. 19.)

RECOMMENDATIONS TO THE CONGRESS

GAO believes that changes in legislation providing the Secretary with the authority to either redeem debentures prior to maturity at less than face value or reject them as payment of mortgage insurance premiums will (1) help reinforce the incentive to avoid foreclosure which debentures were intended to help create by limiting debenture owners' ability to redeem them before they mature and (2) help minimize Treasury borrowing costs to the extent that redemption of low-interest debentures can lead to Treasury borrowing at higher rates of interest.

Specifically, GAO recommends that the Congress amend the National Housing Act to:

--Provide the Secretary of HUD with the authority to redeem debentures prior to maturity at less than face value to adjust for variations between debenture interest rates and Treasury borrowing rates or, if debenture owners choose not to accept less than face value or if the Secretary otherwise deems it appropriate, to reject them as payment for mortgage insurance premiums.

--Protect the rights of current debenture owners by having the legislation apply to (1) all debentures issued after the date of enactment on currently outstanding and future insurance and (2) all premiums due on insurance issued after the date of enactment. (See p. 21 and App. II.)

MATTERS FOR CONSIDERATION BY THE CONGRESS

GAO recognizes that mortgagees and HUD officials are concerned that GAO's recommended legislative changes might result in decreased participation in housing programs. For this reason, GAO believes that the Congress should consider making additional changes in legislation which would modify the procedures for determining interest rates and maturity dates of debentures. Such modifications would provide mortgagees with (1) a stream of interest income similar to the interest income stream which would have been generated had a mortgage not defaulted and (2) a debenture maturity term which reflects the lesser of the current statutory term or the remaining term of the defaulted mortgage. Such changes could provide the Secretary of HUD with the authority and flexibility for modifying debenture terms to make them relatively comparable with the terms of defaulted mortgages, and could be utilized by the Secretary, after appropriate analysis, if investor interest in programs which pay insurance claims in debentures lessens because of the curtailment of redemption privileges. (See p. 22.)

AGENCY COMMENTS AND GAO EVALUATION

HUD said that GAO's recommendations incorporated and/or improved upon the basic substance of what HUD had proposed earlier and, on the whole, did not take exception to GAO's proposals for legislative changes. (See App. III.)

HUD, in its response, discussed what it viewed as the positive and negative aspects of each

GAO draft proposal and suggested, for example, that GAO mention that Treasury borrowing costs do not always exceed debenture rates.

GAO considered HUD's suggestions and comments and made changes where necessary. In particular, GAO noted HUD's concerns relating to the GAO proposal that debenture terms should be modified to provide an interest rate closer to that of the defaulted mortgage. While HUD acknowledged that higher debenture interest rates will improve debentures' investment appeal and help forestall early redemptions, HUD expressed other concerns about raising debenture interest rates, including the increased interest costs which would be incurred. Because of HUD's concerns and the future uncertainties regarding interest, default, and redemption trends, GAO modified its proposal to indicate it should be considered by the Congress.

Although HUD agrees that shortening the maturity terms of debentures should be accomplished simply as a matter of equity, GAO is also proposing this issue as a matter for the Congress to consider because GAO believes that modifying interest rates and maturity terms is a single issue.

CONTENTS

ILLUSTRATIONS

ABBREVIATIONS

GAO	General Accounting Office
HUD	Department of Housing and Urban Development
MIP	mortgage insurance premium
OMB	Office of Management and Budget

CHAPTER 1

INTRODUCTION

The National Housing Act of 1934 (12 U.S.C. 1701 *et seq.*), as amended, authorizes the Department of Housing and Urban Development (HUD) to insure mortgages for various types of housing. In return, the mortgagee pays HUD mortgage insurance premiums. Under the HUD-insured housing programs, private lending institutions provide mortgage money and HUD insures the lenders against default by borrowers. If default occurs (i.e., borrower fails to make required mortgage payments), HUD is obligated to pay the unpaid mortgage balance and certain other items in return for the assignment of the mortgage instrument or the acquisition of the insured property. Claims can be settled in cash or in debentures.

WHAT DEBENTURES ARE AND HOW THEY ARE USED

HUD debentures are registered, transferable securities which carry a federal guarantee as to payment of principal and semiannual interest. Debentures are issued at face value in denominations ranging from $50 to $10,000; mature, generally, in 20 years; and carry interest rates tied to debenture rates in effect either at the time HUD agreed to insure the mortgage or when the mortgage was actually insured. Debentures are redeemable at face value (1) when they mature, (2) if called in by the Secretary, or (3) in payment of mortgage insurance premiums (MIPs) due for the same insurance fund under which the debentures were issued.[1] The U.S. Treasury acts as HUD's agent for processing debenture transactions, including issues, redemptions, and payments. The cycles involved, when debentures are issued and redeemed for MIPs, are illustrated on page 2.

The National Housing Act authorizes the Secretary of HUD--at his or her discretion--to settle insurance claims in either cash or debentures. Because of the administrative expenses involved in accounting for a large number of relatively small denomination debentures, HUD settles single-family insurance claims in cash. Also, to help deter lender reluctance to participate in HUD programs, HUD uses cash to pay claims under certain higher risk multifamily programs unless debentures are specifically requested. All other multifamily claims are settled with debentures as are claims for certain nonhousing programs, such as hospitals and nursing homes.

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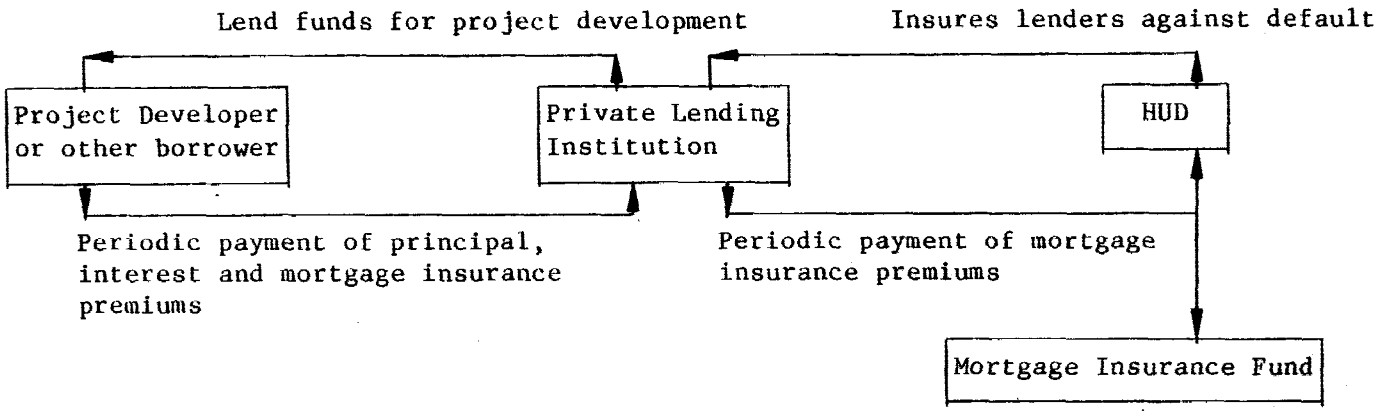
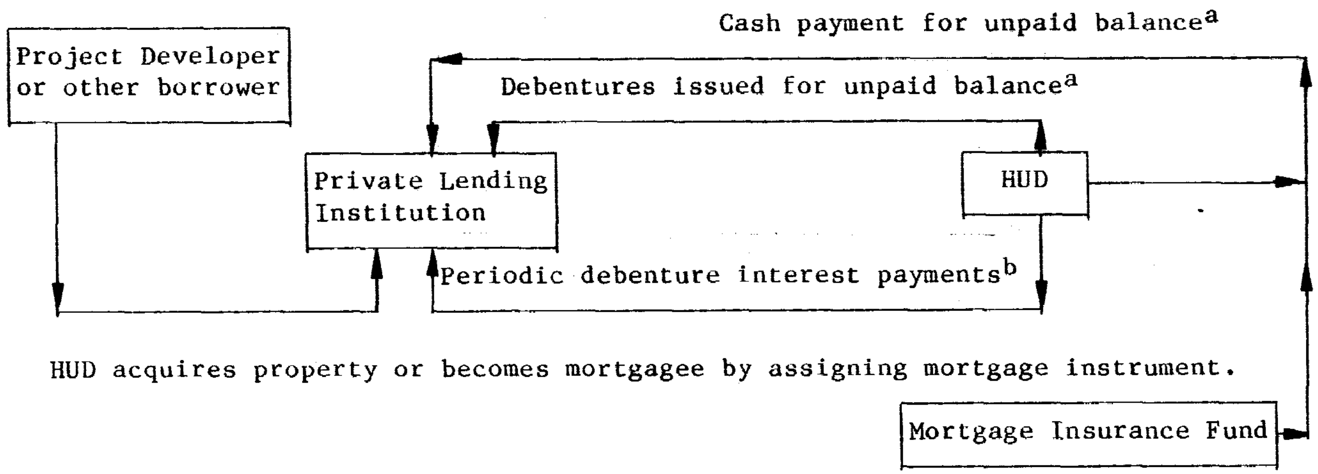
[1]Within HUD's four insurance funds, over 40 different mortgage insurance programs are represented.

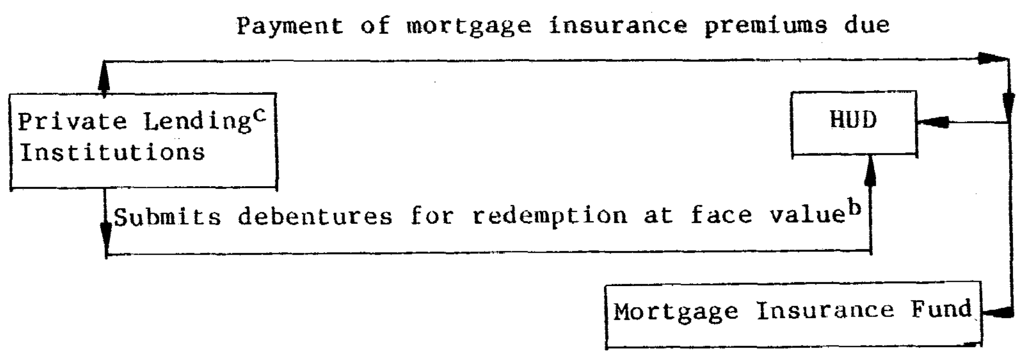
Mortgage Insurance Cycle



Mortgage Default Cycle



Debenture Redemption Cycle



[a]Unpaid principal is paid in cash or in debentures.

[b]Treasury acts as HUD's agent for processing debentures.

[c]Debentures can be traded in the secondary market. Institutions submitting debentures may or may not be the institutions to which originally issued. They are, however, HUD housing program lenders and owe HUD funds for mortgage insurance premiums collected from borrowers.

REASONS FOR USING DEBENTURES

Debentures to pay claims possess two basic theoretical advantages over cash.

- --The prospect of receiving debentures--bearing interest at rates lower than both current market rates and rates on the defaulted loans or mortgages they are used to pay off--and either holding them for the full maturity term or selling them at prices below face value gives lenders the incentive to see projects survive. For example, the payment of all insurance claims in cash for several months during late 1965 and early 1966 resulted in a subsequent rapid increase in claims and prompted a quick reversion to debenture settlements.

- --Debenture settlements enable HUD to delay cash drains from the HUD insurance funds and reduce its need to borrow from the Treasury to make cash payments.

PERSPECTIVES ON DEBENTURES OUTSTANDING, ISSUED AND REDEEMED, AND INSURANCE IN FORCE

HUD's four insurance funds, described on the following page, had debentures outstanding as of September 30, 1983, totalling $206.3 million.

HUD's Insurance Funds

Insurance fund	Description of fund
General	Covers a variety of special purpose insurance programs, including insurance for (1) loans on property repairs and improvements (2) basic and special purpose multifamily housing (3) urban renewal, middle-income, and armed forces housing and (4) war and defense housing.
Cooperative Management Housing	A mutual fund[a] covering mortgage insurance and supplementary loans for cooperative housing.
Mutual Mortgage	HUD's largest fund which includes its basic single-family insurance program. Also a mutual fund.[a]
Special Risk	Includes insurance for (1) mortgages in older, declining urban areas (2) mortgagors who normally would not be eligible for mortgage insurance (3) mortgagors receiving interest reduction payments and (4) mortgages for experimental housing.

[a]Participants under this program are entitled, when their mortgages terminate, to a rebate of premiums not required for expenses or losses.

In fiscal year 1983, $20.5 million in debentures were issued and $149.4 million were redeemed according to HUD's fiscal year 1985 budget justification. For 5 years ending September 30, 1982, debentures totaling about $245 million were issued. During the same period debentures totalling about $458 million were redeemed as payment for MIPs due.

On September 30, 1983, about $32 billion in insurance was in force for active and expired nonhousing and multifamily housing programs, including about $8 billion for programs paying claims in debentures.

OBJECTIVES, SCOPE, AND METHODOLOGY

We made this review as part of our continuing effort to help HUD improve its management of programs and resources and to assist the Congress in deciding whether amendments to the National Housing Act of 1934, with respect to the use of debentures, are warranted. Specifically, the debenture issue surfaced during our review of HUD management activities.[2] Our objective in evaluating the effectiveness of HUD debentures was to ascertain the reasons for and the problems associated with redeeming HUD debentures prior to maturity and to determine what remedial actions would be needed to rectify problems.

For our review, performed at HUD headquarters in Washington, D.C., from November 1982 to June 1983, we reviewed and analyzed accounting records maintained for debentures from October 1, 1977, to September 30, 1982, and the evaluation of budget reports, policies, regulations, procedures, past and proposed legislation, and other related documentation. Also, when available, we updated our information based on HUD's fiscal year 1985 budget justification.

The data we used in our analysis were, as of September 30, 1982, the most current data available at the time of our review. The substance of our analysis is based on the calculated difference between low-interest debentures and higher Treasury borrowing costs. While more current information could change the costs presented, it would not change the substance of our analysis nor our conclusions. Updating to include a later time period would not be practical because HUD's debenture records are maintained manually and cannot be extracted and analyzed in a simplified or timely manner.

We also made several analyses to obtain an overall perspective of the potential that early redemptions of debentures have for inflating interest costs, including (1) computing average turnaround time between when debentures are issued and when they are redeemed, (2) comparing debenture interest rates with Treasury borrowing rates, and (3) determining differences between costs of Treasury borrowing to pay off prematurely redeemed debentures and debenture interest costs had early redemption not occurred.

We interviewed HUD officials and other personnel from various HUD organizational units. We also interviewed officials and other representatives from organizations and agencies outside of HUD to obtain a perspective of the overall debenture issue. We contacted representatives of 17 lending institutions which deal with HUD to obtain their observations regarding HUD's use of debentures to pay claims and its acceptance of debentures as payment for mortgage insurance premiums owed. We selected these lending institutions (1) from HUD mortgagee files, (2) based on recommendations by an official from HUD's Office of Multifamily Housing Management and Occupancy and (3) from a list of HUD's

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[2] Increasing the Department of Housing and Urban Development's Effectiveness Through Improved Management--(GAO/RCED-84-9, Jan. 10, 1984).

most active participating mortgagees. Appendix I contains a listing of the HUD organizational units and other organizations and agencies we contacted.

Our review was made in accordance with generally accepted government auditing standards.

CHAPTER 2

NEED TO CURTAIL REDEMPTION OF DEBENTURES PRIOR TO MATURITY

Through the National Housing Act of 1934, HUD has been authorized to use debentures to settle mortgage insurance claims. HUD uses debentures rather than cash to pay certain insurance claims to (1) avoid the incentive for mortgagees to immediately foreclose on defaulted projects to take advantage of higher interest yields available through alternative cash investments and (2) minimize its borrowing from the Treasury to pay claims in cash. However, certain provisions in the National Housing Act can negate the intended benefits of debentures. These provisions, which permit debentures to be redeemed before maturity to pay MIPs, give mortgagees a mechanism for disposing debentures and retaining cash. As a result, HUD may need to borrow from the Treasury to compensate for subsequent cash shortfalls created by the redemptions. Also, higher interest costs may result when Treasury borrowing rates exceed the interest rates on redeemed debentures.

The act authorizes HUD to collect MIPs from lenders in return for insuring mortgages. The act allows MIPs to be paid either in cash or in the debentures of the particular insurance fund under which the debentures were originally issued. Statutory history is unclear as to the congressional intent of this provision. However, in providing instructions to approved mortgagees, HUD, in 1980, provided its interpretation of the legislative intent as "to provide a means for early redemption of debentures to enhance the cash flow of mortgagees for making loans available to prospective home owners under HUD's mortgage insurance programs." Debentures used in payment of MIPs are accepted at face value regardless of their interest rates or age.

Past proposals by HUD to amend the provisions of the act which allow debentures to be accepted at face value in exchange for the payment of MIPs were unsuccessful, and millions of dollars in debentures are still being redeemed prior to maturity. Unless the act is amended to curtail this practice, the advantages of using debentures will continue to be compromised and the potential for increased interest costs will remain.

INCENTIVE TO AVOID FORECLOSURE COMPROMISED BY REDEMPTION OF DEBENTURES PRIOR TO MATURITY

With their low interest rates and 20-year maturity terms, the prospect of receiving debentures provides an incentive for lenders to see projects survive. However, accepting debentures for redemption at face value prior to maturity in exchange for the payment of MIPs compromises this incentive because it reduces the period of time debentures must be held by providing debenture holders with an outlet for returning the debentures to HUD before they mature.

Using debentures to discourage insurance claims

Debentures issued by HUD to pay insurance claims include characteristics which can discourage lenders from filing claims under programs which pay in debentures. Specifically:

--Debenture rates are determined by the Secretary of HUD in conjunction with the Secretary of the Treasury and are generally based on average maturity yields of all outstanding U.S. marketable obligations maturing in 15 or more years. Because many low-yield obligations are included in this computation, according to a HUD official, debenture rates tend to be lower than prevailing market interest rates.

--Debentures generally bear interest at debenture rates in effect at about the time mortgages were insured. Since interest rates have historically risen, many debentures are low-yield investments compared to market rates available at times in the future when debentures are redeemed. For example, over 46 percent of the debenture issues authorized to cover defaulted loans during fiscal year 1982 carried interest rates below 5 percent, with some as low as 2-1/2 percent. In comparison, Treasury borrowing rates were between 13-3/8 and 15-1/8 percent during this same period.

--Because debenture interest rates and HUD maximum allowable interest rates on mortgages are computed using different bases, the rates can significantly vary within the same time period. We made a comparative analysis of the two rates from 1950 and found that debenture rates consistently range from about 1-1/2 to over 3 percent lower than HUD-approved mortgage lending rates. For example, the mortgage lending rate on January 1, 1983, was 13 percent, whereas the debenture rate was 10-1/4 percent--a 2-3/4 percent difference.

--Most debentures have a maturity length of 20 years and are dated no earlier than the date of default. For example, a debenture issued for a mortgage insured during the latter half of 1978 and which defaulted on January 1, 1981, would be dated January 1, 1981, and would mature on January 1, 2001. This debenture would bear interest at 7-3/4 percent--the rate existing at the time of mortgage insurance in 1978--compared with the 11-3/4 percent rate in effect on January 1, 1981.

Problems with redemptions of debentures prior to maturity and impact on insurance funds

Debentures can be redeemed at face value prior to maturity by mortgagees as payment of MIPs. The incentive to avoid foreclosure, which the prospect of receiving debentures is supposed to create, is thus compromised.

Debentures which carry interest rates lower than current investment rates (see p. 8) are usually saleable at less than their face value. Thus, unless alternative investment yields are less than debenture yields, debenture owners often will take advantage of the MIP redemption provisions. Since most of HUD's income for paying insurance benefit claims and operating expenses comes from the MIPs it collects, the redemption of debentures in lieu of MIPs reduces cash available. When HUD's insurance funds need additional cash, HUD can borrow from the Treasury. Although borrowing from the Treasury is not inevitable, cash drains caused by the redemptions can lead to such borrowing.

HUD has recognized the redemption of debentures prior to maturity as a problem. For example:

--A May 1981 memorandum from the Director, Office of Financial Management, to the Assistant Secretary for Housing, discussed the need for changes in the debenture program and stated that "Permitting lenders the option of redeeming debentures at par in exchange for premiums has seriously reduced the effectiveness of debentures in treating the speculative risk [of insurance]. Also, accepting debentures at par for premiums due is not sound financial management... Not only do debentures so used result in a significant loss of income, they also create cash management problems."

--A May 1976 memorandum from a Special Assistant to the Secretary for Policy and Program Analysis and Development states that "Use of debentures for MIP payments eliminates the cash savings to the fund of a debenture payoff."

--HUD officials and other representatives we interviewed perceived the redemption of debentures before maturity as a problem for HUD because (1) cash flow is adversely affected, (2) insurance funds are drained, and (3) losses occur because of subsequent Treasury borrowing which may be required.

--Officials from the Office of Finance and Accounting said that the rapid turnaround of debentures (from issue to redemption) creates extra workload.

For the 5 years ending September 30, 1982, about $458 million, or almost 95 percent of the debentures redeemed, were used to pay MIPs. The debentures redeemed to pay MIPs represented almost 15 percent of all premiums collected during this period, including over one-half of the $877 million in General Insurance Fund collections. Because premium collections represent the largest part of that fund's income, debenture redemptions to the degree noted here can adversely affect the fund's cash flow.

To determine the average time between issuance and redemption of debentures as payment for MIPs, we analyzed debenture redemption and issue records by randomly selecting April 1982--a month deemed to be typically representative of debenture redemptions by the Office of Finance and Accounting employee responsible for maintaining debenture records and recording related transactions. The methodology used for making this analysis was to (1) select a random sample of debenture redemptions from manual records maintained in the Office of Finance and Accounting, (2) obtain key historical data relating to issue dates and maturity length of the sample debentures from Treasury's Bureau of Public Debt, and (3) compute the turnaround time between issuance and redemption for each sample debenture. Although debenture settlements do help to delay cash drains from the HUD insurance funds, our analysis of debentures redeemed during one typical month showed that the time between issuance and redemption average a little over 7-1/2 years. Thus, HUD cash outlays were delayed to this extent. The following shows the results of our analysis.

Number of debentures redeemed during April 1982	2,752
Our sample size	195[a]
Average turnaround time between issue and redemption of debentures used to pay MIPs	92.25 months, or about 7 years and 8 months[b]

[a]The debentures in our sample had a 20-year maturity date.

[b]We are 95-percent confident that the actual average turnaround time of debentures in the population is between 84.8 and 99.7 months.

Our analysis also showed that debentures used to pay MIPs are redeemed, for the most part, in less than one-half of their stated 20-year maturity length. For example, of the 195 debenture redemptions sampled, only 35 were redeemed after 10 years. The following shows the debentures sampled in terms of the number of years between issuance and redemption.

Years between issuance and redemption	Number of debentures redeemed--our sample
Less than 1 year after issue	0
From 1 to 2 years	1
From 2 to 3 years	39
From 3 to 4 years	4
From 4 to 5 years	5
From 5 to 6 years	3
From 6 to 7 years	12
From 7 to 8 years	78
From 8 to 9 years	11
From 9 to 10 years	7
More than 10 years after issue	35
Total	195

REDEMPTIONS BEFORE MATURITY CAN LEAD TO HIGHER INTEREST COSTS

Paying claims in debentures, rather than cash, is intended to allow HUD to minimize its Treasury borrowing. However, the redemption of debentures prior to maturity can create cash flow problems for HUD. To satisfy the cash needs for redeeming debentures, HUD can borrow from the Treasury. Because funds are borrowed at current borrowing rates and debentures generally carry interest rates which are tied to rates existing at about the time mortgages were insured, HUD can find itself, during periods of rising interest rates, borrowing funds at interest rates higher than rates borne by debentures being redeemed. With the large volume of low-interest debentures being redeemed prior to maturity, the costs to HUD, because of the wide variations in interest rates, can potentially be higher by borrowing from the Treasury.

Although cash claim payments for HUD's mortgage insurance programs, ideally, are to be financed from cash balances and current income, appropriations and Treasury borrowings are used to supplement these payments. Because the General Insurance Fund--HUD's largest multifamily fund, with over 95 percent of the debentures outstanding on September 30, 1982--has not generated sufficient income to meet expenses, HUD has, over the years, borrowed from the Treasury to meet the fund's insurance obligations. For example, on September 30, 1982, HUD owed about

$4.1 billion[3] to the Treasury for all insurance fund borrowings, including $166 million borrowed for General Insurance Fund operations during the 5-year period ending in September 1982. Interest rates on these General Insurance Fund borrowings ranged from 7-3/4 percent to 14-1/2 percent.

Treasury borrowing rates significantly higher than rates on debentures

We made a comparative analysis of (1) Treasury borrowing rates for HUD insurance funds during fiscal year 1982 and (2) interest rates carried by all debentures outstanding at September 30, 1982, in order to determine the differences between interest rates on debentures issued by HUD--which can ultimately be redeemed--and current trends in Treasury borrowing rates. This analysis shows that all of the $341 million in debentures outstanding at September 30, 1982 carried interest rates lower than the lowest existing Treasury borrowing rate during fiscal year 1982, as shown in the following table.

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[3]By September 30, 1983, HUD had reduced its debt to the Treasury from insurance fund borrowing to about $4 billion with payments of over $77 million during fiscal year 1983. Insurance fund appropriations during this same period totaled about $240 million, including $128.4 million for the General Insurance Fund.

Comparison of Treasury Borrowing Rates During Fiscal Year 1982 with Interest Rates on all Debentures Outstanding at September 30, 1982

Treasury borrowing rates (fiscal year 1982)			Debentures outstanding September 30, 1982		
High rate	Low rate	Average rate	Interest rates[a] From	To	Percent of outstanding debentures in rate range
--------percent-------			(percent)		
			2-1/2	2-7/8	1.0
			3	3-7/8	11.3
			4	4-3/4	21.4
15-1/8	13-3/8	14-1/8	5-3/8	5-7/8	16.8
			6	6-7/8	30.1
			7	7-3/4	12.7
			8	8-1/4	6.1
			9-3/8	11-5/8	0.6
			Total		100.0

[a]All debentures outstanding as of September 30, 1982, carried interest rates lower than Treasury's lowest fiscal year 1982 borrowing rate.

We also compared interest rates for the $100 million in debentures redeemed to pay MIPs during fiscal year 1982 with Treasury borrowing rates during the same period to provide a perspective of actual redemption trends. The following table shows that 100 percent of the debentures redeemed during fiscal year 1982 carried interest rates below the lowest Treasury borrowing rate for the year.

Comparison of Treasury Borrowing Rates During Fiscal Year 1982 with Interest Rates on Debentures Redeemed for MIPs in Fiscal Year 1982

Treasury borrowing rates--FY 1982			Interest rate range of debentures redeemed		Debentures within interest ranges
High	Low	Average	From	To	(percent)
			2-1/2	2-3/4	1.6
			3	3-7/8	11.9
			4	4-3/4	19.9
15-1/8	13-3/8	14-1/8	5-1/4	5-7/8	15.8
			6-1/8	6-7/8	48.9
			7	8	1.9
			Total		100.0

Perspectives on potential costs of redemptions before maturity

Borrowing from the Treasury at interest rates higher than rates borne by debentures redeemed can be much more costly to HUD than paying interest on debentures through maturity. We determined the potential impact that such borrowing could have on HUD's insurance funds by (1) computing the interest which would have been paid over the full maturity term if all debentures redeemed in April 1982 had remained outstanding and (2) comparing the cost of Treasury borrowing at various rates for the same maturity terms. For all selected rates, including the lowest rate for the period, this analysis showed that Treasury borrowing can result in higher interest costs than would be incurred if debentures remained outstanding until maturity as illustrated on page 15.

For our analysis, we assumed that there would be a 1:1 relationship between debenture redemptions and Treasury borrowing. While this would, in actuality, probably not occur, cash shortfalls created by debenture redemptions could impact on the following "cost of money" computations through the (1) need for increased appropriations or (2) loss of any opportunity by HUD to earn interest on mortgage insurance premiums paid in cash rather than debentures.

Difference Between Treasury Borrowing Costs
and Debenture Interest Costs if Paid to Maturity
(based on April 1982 actual redemptions)

Treasury borrowing rates (percent)	Reason for using rate	Debentures redeemed in April 1982	Interest costs which would be paid to Treasury from date redeemed to actual maturity[a]	Remaining interest costs which would have been paid to maturity had debentures not been redeemed	Difference in interest costs--Treasury borrowing vs. debentures[b]
7-1/4	Low Treasury borrowing rate for 7-year period (1976-82)	$10,859,750	$ 9,968,934	$8,138,800	$1,830,134
10-5/8	Treasury borrowing rate at end of calendar year 1982	10,859,750	14,609,644	8,138,800	6,470,844
13-3/4	April 1982 Treasury borrowing rate	10,859,750	18,906,599	8,138,800	10,767,798
15-1/8	High Treasury borrowing rate for 7-year period (1976-82)	10,859,750	20,797,259	8,138,800	12,658,458

[a]Assumes that HUD would borrow from the Treasury an amount equal to the amount redeemed.

[b]These figures represent estimates of potential savings in budget outlays that would stem from a modified program. To measure the present value of real cost savings, it would be necessary to discount the value of benefits accruing in future years to account for inflation and the real return on capital investments.

For an additional perspective, we analyzed the potential cost impact to HUD of the $100 million in debentures used to pay MIPs during fiscal year 1982 being redeemed early. For this analysis, we assumed that the debentures were all redeemed after 7 years and 8 months--the average turnaround time computed for debentures redeemed in April 1982. We compared (1) the actual interest costs which would have been paid to maturity if the debentures had not been redeemed and (2) the costs of Treasury borrowing over 12 years and 4 months (i.e., the difference between the average turnaround time and a 20-year maturity date for debentures) at the same borrowing rates used in the previous analysis. As shown, the costs of Treasury borrowing would again be substantial when compared to the option of not redeeming debentures before they mature.

Estimated Potential Cost Impact of Treasury Borrowing for all Debentures Redeemed To Pay MIPs During Fiscal Year 1982

Treasury borrowing rate (percent)	Interest on Treasury borrowing @12 years and 4 months[a]	Interest on debentures @12 years and 4 months	Difference in interest costs--borrowing vs. debentures[b]
7-1/4	$ 89,266,001	$68,000,804	$ 21,265,197
10-5/8	130,820,864	68,000,804	62,820,060
13-3/4	169,297,588	68,000,804	101,296,784
15-1/8	186,227,347	68,000,804	118,226,543

[a]Assumes that HUD would borrow from the Treasury an amount equal to the amount redeemed.

[b]As in the previous table, the difference was not discounted to reflect the present value of savings to the government.

Treasury borrowing rates do not always exceed debenture interest rates. For example, a project mortgage insured between July 1 and December 31, 1981, and defaulting in December 1983, would receive a debenture carrying interest at 12-7/8 percent. Since this percent exceeds the Treasury borrowing rate of 11.78 percent in December 1983, HUD would not incur an increased interest cost by borrowing to pay off this debenture. However, because a 12-7/8 percent investment yield would have been attractive in the marketplace in December 1983, it can reasonably be expected that these debentures would not have been redeemed to pay MIPs.

LEGISLATIVE CHANGES MODIFYING USE AND TERMS OF DEBENTURES

Legislative changes to the provisions of the National Housing Act which currently allow debentures to be redeemed prior to maturity as payment of MIPs could help to reinforce the incentive to avoid foreclosure by limiting debenture owners' ability to redeem them before they mature. Such changes could also help reduce Treasury borrowing and the interest costs associated with this borrowing. However, because lender participation in programs which settle insurance claims in debentures could be deterred by legislation modifying the debenture redemption feature currently provided by the act, additional modifying legislation may be needed to provide the Secretary of HUD with alternatives directed toward enhancing the attractiveness of debentures. Providing the Secretary with the authority and flexibility to modify the interest and maturity terms of debentures could be a rational alternative.

Legislative changes offered by HUD

As part of its fiscal year 1982 housing authorization bill (S. 2361), HUD proposed to eliminate the statutory requirement that debentures issued in payment of insurance claims be redeemable at par in exchange for the payment of MIPs. This change would, in effect, have allowed HUD to redeem debentures at less than their par value and was justified by HUD on the basis that such redemptions (1) can result in a significant loss of insurance fund revenues because of the low interest rates borne by the debentures and (2) are not conducive to sound financial management.

HUD's proposal, however, was not included in either the Senate version of the 1982 authorizing bill (S. 2607) or the House version (H.R. 6296). Congressional staff members said that this proposal was overlooked during the congressional process, attributing the oversight to the size and complexity of the housing bill.

According to documents written by HUD's Office of Financial Management and by a former Deputy Assistant Secretary for Housing, among others, the prospect of receiving debentures in settlement of defaulted mortgages can deter lender participation in HUD's mortgage insurance programs because (1) low interest rates on debentures result in yields below those expected when funds were loaned or which are otherwise available in the investment market and (2) lengthy maturity terms of debentures can alter a lender's originally projected rate of return or income stream because the estimated or actual remaining life of defaulted loans or mortgages is less than the maturity period of the debentures. Thus, while debentures create incentives against foreclosure, they can also provide disincentives to investment. To alleviate these perceived disincentives to investment in mortgage insurance programs and to provide a trade-off against the proposed statutory amendment to eliminate the redemption of debentures at par in exchange for the payment of MIPs, HUD drafted several other related legislative proposals for inclusion in its 1982 authorization bill. These proposals included

--raising the interest rates of debentures to tie in more closely with rates borne by defaulted loans or mortgages while considering an appropriate differential which would account for the lenders' loss of mortgage servicing responsibility when the defaulted mortgage is assigned to HUD and would retain some disincentive to foreclosure and

--adjusting maturity terms of debentures so lenders can anticipate an income stream and a full pay out at about the same rate of return and in about the same period of time as was originally assumed when the loan was made.

Officials from HUD's Housing, General Counsel, Policy Development and Research, and Legislation and Congressional Relations offices said that these draft proposals were not adopted by the Administration and, as a result, were not included in HUD's proposed fiscal year 1982 housing authorization bill.

A HUD official from the Office of Policy Development and Program Evaluation said that legislation to eliminate the early redemption of debentures has not been reintroduced by HUD because, without the interest increase and maturity term adjustment trade-offs, such legislation would not be well received by lenders. He said that OMB's past rejection of the trade-off provisions would appear to make future attempts by HUD to propose similar legislation improbable.

Legislation modifying the procedures for determining the interest rate and maturity terms borne by debentures offers an opportunity to offset any disincentives to investment in programs which settle defaults in debentures. Such legislation could provide a rational tradeoff to encourage continued interest in HUD mortgage insurance programs by (1) providing debenture holders with a stream of interest income more closely related to that of the defaulted mortgage and (2) allowing investors to recapture their original investment within the same time period anticipated when the mortgage was approved.

The cost trade off between reduced Treasury borrowings and increased costs of higher debenture interest rates is not readily quantifiable because of unpredictable future interest, default, and debenture redemption variations. However, by giving the Secretary of HUD the authority to redeem debentures issued in the future at less than face value and the option to adjust interest rates on debentures issued in the future, the flexibility to make sound financial and program decisions would be provided and the ability to maintain lender investment interest in HUD's insurance programs would be retained. To assure that the integrity of the insurance funds are maintained, any such legislation could also provide the Secretary of HUD with the flexibility for determining actual interest rates and maturity terms.

Representatives from 17 mortgage lending institutions made the following observations regarding HUD's use of debentures to pay claims and HUD's acceptance of debentures as payment for mortgage insurance premiums owed.

--The mortgagees generally stated that although they prefer cash rather than debenture settlements, decisions to participate in HUD mortgage insurance programs is primarily based on other factors including (1) the guarantee of the mortgages by HUD, (2) the saleability of the mortgages, and (3) a desire to remain competitive in the mortgage market and to help low- and moderate-income families to obtain housing. Some mortgagees said that mortgages which pay claims in debentures are worth less when sold on the secondary market; however, they can compensate for this by charging additional fees when issuing these mortgages.

--Most mortgagees said that the MIP redemption feature provides no particular incentive for getting involved with HUD programs which pay in debentures. On the other hand, 5 of the mortgagees who responded to this question believed that the MIP redemption feature does provide some incentive for investing in HUD programs which pay in debentures although it is not an overriding factor in making investment decisions.

--The majority of the mortgagees said that they would continue to get involved in HUD programs if the MIP redemption feature was eliminated. Only one said it would not continue its involvement if the MIP redemption feature was eliminated.

<u>Prospective impacts of legislative changes</u>

The greater the number of debentures and insurance premiums which can legally be covered by a legislative change limiting the debenture redemption feature, the greater the potential savings. However, to protect the rights of current debenture owners, legislative amendments limiting debenture redemptions legally could only apply to debentures issued after the date of enactment and premiums due on insurance issued after the date of enactment. Thus, owners of debentures outstanding on the date of enactment would retain the right to redeem them at par value as payment of MIPs due on mortgage insurance outstanding at the date of enactment. At September 30, 1983, about $206 million of debentures were outstanding. These could be used to pay premiums on billions of dollars of outstanding insurance.

Under future legislation, the Secretary may be given authority to either reject debentures or redeem them at less than face value if they were issued after the date of enactment or submitted as payment of MIPs on insurance issued after the date of enactment. Because debentures bear interest at rates in effect at about the time the mortgages were insured, the potential remains for the future issuance of low-interest debentures. Under existing law, redeeming these debentures at par prior to maturity while borrowing from the Treasury at higher rates to pay the debentures off could result in additional costs to HUD as shown by the examples on pages 15 and 16. Legislation restricting the use of debentures could help to minimize such future Treasury borrowing costs.

CONCLUSIONS

The redemption of debentures before maturity in exchange for the payment of MIPs compromises HUD's primary purposes for using debentures to settle insurance claims. Debentures may not create a disincentive to foreclosure because accepting them for redemption at face value prior to maturity in exchange for the payment of MIPs reduces the period of time they must be held by providing holders of the debentures with an outlet for returning them to HUD before they mature. And, when they are redeemed before the maturity periods expire, the need for Treasury borrowing may be hastened. In this respect, we found that the Treasury borrowing which may be required as a result of paying off low-interest debentures prior to maturity would result in higher interest costs than would be incurred if debentures remained outstanding.

An alternative would be to modify the National Housing Act to provide the Secretary with the discretionary authority to redeem debentures prior to maturity at less than face value or, if debenture owners choose not to accept less than face value, to reject debentures as payment of mortgage insurance premiums. This would help to (1) reinforce the incentive to avoid foreclosure which debentures are supposed to provide by limiting the debenture owners' ability to redeem them before they mature and (2) minimize interest costs by allowing the Secretary to reject debentures or value adjust them to assure that the interest costs incurred through Treasury borrowing would not exceed the interest costs which would be incurred if the debentures were held to maturity.

Modifying the National Housing Act to apply to all debentures issued after the date of enactment and all premiums due on insurance issued after the date of enactment will protect the rights of current debenture owners and minimize administrative burdens which could be encountered by the above legislative changes.

Further, because amendments to the act which would modify the conditions for accepting debentures to pay MIPs could, as indicated by some industry representatives, and as implied by HUD in drafting its previous legislative proposals, reduce the attractiveness of HUD-insured mortgages to prospective lenders, we believe additional modifying legislation may be needed.

Specifically, to provide mortgagees with a stream of interest income similar to the interest income stream which would have been generated had a mortgage not defaulted, interest rates borne by debentures could be adjusted so that they are more closely aligned with interest rates borne by defaulted mortgages. Such actions would be taken at the determination and option of the Secretary of HUD after considering (1) the appropriate differentials needed to account for lenders' loss of servicing responsibility and to retain some disincentive to foreclosure, and (2) costs and benefits of such actions. Also, to protect mortgagees against the prospect of receiving debentures which mature after the defaulted mortgage, had it come to maturity and been paid off, the maturity terms for each debenture issued could be established as the lesser of the current statutory term or the remaining term of the defaulted mortgage. Such legislation, if enacted, would apply to debentures issued after the date of enactment.

RECOMMENDATIONS TO THE CONGRESS

To help make debentures more effective in accomplishing HUD's intended purposes and to help reduce the costs of Treasury borrowing to the extent that the redemption of low-interest debentures prior to their stated maturity can lead to Treasury borrowing at higher rates of interest, we recommend that the Congress amend the National Housing Act to provide the Secretary of HUD with the authority to

--redeem debentures prior to maturity at less than face value in order to adjust for variations between debenture interest rates and Treasury borrowing rates or

--if debenture owners choose not to accept less than face value, or if the Secretary otherwise deems it appropriate, to reject debentures as payment of mortgage insurance premiums.

We also recommend that the legislation apply to all debentures issued after the date of enactment on currently outstanding and future insurance and all premiums due on insurance issued after the date of enactment.

Appendix II contains suggested language for implementing the recommended legislative changes.

MATTERS FOR CONSIDERATION BY THE CONGRESS

To enhance the attractiveness of debentures to lenders and to help offset any investment disincentives created by legislation curtailing the redemption privileges of debentures, the Congress should consider changes in legislation which would modify the procedures for determining interest rates and maturity dates of debentures. Such legislation could provide the Secretary of HUD with the authority and flexibility for modifying debenture terms to make them relatively comparable with the terms of defaulted mortgages and could be utilized by the Secretary if investor interest lessens in programs which pay insurance claims in debentures.

Specifically, the legislative changes to be considered would apply to debentures issued after the date of enactment and would provide the Secretary of HUD with the authority and flexibility to

--align debenture interest rates more closely with the actual rates of defaulted mortgages after giving consideration to (1) the appropriate differentials needed to account for lenders' loss of servicing responsibility and to retain some disincentive to foreclosure and (2) any other factors considered appropriate, including the cost/benefit impacts of revising debenture interest rates and

--establish the maturity term for each debenture as the lesser of the current statutory term or the remaining term of the defaulted mortgage to the nearest semiannual interest date.

AGENCY COMMENTS AND OUR EVALUATION

HUD said that our draft proposals incorporate and/or improve upon the basic substance of what it had earlier proposed and, on the whole, did not take exception to our proposals for legislative changes noting that:

> "In summary, the GAO proposals should on balance improve cash management of the insurance funds, but they are peripheral to the more fundamental risk management tasks of maintaining sound mortgage insurance underwriting standards and charging actuarially adequate premiums."

While we agree that other risk management tasks are important to HUD, we believe that our proposals present an opportunity to help increase the effectiveness of debentures and, as HUD agrees, help improve insurance funds' cash management.

HUD discusses what it views as the positive and negative aspects of each proposal and suggests, for example, that (1) we mention that Treasury borrowing costs do not always exceed debenture rates, (2) we highlight the finding that debentures sampled did serve their intended purpose of postponing drains on insurance funds for almost 8 years, and (3) reductions in cash flow to already cash short insurance funds because of debenture redemptions can, but does not inevitably, lead to Treasury borrowing.

We considered HUD's suggestions and comments and made changes where necessary, including the HUD comments discussed above. In particular, we noted HUD's concerns relating to our proposal that debenture terms should be modified to provide an interest rate closer to that of the defaulted mortgage. While HUD acknowledged that higher debenture interest rates will improve debenture investment appeal and could help forestall early redemptions, HUD was concerned that (1) higher debenture rates will obligate the government to pay more interest and could force mortgage insurance premiums to rise, (2) raising debenture interest rates would not remove the risk of exposure to fluctuating market rates for debenture holders, and (3) changes in the method of setting debenture interest rates may not be necessary because current procedures may eventually produce rates which are more favorable to investors. Because of HUD's concerns regarding the efficacy of modifying procedures for determining debenture interest rates and because of the future uncertainties which exist regarding interest, default, and redemption trends, we are proposing this issue as a matter to be considered by the Congress. In this regard, we are suggesting that the authority and flexibility for modifying debenture interest terms could be vested with the Secretary of HUD and would be utilized by the Secretary, pending appropriate cost/benefit analysis, if curtailment of debenture redemption privileges affects investor interest in HUD programs.

Although HUD agrees that shortening the maturity terms of debentures should be accomplished simply as a matter of equity, we are also proposing this issue as a matter for the Congress to consider because we believe that modifying interest rates and maturity terms is a single issue. In this connection, HUD agrees that the debenture term modifications would apply to debentures issued after enactment with respect to mortgages insured before and after the date of enactment.

Regarding our proposals to amend the National Housing Act to provide the Secretary additional authority when choosing to accept debentures for MIPs, HUD said that our formulation is an improvement over its version because the flexible discretionary approach should be more agreeable to the industry than outright repeal of the MIP redemption feature. HUD notes, however, that

> "If the Secretary has authority to adjust older-yield debentures to market by redeeming at less than face value (on the basis of debenture interest rates versus Treasury borrowing rates), then the Secretary should not have occasion to reject debentures for MIP payments as 'financially unfavorable to HUD.'"

In this regard, HUD suggests that this shows some logical inconsistency.

We have revised our draft proposals to more clearly delineate the two alternatives available to the Secretary. Our revision provides the Secretary the flexibility to redeem debentures prior to maturity at less than face value in order to adjust for variations between debenture interest rates and Treasury borrowing rates or to reject debentures for MIP payments if debenture owners choose not to accept less than face value or if the Secretary otherwise deems it appropriate to reject them.

HUD said that redemption at less than face value may be "perhaps difficult to defend legally." HUD reasons that "HUD contractually owes this amount to the lender in settling the insurance claim. In marking this amount down at some point in the future...HUD may be seen to renege on its FHA insurance obligation."

In making this proposal, we considered how the legislation might affect the rights of debenture holders and lenders. We believe that the recommendation is legally sound and would not be inconsistent with HUD's insurance obligations. The limit on early redemption at par value would only apply to debentures issued after the date of enactment and to premiums due on insurance issued after the date of enactment. Owners of existing debentures could continue to redeem them at par to pay MIPs on existing insurance. Moreover, if debenture owners hold the debentures to maturity, they would receive full face value. HUD's contractual obligation to pay full principal at maturity would not be changed by modification of the early redemption provision of the law.

HUD agrees that the par redemption change should only apply prospectively to insurance endorsements after our proposed legislative changes have been enacted. HUD's agreement, however, appears to be limited to future insurance written and does not include currently outstanding insurance nor all premiums due on insurance issued after the date of enactment. Including all three provisions increases the opportunity to minimize future interest cost while protecting the rights of current debenture holders and mortgagees.

HUD also questions whether our proposal for redeeming debentures at less than face value will add an administrative burden which may prove difficult to rationalize to investors.

We believe the prospective application of our proposals will help minimize any administrative burdens and investor problems which could be encountered.

HUD ORGANIZATIONAL COMPONENTS AND OTHER ORGANIZATIONS AND AGENCIES WE CONTACTED

Department of Housing and Urban Development:

Assistant Secretary for Housing

Office of Financial Management
Office of Policy Development and Program Evaluation
Office of Budget and Economic Analysis
Office of Multifamily Housing Management and Occupancy

Assistant Secretary for Administration

Office of Finance and Accounting
Office of Budget

Assistant Secretary for Policy Development and Research

Office of Economic Affairs

General Counsel

Office of Legislation
Office of Insured Housing and Finance

Office of Legislation and Congressional Relations

Office of Inspector General

Other Organizations and Agencies:

Congressional Research Service
Congressional Budget Office
Office of Technology Assessment
Office of Management and Budget
Treasury Department--Bureau of Public Debt

Mortgagees:

American Savings and Loan Association of Florida, Miami, FL
Arlington Mortgage Company, Falls Church, VA
Bank of New England, Boston, MA
Broadview Savings and Loan Company, Cleveland, OH
Colonial Mortgage Service Company, Philadelphia, PA
Economy Federal Savings and Loan, St. Louis, MO
First Interstate Bank of California, Pasadena, CA
Genstar Pacific Financial Corporation, Glendale, CA
Lomas and Nettleton, Dallas, TX
Manufacturers Hanover Mortgage Corporation, Farmington Mills, MI
Missouri Housing Development Corporation, Kansas City, MO
New York City Housing Development Corporation, New York, NY

Reilly Mortgage Group, Washington, D.C.
Security Pacific Mortgage Corporation, Denver, CO
South Coast Mortgage Company, Beaumont, TX
Southeastern Savings Association, Racine, WI
Trans America Mortgage Company, San Francisco, CA

NATIONAL HOUSING ACT AMENDMENTS RECOMMENDED TO LIMIT REDEMPTION OF DEBENTURES PRIOR TO MATURITY

The second sentence of sections 203(c) [12 U.S.C. §1709 (c)], 603(c) [12 U.S.C. §1738(c)], 803(c) [12 U.S.C. §1748b(c)], and 903(c) [12 U.S.C. §1750b(c)] should be amended to read as follows:

> "Such premium charges, with respect to mortgages endorsed for insurance as of [date of enactment] shall be payable by the mortgagee, either in cash or in debentures issued by the Secretary under this subchapter at par plus accrued interest, in such manner as may be prescribed by the Secretary. With respect to mortgages endorsed for insurance and debentures issued on or after [date of enactment] debentures accepted for such premium charges shall be at par adjusted for the difference between the current Treasury borrowing rate and the debenture interest rate: Provided, That the Secretary is authorized in his discretion to reject debentures offered as payment of mortgage insurance premiums: Provided further, That debentures presented in payment of premium charges shall represent obligations of the particular insurance fund or account to which such premium charges are to be credited: Provided further, That the Secretary may require the payment of one or more such premium charges at the time the mortgage is insured, at such discount rate as he may prescribe not in excess of the interest rate specified in the mortgage."

The second sentence of section 8(c) [12 U.S.C. §1706c(c)] should be amended to read as follows:

> "Such premium charges, with respect to mortgages endorsed for insurance as of [date of enactment] shall be payable by the mortgagee, either in cash or in debentures issued by the Secretary under this section at par plus accrued interest, in such manner as may be prescribed by the Secretary. With respect to mortgages endorsed for insurance and debentures issued on or after [date of enactment] debentures accepted for such premium charges shall be at par adjusted for the difference between the current Treasury borrowing rate and the debenture interest rate: Provided, That the Secretary is authorized in his discretion to reject debentures offered as payment of mortgage insurance premiums: Provided further, That the Secretary may require the payment of one or more such premium charges at the time the mortgage is insured, at such discount rate as he may prescribe not in excess of the interest rate specified in the mortgage."

The first sentence of section 207(d) [12 U.S.C. §1713(d)] should be amended to read as follows:

"The Secretary shall collect a premium charge for the insurance of mortgages under this section which shall be payable annually in advance. Such premium charges, with respect to mortgages endorsed for insurance as of [date of enactment] shall be payable by the mortgagee, either in cash or in debentures issued by the Secretary under any subchapter and section of this chapter, except debentures of the Mutual Mortgage Insurance Fund, or of the Cooperative Management Housing Insurance Fund at par plus accrued interest. With respect to mortgages endorsed for insurance and debentures issued on or after [date of enactment] debentures accepted for such premium charges shall be at par adjusted for the difference between the current Treasury borrowing rate and the debenture interest rate: Provided, That the Secretary is authorized in his discretion to reject debentures offered as payment of mortgage insurance premiums."

Section 213(n) [12 U.S.C. §1715e(n)] should be amended by adding the following at the end thereof:

": Provided, That with respect to mortgages endorsed for insurance and debentures issued on or after [date of enactment] debentures accepted for such premium charges shall be at par adjusted for the difference between the current Treasury borrowing rate and the debenture interest rate: Provided further, That the Secretary is authorized in his discretion to reject debentures offered as payment of mortgage insurance premiums."

The second sentence of section 220(h)(5) [12 U.S.C. §1715k(h)(5)] should be amended to read as follows:

"Such premium charges, with respect to mortgages endorsed for insurance as of [date of enactment] shall be payable by the financial institution either in cash or in debentures (at par plus accrued interest) issued by the Secretary as obligations of the General Insurance Fund, in such manner as may be prescribed by the Secretary, and the Secretary may require the payment of one or more such premium charges at the time the loan is insured, at such discount rate as he may prescribe not in excess of the interest rate specified in the loan: Provided, That with respect to mortgages endorsed for insurance and debentures issued on or after [date of enactment] debentures accepted for such premium charges shall be at par adjusted for the difference between the current Treasury borrowing rate and the debenture interest rate: Provided further, That the Secretary is authorized in his discretion to reject debentures offered as payment of mortgage insurance premiums."

The fourth sentence of section 223(d) [12 U.S.C. §1715n(d)] should be amended as follows:

"This premium, with respect to mortgages endorsed for insurance as of [date of enactment] shall be payable in cash or in debentures of the insurance fund under which the loan is insured at par plus accrued interest: Provided, That with respect to mortgages endorsed for insurance and debentures issued on or after [date of enactment] debentures accepted for such premium charges shall be at par adjusted for the difference between the current Treasury borrowing rate and the debenture interest rate: Provided further, That the Secretary is authorized in his discretion to reject debentures offered as payment of mortgage insurance premiums."

The second sentence of section 703(a) [12 U.S.C. §1747b(a)] should be amended to read:

"Such premium charge, with respect to insurance contracts executed as of [date of enactment] shall be payable annually in advance by the investor, either in cash or in debentures issued by the Secretary under this subchapter at par plus accrued interest. With respect to mortgages endorsed for insurance and debentures issued on or after [date of enactment] debentures accepted for such premium charges shall be at par adjusted for the difference between the current Treasury borrowing rate and the debenture interest rate: Provided, That the Secretary is authorized in his discretion to reject debentures as payment of mortgage insurance premiums: Provided further, That, if in any operating year the gross income shall be less than the operating expenses, the premium charge payable during such operating year shall be waived, but only to the extent of the amount of the difference between such expenses and such income and subject to subsequent payment out of any excess earnings as hereinafter provided."

The sixth sentence of section 1102 [12 U.S.C. §1749aaa-1] should be amended to read as follows:

"Premium charges fixed under this section with respect to mortgages endorsed for insurance as of [date of enactment] shall be payable by the mortgagee either in cash, or in debentures which are the obligation of the General Insurance Fund, at par plus accrued interest, at such times and in such manner as may be prescribed by the Secretary. With respect to mortgages endorsed for insurance and debentures issued on or after [date of enactment] debentures accepted for such premium charges shall be at par adjusted for the difference between the current Treasury borrowing rate and the debenture interest rate: Provided, That the Secretary is authorized in his discretion to reject debentures offered as payment of mortgage insurance premiums."

U.S. DEPA IENT OF HOUSING AND URBAN DEVELOPM
WASHINGTON, D.C. 20410

OFFICE OF THE ASSISTANT SECRETARY FOR
HOUSING-FEDERAL HOUSING COMMISSIONER

DEC 20 1983

Mr. J. Dexter Peach
Director, Community and Economic
Development Division
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Peach:

Your letter of November 2, 1983, addressed to the Secretary of Housing and Urban Development transmitting a proposed report to the Congress entitled: "Debentures Not Serving Purposes Intended by HUD--Legislative Changes Could Increase Effectiveness and Reduce Costs," has been referred to me for reply.

HUD welcomes the GAO's "continuing effort to help HUD improve the management of its programs and resources" (p. 4), and specifically its endorsement of HUD legislative proposals (pp. 13-17) which had been prepared for the fiscal year 1982 housing authorization bill to improve the effectiveness of debenture settlement of claims. Actually, financial and actuarial staff within Housing originated these proposals as far back as 1979 and we discussed these proposals at length when visited last year by GAO staff researching the proposed report.

At that time, Housing's solution consisted of a coherent set of legislative proposals to provide that debentures issued as payment on insurance claims: (1) would have an interest rate set at 1/4 percent below the rate of the insured mortgage, (2) would be issued for a term of not more than half the remaining term of the insured mortgage, and (3) the requirement for redemption of debentures at par in exchange for premiums would be eliminated. Finally, the Secretary would use HUD's statutory option to pay claims either in cash or debentures in all multifamily insurance programs. In other words, cash settlement would no longer be automatic as is currently the case under sections 220, 221, 236 and certain other programs.

As GAO understands (p. 13), the anticipated adverse reaction of lenders and investors to losing the right to redeem debentures at par for payment of MIP would be softened by (1) and (2) above, "sweeteners" to bring debenture yields closer to those of the defaulted mortgages submitted for settlement. These two modifications in debenture terms were not acceptable to OMB; elimination of redemption at par alone, without the debenture modifications, was not acceptable to HUD. Therefore, the issue lay dormant until revived by this GAO report.

The GAO recommendations at pages 16-17 adopt HUD's comprehensive approach and incorporate the basic substance of what we had proposed. Both versions would apply prospectively and preserve the rights of current debenture holders and mortgagees. The Department does not take exception to the Comptroller General's recommendation of these legislative changes to the Congress. For reasons discussed below in reference to the specific GAO recommendations, we do not believe that the enactment of the recommendations is crucial to improving the management of the FHA insurance funds, particularly the General Insurance Fund (which includes the debenture-settlement multifamily programs).

I will answer the recommendations in the order that they are presented in the report.

Recommendations No. 1 and 2: Amend the National Housing Act to give the Secretary of HUD authority to: 1) "reject debentures as payment for mortgage insurance premiums when the Secretary determines that acceptance of such debentures would be financially unfavorable to HUD"; and 2) "when choosing to accept debentures, to redeem them at less than face value in order to adjust for variations between debenture interest rates and Treasury borrowing rates."

Reply: The GAO formulation is an improvement over HUD's original version, in that the flexible discretionary approach should be more palatable to the industry than outright repeal of the par MIP redemption feature. On the other hand, the two recommendations, taken together, show some logical inconsistency. If the Secretary has authority to adjust older lower-yield debentures to market by redeeming at less than face value (on the basis of debenture interest rates versus Treasury borrowing rates), then the Secretary should not have occasion to reject debentures for MIP payment as "financially unfavorable to HUD."

GAO's concern is that HUD may have to borrow from the Treasury to redeem debentures which carry interest rates lower than the rate we pay to the Treasury. As documented in the report, HUD's borrowing cost in recent years considerably exceeds the interest rate paid on debentures. To the extent that debenture redemption from an insurance fund in a deficit position, i.e., GIF, compels HUD to raise cash by borrowing from the Treasury, HUD incurs a net cost of the difference between the Treasury's interest rate and the debenture interest rate. For example, HUD borrows at 10% to retire a debenture which obligated the government to pay interest at 3%. Note, however,that debenture redemption does not impose a 1:1 cash borrowing need from the Treasury. In redeeming the debenture for MIP, HUD cancels an amount of MIP equivalent to the face amount of the debentures and foregoes cash receipts in the amount of the MIP obligation. The reduction in cash flow to a fund already cash-short **can**, but does not inevitably, lead to Treasury borrowing. HUD also loses any opportunity to earn interest on the foregone cash receipts.

HUD also faces a potential loss in that the debentures redeemed at par may have been issued originally, following default, on outstanding mortgage debt in a nominal dollar amount far in excess of the market value of the mortgage (relating the mortgage interest rate to prevailing market yields at time of default). HUD's loss of the excess debenture amount over resale value of the foreclosed property is, of course, an essential element of insurance risk. It is exacerbated if HUD later redeemed the debentures at par in exchange for the same dollar amount of MIP owed.

GAO's analysis should mention more prominently that Treasury borrowing costs do not always exceed debenture interest rates. In the period chosen by GAO for analysis, 1978-82, Treasury borrowing costs reached an all-time high and greatly exceeded the interest rates on debentures redeemed at that time. But interest rates on new debentures also rose. For example, if a project mortgage insured between July 1 and December 31, 1981 results in a claim today, debentures will be issued at an interest rate of 12-7/8 percent. This exceeds the current yield of approximately 12 percent on 30-year Treasuries and offers an attractive investment. In fact, HUD could be better off borrowing from the Treasury to settle this claim in cash, rather than obligating the government to pay 12-7/8 percent interest for the next 20 years. It is unlikely that this debenture will be submitted for payment of MIP at par, since the high rate would command a premium in the market. If, on the other hand, market rates escalate to a higher level at some point in the future, this debenture might be turned into HUD for par redemption.

The relative value of a debenture to the investor (and its potential cost to the government) fluctuates over time in relation to the market. This probably explains the surprising finding by GAO (p. 8) of an average turnaround time of 7 years, 8 months between debenture issue and redemption for MIP (based on a random sample of debenture redemptions in April 1982). In this average 7 years, 8 months time span, the debenture rate climbed from 6-7/8 to 12-3/4 percent and the FHA multifamily rate ceiling, from 9-1/2 to 16-1/2 percent. In such a rising rate environment, one would expect the debenture turnaround time to be much shorter. To be fair, GAO should highlight this finding that debentures sampled did serve an intended purpose of debenture settlement in postponing by roughly 8 years potential cash drains on insurance funds.

Although debenture settlement creates cash flow problems for the insurance funds, we are less certain that the government suffers an accounting loss in accepting debentures at par for the same dollar amount of MIP owed. This is a paper transaction. A given amount of MIP obligation is cancelled for the same face amount of debentures presented to HUD. The GAO proposal for redemption at less than face value will add an administrative complication which may prove difficult to rationalize to investors and perhaps difficult to defend legally. Remember, the face amount of the debentures is determined by the amount of unpaid mortgage debt at default (subject to certain adjustments). HUD contractually owes this amount to the lender in settling the insurance claim. In marking this amount down at some point in the future, in reference to a differential between Treasury and debenture interest rates, HUD may be seen to renege on its FHA insurance obligation.

The legally and administratively preferred course lies in part (1) of the GAO proposal: discretionary authority in the Secretary to suspend par redemption when warranted by the financial condition of an insurance fund. That is, at a point when MIP cash receipts foregone by debenture redemption compels HUD to borrow from the Treasury at rates in excess of the average rate on debentures submitted, HUD could suspend redemption. Suspension could terminate at the earlier of maturity or return to favorable condition of the affected insurance fund. This element of GAO's two-part remedy fits the legislative purpose of debenture settlement and should therefore have stronger legal credibility than part (2). At inception of the FHA in 1934, the National Housing Act created debentures to prevent a drain on the Treasury in settling FHA claims presented before the insurance fund had accumulated sufficient cash reserves. This same rationale supports suspension of par redemption during periods of cash flow shortgage in an insurance fund. Given the present condition of the General and Special Risk Insurance Funds, the suspension may last a long time.

Recommendation No. 3 The above statutory changes should "apply to all debentures issued after the date of enactment on currently outstanding and future insurance and all premiums due on insurance issued after the date of enactment."

Reply: We agree that the par redemption change should only apply prospectively to insurance endorsements after the date of enactment and that the debenture term modifications would apply to debentures issued after enactment both with respect to mortgages insured before or after the date of enactment.

Recommendation No. 4: In conjunction with changes affecting par redemption, debenture terms should be modified to provide an interest rate closer to that of the defaulted mortgage and a term which is the lesser of the current statutory term or the remaining term of the defaulted loan to the nearest semiannual interest date.

Reply: The original HUD proposal would have set the debenture interest rate at 1/4 percent below the mortgage rate and reduced the term to one-half the remaining term, at default, of the mortgage. Modifications are intended to compensate investors for the proposed loss of automatic redemption at par, so that debentures still provide some foreclosure disincentive. Simply as a matter of equity, the debenture term should be shortened. The present requirement of a 20-year term beyond claim settlement is unreasonable, particularly in that the debenture-settlement multifamily programs have terms less than the 40-year term for Section 221 programs (which settle in cash). GAO's proposal would use the remaining term of the mortgage, or 20 years if that is shorter. This is less liberal than HUD's proposal but an acceptable improvement.

The interest rate issue is more complex. First, no sweeteners in term modifications can remove the debenture holders risk of exposure to interest rate fluctuations (unless we issued indexed variable rate debentures). As discussed above, at any point in time the debenture rate may be higher or lower than alternative market yields. Tying the debenture rate more closely to the underlying mortgage rate would reduce the amplitude of this risk but not remove it.

When mortgage interest rates increase, the real economic value of older loans to investors obviously declines. Under existing law, insurance benefits, when paid in cash, are based on the outstanding balance of the loan, which is not necessarily the actual value of the loss. Application for a claim in this instance can be quite beneficial to the insured party but obviously not to the Federal insuror. In effect, debenture settlements seek to address this particular risk by basing FHA debenture rates on long-term Treasury rates at about the time of loan origination or commitment. Any change in the interest rate by the time of claim will result in a comparable change in the value of the debenture and the insurance benefit thus should roughly match the value of the loan.

Basing the debenture rate on something other than (and higher than) long-term Treasury rates will improve the investment appeal. This may forestall early redemption of debentures (to the extent the legislation would still permit par redemption) but will obligate the government to pay more interest on the debentures. Since mortgage rates are generally 150 to 200 basis points higher than Treasury yields of comparable maturities, HUD would incur a certain increase in interest costs in exchange for a contingent (on market changes and redemption restrictions) improvement in cash flow to the insurance funds. In fact, in a relatively stable interest rate environment, HUD will always be better off borrowing from the Treasury to settle claims in cash rather than issuing debentures at rates closely tied to mortgage rates.

A further complication will occur under deregulation of FHA interest rate ceilings. Without reference to an FHA multifamily interest rate ceiling, the debenture rate would be set with reference to a multiplicity of negotiated rates which, in lieu of discounts, would be higher than administered rates.

It is possible, then, that the interest rate sweetener could impose insurance costs which would necessitate raising MIP for the multifamily programs. Obviously, the effect on program participants would be counter-productive. This aspect of the proposal needs reappraisal. Simulation of possible results is desirable but not possible within the short deadline for this response. Probably, the modified debenture rate should be at least 100 basis points below the mortgage rate.

In time, the current rate procedure may produce results more favorable to investors. Debenture rates are now determined by the Treasury "...by estimating the average yield of maturity, on the basis of daily closing market bid quotations or prices during the calendar month next preceding the establishment of such rate of interest, on all outstanding marketable obligations of the United States having a maturity date of fifteen years or more...." Included in the outstanding obligations that serve as a basis for this calculation are a number of "flower bonds". (These are old low-coupon Treasury bonds that can be redeemed at par in exchange for estate taxes). The low yields on the "flower bonds" have significantly depressed the statutory debenture rate. As a result, although FHA debentures are backed by the full faith and credit of the Federal Government, experience has shown that they cannot command a yield comparable with Treasury issues. However, this should change with the continuing retirement and eventual disappearance of "flower bonds".

In summary, the GAO proposals should on balance improve cash management of the insurance funds, but they are peripheral to the more fundamental risk management tasks of maintaining sound mortgage insurance underwriting standards and charging actuarially adequate premiums.

Sincerely,

W. Calvert Brand

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Acting Assistant Secretary

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