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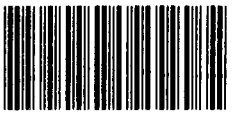

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Impact of FHA Loan Policy Changes

Statement of
John M. Ols, Jr., Director
Housing and Community Development Issues

Before the
Subcommittee on Housing and Community Development
Committee on Banking, Finance, and
Urban Affairs
House of Representatives

Mr. Chairman and Members of the Subcommittee:

We are pleased to appear here today to discuss the interim results of our analyses of the impact of three proposed policy changes on the financial condition of the Federal Housing Administration's (FHA) Mutual Mortgage Insurance (MMI) Fund. Our work, which was performed at the request of Congressman Gerald Kleczka, focused on the financial impacts of (1) increasing the FHA mortgage ceiling limits, (2) reducing down payment requirements, and (3) increasing the availability of adjustable rate mortgages. In addition, I will comment briefly on the role of FHA in the national mortgage market and provide a summary of the comments we received from academia, government, and housing industry representatives on FHA's role. I also will discuss several management areas that our past work has shown FHA needs to improve to avoid future losses to the Fund. We expect to issue a report containing a more complete discussion of the policy changes' financial impacts and related FHA management issues in early 1990.

In summary, if house prices appreciate at a rate of at least 6 percent per year and overall economic conditions remain generally favorable, the fund will likely stay solvent; the fund will likely grow faster if the mortgage ceiling is raised. However, if the rate of housing appreciation drops below 6 percent, the fund will be stressed even if overall economic conditions remain generally favorable. If the rate is only 2 to 4 percent, the fund will likely not be able to survive without U.S. Treasury assistance.

What does this tell us? It tells us to proceed with caution as to how high to raise the mortgage ceiling, recognizing that raising the ceiling will increase the volume of insurance in effect.

To analyze the financial impacts on the MMI Fund, we developed a model for performing economic estimations of the fund's cash flow over a 10-year period covering fiscal years 1989 through 1998.

To develop our model, we performed a historical analysis of FHA's data base on single-family home loans. We applied selected variables, from the economic forecasts of Data Resources, Inc. (DRI), a widely used source for econometric projections of the type needed to perform our analysis, to our model in order to project the fund's performance over the next 10 years..

Because some analysts believe that housing prices will rise less rapidly than DRI has forecasted, we tested the sensitivity of our results by substituting lower house price appreciation rates into our model, while retaining other forecasted values. We also tested the effect of general economic conditions by estimating the fund balance under the assumption that the country would experience a repeat of the economic conditions of the 1980s.

The overall financial condition of the MMI Fund during the 1990s and the effects of the various policy options will depend heavily on actual economic conditions during the next decade. Accordingly, today's results are based on a range of possible economic conditions.

Assuming generally favorable economic conditions, that is, mortgage rates average 9.5 to 10 percent, the unemployment rate does not exceed 5.5 percent, and house prices increase at about 8 percent annually, our analysis shows the following:

-- If the current loan ceiling of $101,250 is adjusted only for the national average annual increase in house prices (the house price increase reaches $206,000 in 1998), the MMI Fund's end-of-year cash balance would increase from $6.2 billion in fiscal year 1988 to an estimated $8.7 billion in fiscal year 1998, a net increase of $2.5 billion (see exhibits I & III). However, the fund would have more insurance in force at this point and thus would have greater exposure to future loan defaults.

-- Raising the loan ceiling to 95 percent of each state's median house price would result in an estimated net cash increase of $8.2 billion by the end of fiscal year 1998, a cash balance of $14.4 billion, and a correspondingly higher volume of insurance in force. These estimates, however, are less precise the further above the historical FHA ceiling that projections are made.

-- Lowering down payment requirements could expand opportunities for homeownership but would increase the likelihood of default and losses to the fund. The reduced down payment option we examined would result in a cash balance of $7.9 billion. This cash balance would be about $850 million less than our base case. Requiring no down payment would reduce the cash balance by an estimated $1.8 billion by fiscal year 1998.

-- Increasing the use of adjustable rate mortgages (ARMs) would also provide additional opportunities for homeownership. The impact of these mortgages on the fund's cash position depends to a large extent on how interest rates perform over the next 10 years. Borrowers would be more likely to default on these mortgages during periods of rising interest rates but less likely to default during periods of declining interest rates.

Under less favorable economic conditions, the fund does not perform nearly as well. Assuming either (1) a repeat of the economic conditions of the 1980s or (2) annual house price increases of only 2 to 4 percent a year over the next 10 years, our analysis shows the following:

-- Under a repeat of the 1980s economic conditions, end-of-year balances would remain positive both when the current ceiling is adjusted for only the average annual increase in

house prices, which we refer to as our base case, and when the loan ceiling is raised to 95 percent of each state's median. However, by fiscal year 1998, the cash balances--rather than increasing as they would using our more favorable forecast-- fall by $2.5 billion under the base case and by $1.8 billion under the 95-percent-of-state-median case (see exhibit II).

-- Under the scenario in which the forecasted value of house price appreciation varies between 2 to 4 percent, rather than 7 to 8 percent, the impact on the fund's cash balances is much more severe. By fiscal year 1996, the MMI balances would be totally depleted under our base case. A similar result occurs in fiscal year 1997 under our 95-percent-of-state-median case (see exhibit III).

The final results of our analysis will be presented in a report that will be available in early 1990. We believe that, while some changes may occur as we refine our analysis and make additional calculations, the trend directions of our results will not change with regard to the potential impact of the proposed changes on the MMI Fund and the relationships among the various policy options.

Apart from our econometric projections, we believe that basic FHA management weaknesses must be addressed if future losses are to be kept under control no matter what changes are made to the ceiling limits, down payment requirements, and use of adjustable rate mortgages. In this regard, our prior audit work has identified several serious management problem areas.

-- Monitoring of program activities delegated to the private sector has not been effective.

-- Important internal controls have not been effective, particularly cash management controls and the system for monitoring the activities of regional and field offices.

-- Management has not been diligent in correcting the weaknesses identified in earlier reviews.

Because of the magnitude and diversity of HUD's management problems, we believe that HUD needs to unify its financial management under a management structure that will provide cohesiveness among all HUD activities. This unification can be accomplished by providing central direction to financial management through establishing a chief financial officer within HUD and a controller within FHA. I would like to add that the new management team at HUD under Secretary Kemp has started to address various management deficiencies to strengthen FHA's financial position.

BACKGROUND

FHA was established in 1934 under authority granted to the President by the National Housing Act (P. L. 73-479). In 1948, FHA became a wholly owned government corporation subject to the Government Corporation Control Act, as amended. FHA and its functions were transferred to the Department of Housing and Urban Development (HUD) in 1965. After the transfer, FHA's staff and facilities were merged with those of other housing activities.

The basic purpose of FHA programs is to encourage improvement in housing standards and conditions, provide an adequate home financing system through mortgage insurance, and exert a stabilizing influence on the mortgage market. To carry out this purpose, the Secretary of HUD administers FHA through four separate funds for its various mortgage insurance programs--the Mutual Mortgage Insurance (MMI) Fund, the Cooperative Management Housing

Insurance (CMHI) Fund, the General Insurance (GI) Fund, and the Special Risk Insurance (SRI) Fund.

GAO'S ANALYSIS OF MMI FUND POSITION

My testimony today focuses on the MMI Fund, FHA's largest fund with $276 billion of insurance in force as of September 30, 1989. The MMI Fund had a loss in equity of $1.4 billion in fiscal year 1988. This loss caused the government's equity in this fund to fall to $1.8 billion at the end of the fiscal year. The MMI Fund provides basic single family mortgage insurance and is intended to be self-sustaining through charging the home buyer a premium of 3.8 percent of the mortgage amount.

Let's look at why the MMI fund is losing money.

The $1.4 billion loss in the MMI Fund for fiscal year 1988 is mainly attributable to a $1.2 billion increase in its loss reserves. These reserves are necessary to account for losses on defaulted loans and will eventually lead to claims.

Two major factors contribute to the MMI Fund's increase in loss reserves. First, the record high single family mortgage insurance endorsements from 1986 and 1987 are entering the period in which historical evidence suggests that high claim rates would occur. Thus, defaults have remained at a high level. Like many private mortgage insurers, the MMI Fund generally experiences its highest rate of claims in the second and third year after the insurance is written. The claim rate usually decreases gradually after the third year and levels off after the tenth year of the policy. Given the significant level of insurance written by the MMI Fund in 1986 and 1987, defaults are likely to continue at a relatively high level, at least in the near term.

The other factor contributing to the increase in loss reserves in the MMI Fund is the persistently high default and foreclosure rates in economically stressed regions, particularly the Rocky Mountain and Southwest regions. While the percentage of total MMI insurance in force written in these regions has remained relatively stable, claim rates, and thus losses, have been substantial in these stressed regions.

FHA POLICY SCENARIOS

Our current analysis focused on the cash position of the fund at the end of each fiscal year, during the period 1989 to 1998. The cash position of the fund was influenced by FHA loan guarantee policies and economic conditions.

To conduct this analysis, we developed econometric models based on an analysis of historical trends in FHA mortgages originated during fiscal years 1979 through 1988. These econometric models identify the relationships between claim and nonclaim terminations and a variety of explanatory variables, including loan-to-value ratios, loan amounts, the rate of house price appreciation, and other economic variables. The results from these models were then combined with a cash flow model to provide projections of the cash position of the fund over fiscal years 1989 through 1998.

Our analysis of claim rates developed from FHA's data base is consistent with prior studies and conventional economic reasoning. For example,

-- Claim rates tend to peak in the second and third year after loan origination and then decline in subsequent years.

-- Claim rates are higher for loans with higher loan-to-value ratios.

-- Current FHA higher valued mortgages (within the current FHA loan limit of $101,250) tend to have lower claim rates.

-- Claim rates decline as a homeowner's equity increases through repayment of the mortgage balance and through home price appreciation.

We projected the cash position of the fund under several scenarios. These included a base case reflecting current policy, an increase in the loan ceiling, a reduction in down payment requirements, and an increase in FHA guarantees of ARMs.

To make these projections, we used forecasted values of economic variables developed by Data Resources, Incorporated (DRI). DRI provided forecasts of unemployment rates, interest rates, housing prices, and loan volumes and values. The DRI "trend" economic forecast we used predicts that the economy will perform reasonably well over the next 10 years--mortgage rates average from 9.5 to 10 percent; the unemployment rate does not exceed 5.5 percent; and housing prices, except for fiscal year 1989 which shows an annual increase of about 4 percent, increase at about 8 percent annually over the 1990-1998 period. The forecast values that were used are shown in exhibit IV.

Base Case Analysis

In our base case analysis, we used the current loan ceiling of $101,250 for 1989 and changed this limit each year according to an index of housing prices so that, using DRI's trend economic forecast, it reaches slightly more than $206,000 in 1998. The base case thereby assumes that FHA's market share is not eroded because of FHA-eligible properties increasing in price so that they can no longer qualify for FHA guarantees. The base case further assumes that the proportion of ARMs will remain at its current level in the

FHA portfolio and that current down payment requirements will remain unchanged.

Under this base case scenario and using DRI's trend economic forecast, we projected the MMI Fund will have positive cash flows in 8 of the 10 forecast years. These results are displayed in exhibit III. The projections show the cash position of the fund increasing from $6.2 billion at the end of fiscal year 1988 to $8.7 billion at the end of 1998. The base forecast shows a substantial reduction in cash during 1989--a reduction that is consistent with preliminary, unaudited results for fiscal year 1989. This position gradually improves during the 1990s, as no major economic changes are predicted to cause substantial losses due to defaults.

Raising FHA Loan Ceiling to
95-Percent of State Median House Price

In our analysis of alternative policies, we allow the ceiling to increase to 95 percent of each state's median house price. Setting the ceiling in this manner provides a higher ceiling thereby expanding FHA's business in very high price states, such as California and Connecticut (See exhibit V). FHA would be able to write substantially more guarantees in these states, although it still would be limited within certain metropolitan areas. By increasing FHA's volume of business, this change would increase FHA's premium income and cash position.

The increased ceiling would provide higher cash balances for the fund for two reasons. First, the fund would receive greater premium income because it would insure more mortgages. On the other hand, accompanying the higher premium income would be a greater volume of insurance in force, meaning that the fund may have higher future liabilities. Second, our analysis of the loans guaranteed by FHA showed that the default and loss rates would be slightly lower for higher valued loans. According to FHA's

experience over the last 10 years, larger loans tend to show slightly lower default rates and experience lower percentage losses when they default.

Using DRI's trend economic forecast, we found that end-of-year cash balances would grow from $6.2 billion in 1988 to $14.4 billion by 1998, an increase of $8.2 billion. While raising the loan ceiling would lead to a large growth in FHA business and cash balances, lower claim rates and losses would result, given the fairly stable economic conditions and sizeable increases in house prices projected under the DRI forecasts. (See exhibit III.)

However, several factors that might reduce the positive impact of this policy change on the fund are:

-- Analysis of FHA's data base indicates that higher value loans within present FHA limits have lower claim rates, partly because these loans have had higher down payments associated with them. However, as the ceiling amount of the loan would be raised in high cost areas, many new borrowers either might not desire or might not be able to make correspondingly higher down payments. Therefore, to the extent this happens, the potential risk associated with these loans would increase.

-- When higher value loans default, dollar losses might be higher than they are on lower value loans. Private mortgage insurers contend that claim rates rise with loan size. High-value mortgages would also result in higher dollar losses, should a default occur.

-- Raising the ceiling to 95 percent of the state median house price would increase maximum loan amounts in some markets with heavy mortgage activity well beyond the range we observed in estimating claim and loss rates from FHA's

current database. Such extrapolation lowers the precision of our results.

-- The FHA insurance portfolio may be subject to self-selectivity toward relatively riskier loans compared to those loans with high values that are insured by private mortgage insurers. For example, private mortgage insurers may underprice FHA, which charges a uniform price, for high value loans with larger down payments.

As part of our study, we obtained the sometimes conflicting views of officials knowledgeable about housing issues, representing government agencies, academia, and housing industry organizations. Examples of the comments received in support of raising the limit to a percentage of the median house price follow:

-- Raising the limit is the only way to deal with the housing affordability problem because it would increase homeownership opportunities while reducing claim rates and losses.

-- Raising the limit would increase FHA's volume and market share and improve the geographical distribution of FHA loans, better insulating it from sectional risks.

-- Raising the limit would have only a minimal impact on private mortgage insurers.

On the other hand, examples of comments from those opposed to the increase in the loan ceiling differ:

-- Losses on high-loan-to-value loans will be compounded for FHA because more loans will be concentrated in places like California and some eastern states.

-- As builders use the FHA ceiling as their benchmark, house prices will increase.

-- The market share of private insurers will be reduced substantially.

-- Linking FHA limits to area median house prices will (1) significantly increase FHA's market and risk exposure without benefitting moderate- or low-income households and (2) inevitably make FHA insurance more available to households in areas with higher real incomes than in areas with lower real incomes.

Revised Down Payment Requirements

FHA currently requires a down payment of 3 percent on the first $25,000 and 5 percent on the amount above $25,000 unless the appraised value of the home is less than $50,000, in which case the required down payment is 3 percent. We evaluated two possible changes in down payment requirements:

1) zero down payment loans and

2) 3 percent down for amounts below $50,000, 5 percent down for amounts between $50,000 and $101,250, and 10 percent down for amounts over $101,250.

Home purchasers are currently permitted to finance the FHA insurance premium without including this amount in the loan-to-value ratio (LTV). Therefore, the "zero down payment" label is somewhat misleading in that borrowers would be able to borrow more than the assessed value of the house.

In analyzing the zero down payment alternative, we assumed that a substantial percentage of borrowers currently making the

minimum down payment would select the zero down payment option. Based on this assumption and using DRI's trend economic forecast, we found the fund would experience a negative cash flow in 7 of the 10 forecast years. The fund balance would decline by $1.8 billion during the period while the amount of insurance in force is increasing. Relative to the base case, the cash balance at the end of the period would be $4.3 billion lower. (See exhibit III.)

These calculations do not take into account any additional business the FHA might attract because of the zero down payment. If this feature succeeded in attracting additional borrowers, the fund's cash position would be substantially worse. High LTV borrowers typically have much higher default levels than other borrowers and could be expected to diminish the fund's resources.

The alternative down payment requirement we considered incorporated a three-step formula:

Up to $50,000	--- 3 percent
$50 - 101,250	--- 5 percent
Over $101,250 (adjusted for annual house price appreciation)	--- 10 percent

For example, a $100,000 mortgage would require a minimum down payment equaling 4 percent--3 percent on the first $50,000 and 5 percent on the second $50,000. This formula was devised to reduce the down payment now required at the lowest price level, but increase the requirement for higher priced houses. If this alternative is adopted, under DRI's trend economic forecast, the fund balance would increase by $1.7 billion from the end of 1988 to 1998--a reduction of $0.9 billion in ending cash balance from the base case. (See exhibit III.)

ADJUSTABLE RATE MORTGAGES

The FHA currently insures ARMs having a 1 percent annual cap and a 5 percent lifetime cap. The ARM most frequently offered by private lenders has a 2 percent annual cap and a 6 percent lifetime cap. Under current policy FHA cannot insure the preferred instrument. Therefore, very little of its portfolio is in ARMs. The third policy change we considered in our analysis was to allow FHA to insure "two-six" ARMs but to limit them to 30 percent of the FHA portfolio.

Under DRI's trend economic forecast, adoption of this policy would have very little effect on the cash balances of the fund, increasing it by less than $200 million by the end of the forecast period. This occurs for two reasons. First, we have assumed that ARMs will not represent new business but simply transfers of fixed mortgages into ARMs. To the extent that ARMs represent new business, the fund will receive additional premium income--but experience corresponding growth in loan exposure. Second, the forecast of economic conditions includes no significant increases in interest rates. ARMs, unlike fixed rate mortgages, increase the risk of default during periods of rising interest rates and reduce risks during periods of declining rates. With forecasts of stable rates, losses associated with ARM business would not differ significantly from those of fixed rate loans.

Impact Under Less Optimistic Economic Forecasts

DRI's trend economic forecast reflect generally stable economic conditions and housing price appreciation rates that exceed the inflation rate--factors that are very favorable to the results of the fund. This forecast is generally consistent with that available from another major vendor of macroeconomic

forecasts--Wharton Econometric Forecasting Associates--whose forecasts we reviewed.

To test the sensitivity of our results to our economic forecast, we considered alternative economic scenarios. For two alternative economic scenarios, we assumed lower rates of house price appreciation while keeping DRI's other forecast values unchanged. We used a median housing price appreciation scenario in which house prices rise at 2 percent per year less than the DRI forecast. This produces price increases in the range of 5 to 6 percent annually which are consistent with short-term forecasts produced by the National Association of Realtors. We also constructed a low housing price appreciation scenario in which house prices rise at 5 percent per year less than forecast by DRI. At this level, the housing price appreciation rate would be less than the overall rate of inflation. A widely publicized academic study has suggested that long-term housing price increases may be at a level below the inflation rate.

We also considered a third scenario that assumed that the country would experience a repeat of the economic conditions of the 1980s. During the 1980s, interest rates rose to 15 percent; unemployment levels reached 10 percent; and house price appreciation, up until 1986, stayed below 3 percent.

Under the base policy case (loan ceiling increases with housing prices, ARMs and down payment requirements remain unchanged), the fund would fare substantially worse than under DRI's trend economic forecast. Under the low housing price appreciation scenario, the fund would become insolvent in 1996. Under the other two alternative economic scenarios, the fund balance would shrink to less than $4 billion despite the increased exposure of a greater volume of insured mortgages. Medium house price appreciation would result in a $4.9 billion reduction in 1998 cash balance relative to the trend economics case; the 1980s

economic conditions scenario would result in a $5.0 billion reduction relative to that same base.

The effects of the alternative policy options under the alternative economic scenarios are sometimes different than their effects under the trend economic forecast. As shown in exhibit III, under the 1980's economic conditions scenario, increasing the loan ceiling would produce only a small increase in the cash balance of the fund--despite the higher future liabilities associated with the increased loan ceiling. In contrast, that same policy change had a large favorable effect on the fund's balance under DRI's trend economic condition relative to maintaining market share. On the other hand, revising the down payment requirement would lower the fund balance relative to the base case under both the trend and 1980s economic conditions. Similarly, the increased use of ARMs shows results nearly equal to the base case under both trend and 1980s economic conditions.

ROLE OF FHA

From the time of the Great Depression through the 1960s, FHA was the Nation's primary insurer of mortgage credit for the purchase of single-family homes. With the subsequent growth of the private mortgage insurance industry, policymakers began to ask what role FHA's programs should play in the housing market and how its responsibilities should differ from those of private mortgage insurers (PMIs).

In response to conditions in the housing market and the economy in general, major changes in FHA's single family insurance program since the 1960s included

-- removing FHA's ceiling interest rate,

-- increasing the maximum mortgage amount,

-- encouraging the direct endorsement of FHA-insured loans by private lenders,

-- collecting the full premium payment at loan closing and allowing the premium to be added to the mortgage amount and financed over the life of the mortgage,

-- liberalizing underwriting standards to enable more people to participate in FHA's program,

-- liberalizing loan to value ratios, and

-- allowing the use of adjustable rate mortgage.

The extent to which FHA duplicates private sector activity was considered by the 1982 President's Commission on Housing. The Commission recommended that "FHA should increasingly complement, rather than compete with, the private market." In the Commission's view, FHA should maintain its "historic role in assisting low- and moderate-income families to achieve homeownership," while allowing the private insurance companies to take all home loans that they "... can and will insure."

As you know, the current proposals to change the loan ceiling amount, lower down payments, and promote adjustable rate mortgages would once again change the role of FHA. As part of our work we solicited views on the impact of such changes from knowledgeable representatives of government agencies, academia, and industry organizations. Examples of the favorable views expressed to us follow:

-- FHA's basic role is the same now as before--to provide homeownership opportunities for low- and moderate-income families. With higher home prices, it has become more

essential now to help first time, lower income families. But, providing this help should be done without a government subsidy and, therefore, FHA must expand its business to raise its revenues.

-- There is little evidence that PMIs will provide insurance to those families who can afford a down payment of only 5 percent or less to purchase a home. Therefore, there is a continuing need for FHA to assist these families and, to do so, FHA must be able to maintain its participation in healthier markets. Without the positive effects of cross subsidization, FHA would be unable to provide assistance to riskier households.

On the other hand, we also heard from those with serious misgivings about proposed changes. For example, we were told that

-- Raising the loan limit to 95 percent of the area median house price would significantly increase FHA's market and risk exposure without proportionate benefits to moderate- or low-income households.

-- It is time for FHA to re-focus on its mission of serving people most in need. The best way to do this is to target FHA's assistance based on income because income is directly related to the house one can afford.

Although the answers to policy questions on FHA's future role are not easy, we believe that there are bases for formulating policies that take into account the potential impacts on the financial viability of the MMI Fund.

FHA'S MANAGEMENT PROBLEMS

A number of financial management problems exist that HUD and FHA top management need to address if future losses are to be kept under control no matter what changes are made to the ceiling limits, down payment requirements, or adjustable rate mortgages. GAO and HUD's Inspector General have been reporting on these management problems since the early 1980s. Among these problems are the need for (1) effective monitoring, (2) improved internal controls, (3) follow-up of audit findings, and (4) a HUD Chief Financial Officer and FHA Controller.

Effective Monitoring Needed

In terms of its direct effect on FHA's financial condition, the most critical weakness was in HUD's monitoring of functions involving large amounts of money delegated to other parties.

We noted deficiencies in the following broad categories of functions delegated to other parties:

-- HUD's delegation of authority to certain lenders to underwrite FHA mortgage insurance, particularly single family mortgage insurance.

-- HUD's delegation of authority to Area Management Brokers to maintain, manage, and sell properties that FHA obtained in foreclosure.

-- HUD's delegation of authority to private closing agents to handle the collection of property sale proceeds, including their deposit in HUD's account at the U.S. Treasury.

Oversight of the private underwriters suffered from inadequate coordination among the various parts of HUD that have information

important to the oversight functions. Also, up-to-date default information to identify the causes of excessive insurance losses is insufficient.

Oversight of Area Management Brokers and private closing agents suffered, at least partially, from insufficient experienced staff to handle the large number of foreclosed properties that came to HUD in economically stressed regions. For example, because of poor oversight, one broker was allowed to manage over 1,000 properties, well in excess of the HUD-mandated limit of 100. Allowing brokers to manage excessive numbers of properties exposes FHA to excessive losses should one or more of the large brokers decide not to follow HUD rules.

Internal Controls Need Improvement

HUD's internal controls over cash management and claims processing are weak and require improvement. HUD has not done enough, through the use of its own systems, to ensure that proceeds collected by other parties are promptly deposited in FHA's Treasury account, and that claims for insurance benefits are being paid timely and only after proper review and examination.

HUD has followed the policy of accepting sales packages and of recording sales before sales proceeds are actually deposited in its Treasury account. Follow-up of case-by-case situations where sales have been processed but where no cash has been received has been inconsistent across regions. Indeed, reports of sales for which proceeds have not yet been located exist for over 8,000 cases, some dating back to 1983. One region, in particular, was so deficient in this regard that a private closing agent ("Robin HUD") has admitted to embezzling a sizable amount of sale proceeds without prompt detection.

More Diligent Follow-Up of Audit Findings Needed

HUD has not been diligent in correcting problems cited by auditors or in its own Federal Managers' Financial Integrity Act (FMFIA) reports. While HUD staff responsible for FHA activities have generally responded to recommendations by GAO and the Inspector General and the weaknesses disclosed in the FMFIA reports, resolution of some findings has often been delayed and others have not been addressed at all. In addition, in some cases, HUD has not followed-up to determine if implemented procedures in fact cured the cited problems.

For example, HUD's 1987 FMFIA report disclosed that inadequate controls existed which provided the potential for private closing agents to manipulate or otherwise take funds for their own use or to delay the transfer of such funds to HUD. However, this same weakness was noted during the 1988 audit. Inadequate follow-up and implementation unnecessarily exposes FHA to the risk of waste, loss, unauthorized use, or misappropriation of government funds, property, and other assets.

HUD Chief Financial Officer and FHA Controller Needed

As mentioned earlier, we believe that a Chief Financial Officer should be established within HUD and a corresponding controller within FHA.[1] A Chief Financial Officer would devote continuous attention to carrying out the financial management functions. This organizational change would provide a focal point with organizational oversight and accountability for all financial management activities, including development of modern financial

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[1]GAO/T-AFMD-89-17, Sept. 27, 1989 and GAO/RCED-84-9, January 10, 1984.

management information systems. Among the responsibilities of this individual could be the following:

-- Establishing, coordinating, and maintaining an integrated plan for the control of accounting and financial operations.

-- Reporting and interpreting the results of financial operations for all levels of management.

-- Reporting financial data on HUD operations to government agencies, such as Treasury and OMB.

-- Protecting the assets of the agency.

-- Defining data processing goals, setting priorities to achieve these goals, and measuring results through systemic comparative analyses.

The FHA Controller would share the same responsibilities as the HUD Chief Financial Officer, but within FHA.

CURRENT FHA INITIATIVES

The new management at HUD under Secretary Kemp has started to address various problems to strengthen FHA's financial position, such as

-- stepping up monitoring and enforcement activities,

-- redirecting FHA's accounting and computer systems,

-- performing an independent actuarial analysis of the MMI and GI Funds,

-- publishing annual audited financial statements,

-- complying with recommendations resulting from HUD's financial audit,

-- reviewing the steps necessary to ensure full compliance with the Federal Managers' Financial Integrity Act, and

-- reviewing lender requirements to ensure that only responsible and soundly capitalized firms participate in FHA programs.

I have met with the Assistant Secretary for Housing and her management team and discussed our concerns about HUD's financial management problems. She stated her strong desire to improve HUD's financial management problems, and we look forward to working with her.

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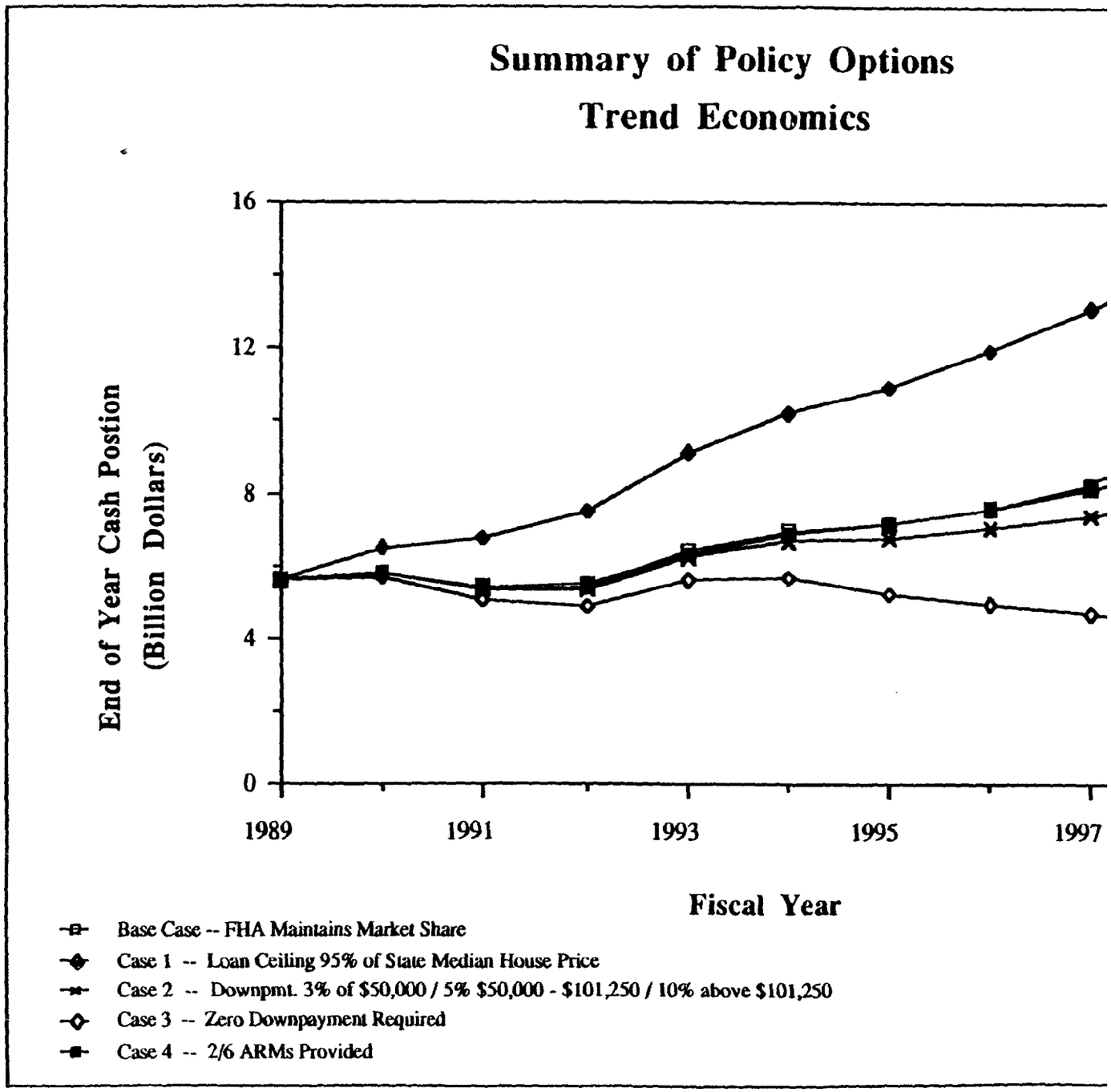
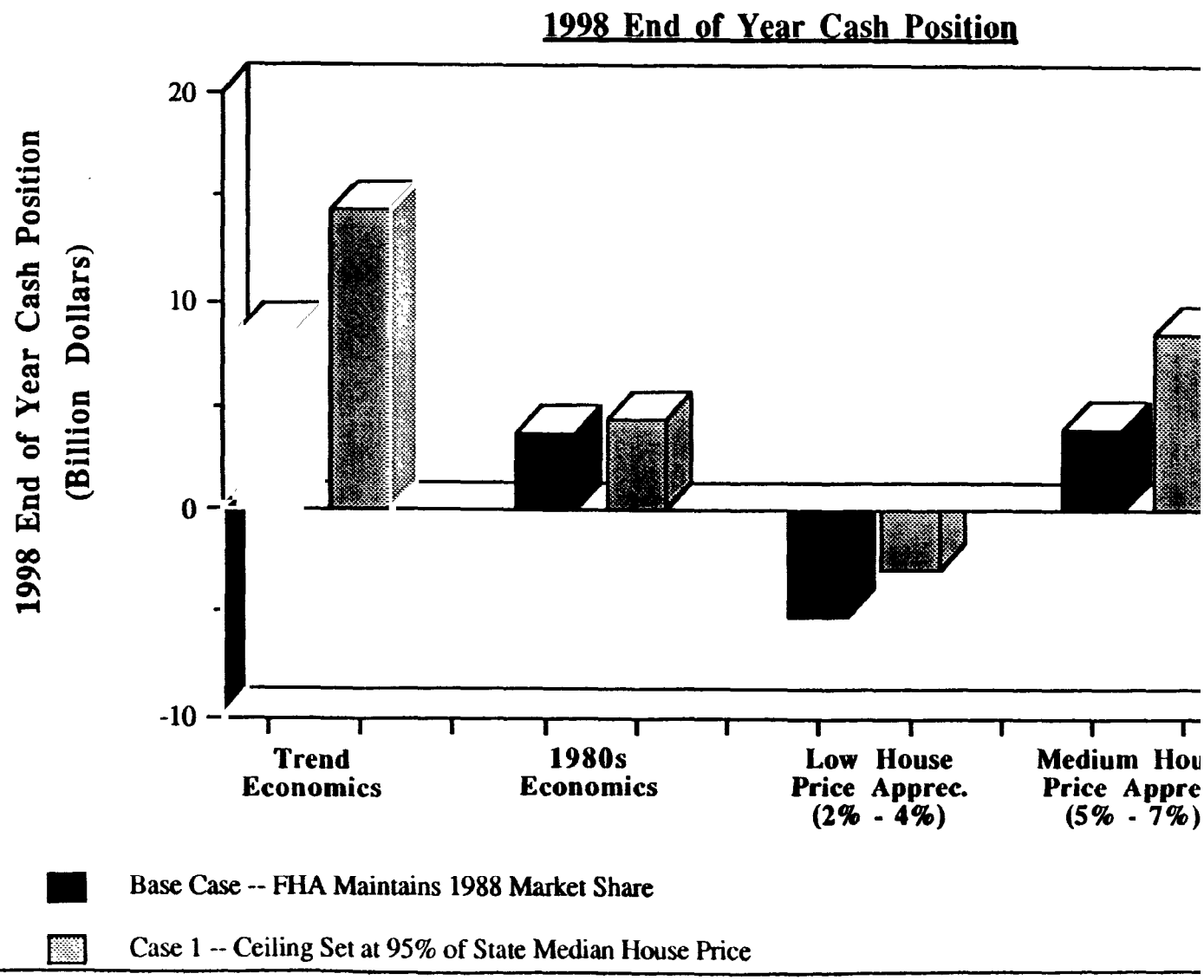
This concludes my statement, Mr. Chairman. We will be pleased to respond to any questions you or members of the Subcommittee may have.


Summary of Policy Options
Trend Economics
End of Year Cash Postion
(Billion Dollars)
16
12
8
4
0
1989
1991
1993
1995
1997
Fiscal Year
Base Case -- FHA Maintains Market Share
Case 1 -- Loan Ceiling 95% of State Median House Price
Case 2 -- Downpmt. 3% of $50,000 / 5% $50,000 - $101,250 / 10% above $101,250
Case 3 -- Zero Downpayment Required
Case 4 -- 2/6 ARMs Provided

FHA Maintains 1988 Market Share

vs.

Loan Ceiling -- 95% of State Median House Pric



Summary of Policy Options by Economic Scenario

End of Fiscal Year Cash Balance ($000)

Policy Scenario	1989	1990	1991	1992	1993	1994	1995	199
Trend Economics								
FHA Maintains 1988 Market Share	$5,584,592	$5,795,112	$5,354,496	$5,448,670	$6,431,447	$6,955,044	$7,172,214	$7,55
Loan Ceiling--95% of State Median House Price	$5,606,852	$6,520,177	$6,776,695	$7,483,073	$9,134,690	$10,234,637	$10,955,958	$11,90
Dnpmt 3% of $50K/5% $50K - $101K/ 10% above $101K	$5,584,216	$5,784,448	$5,302,185	$5,336,649	$6,258,493	$6,689,252	$6,781,472	$7,02
2/6 ARMs Provided	$5,584,447	$5,801,395	$5,393,706	$5,483,471	$6,372,715	$6,880,087	$7,164,054	$7,61
Zero Downpayment Required	$5,582,681	$5,741,880	$5,096,768	$4,900,316	$5,587,019	$5,658,420	$5,265,588	$4,94
1980s Economics								
FHA Maintains 1988 Market Share	$5,584,861	$5,550,591	$6,051,703	$7,062,571	$8,085,521	$8,494,501	$7,245,393	$7,16
Loan Ceiling--95% of State Median House Price	$5,607,122	$6,148,291	$7,071,424	$8,409,593	$9,679,770	$10,255,589	$8,713,384	$8,70
Dnpmt 3% of $50K/5% $50K - $101K/ 10% above $101K	$5,584,486	$5,539,786	$6,014,690	$6,995,958	$7,989,482	$8,339,440	$6,964,162	$6,77
2/6 ARMs Provided	$5,587,719	$5,556,163	$6,002,758	$6,792,936	$7,468,419	$7,343,650	$6,113,980	$6,06
Medium House Price Appreciation								
FHA Maintains 1988 Market Share	$5,584,591	$5,775,378	$5,133,482	$4,782,966	$5,316,764	$5,265,301	$4,763,586	$4,36
Loan Ceiling--95% of State Median House Price	$5,606,852	$6,487,417	$6,517,797	$6,727,163	$7,850,219	$8,264,815	$8,118,732	$8,10
Low House Price Appreciation								
FHA Maintains 1988 Market Share	$5,584,591	$5,744,482	$4,701,697	$3,670,574	$3,474,759	$2,370,860	$450,660	($1,51
Loan Ceiling--95% of State Median House Price	$5,606,852	$6,436,989	$6,028,357	$5,484,653	$5,763,193	$4,949,685	$3,130,642	$1,17

Note: End of Fiscal Year 1988 cash balance was approximately $6.2 billion.

Summary of Economic Variables

Economic Variables	1989	1990	1991	1992	1993	1994	1995	1
Trend Economics								
Mortgage Interest Rate	9.88	9.44	9.66	10.26	10.02	9.74	9.66	9
Median House Price	$97	$104	$112	$121	$130	$141	$153	$1
Unemployment Rate	5.23	5.50	5.40	5.22	5.39	5.37	5.28	5
Ave. Nominal Loan Value	$74	$80	$85	$91	$99	$107	$117	$1
1980s Economics								
Mortgage Interest Rate	9.88	10.92	12.95	15.12	15.38	12.85	12.49	11
Median House Price	$97	$107	$117	$125	$128	$134	$139	$1
Unemployment Rate	5.23	5.83	7.16	7.78	9.87	9.33	7.41	7
Ave. Nominal Loan Value	$74	$81	$89	$95	$97	$102	$106	$1
Medium House Price Appreciation								
Mortgage Interest Rate	9.88	9.44	9.66	10.26	10.02	9.74	9.66	9
Median House Price	$97	$103	$107	$113	$120	$128	$137	$1
Unemployment Rate	5.23	5.50	5.40	5.22	5.39	5.37	5.28	5
Ave. Nominal Loan Value	$74	$78	$82	$86	$92	$98	$104	$1
Low House Price Appreciation								
Mortgage Interest Rate	9.88	9.44	9.66	10.26	10.02	9.74	9.66	9
Median House Price	$97	$100	$101	$104	$107	$111	$115	$1
Unemployment Rate	5.23	5.50	5.40	5.22	5.39	5.37	5.28	5
Ave. Nominal Loan Value	$74	$76	$77	$79	$82	$84	$88	$

Note: Rates are expressed in percents. Prices and values are expressed in $000.

EXHIBIT V

1988 State Median Home Prices

(in $000)

Alabama	101.14	Montana	72.84
Alaska	81.88	North Carolina	84.67
Arizona	72.89	North Dakota	67.18
Arkansas	99.26	Nebraska	61.15
California	168.14	New Hampshire	124.87
Colorado	85.18	New Jersey	155.55
Connecticut	164.84	New Mexico	72.02
District of Columbia	132.35	Nevada	110.50
Delaware	79.82	New York	146.52
Florida	80.79	Ohio	66.42
Georgia	92.97	Oklahoma	68.53
Hawaii	163.70	Oregon	70.17
Iowa	60.83	Pennsylvania	74.86
Idaho	81.23	Rhode Island	124.07
Illinois	86.07	South Carolina	82.62
Indiana	54.15	South Dakota	72.90
Kansas	71.13	Tennessee	76.68
Kentucky	56.05	Texas	78.87
Louisiana	79.24	Utah	76.64
Massachusetts	155.50	Virginia	120.87
Maryland	102.66	Vermont	83.92
Maine	95.02	Washington	100.27
Michigan	78.64	Wisconsin	66.53
Minnesota	90.58	West Virginia	83.96
Missouri	72.05	Wyoming	81.90
Mississippi	71.59		