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Impact of FHA Loan Policy Changes on Its Cash Position

Statement of
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Before the
Subcommittee on Housing and Urban Affairs
Committee on Banking, Housing, and Urban Affairs
United States Senate

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear here today to discuss the results of our analyses of the impact of three proposed policy changes on the cash position of the Federal Housing Administration's (FHA) Mutual Mortgage Insurance (MMI) Fund. This discussion will serve to update the interim results and data that we presented in November 1989 before the Subcommittee on Housing and Community Development, House Committee on Banking, Finance and Urban Affairs.[1] Our work, which was performed at the request of Congressman Gerald Kleczka, focused on the impact, over the next 10 years, on the Fund's cash balance from (1) increasing the FHA mortgage ceiling limits, (2) reducing downpayment requirements, and (3) allowing FHA to insure adjustable rate mortgages (ARM) with higher interest rate caps. 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.

Before presenting the results of our work, however, I would like to stress that our analysis focused on the cash position of the Fund and is therefore not an assessment of the actuarial soundness of the Fund. The difference is that a cash analysis focuses on the revenue and expenses of the Fund on an annual basis rather than on the Fund's ability to support potential losses over the entire life of the insured mortgages.

An actuarial analysis, on the other hand, would focus on whether the Fund has enough reserves to cover future losses from insurance currently in force and new insurance written. The important distinction here is that the cash balance alone cannot indicate the Fund's actuarial soundness. The volume of loans insured and anticipated future losses must also be considered to determine if policy changes (such as raising the mortgage ceiling) that result in higher cash balances, but higher potential

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[1]"Impact of FHA Loan Policy Changes" (GAO/T-RCED-90-17, Nov. 16, 1989).

liability, are preferable from an actuarial standpoint. In this regard, the President's fiscal year 1991 budget states that the Fund is not actuarially sound and changes, such as increasing the FHA premium, will be needed. FHA has contracted for an independent actuarial study to determine what reforms are needed to make the Fund actuarially sound.

Having said all that, let's take a look at what our model shows are the possible impacts of each policy alternative on the Fund's cash position.

SUMMARY

The overall cash position of the MMI Fund during the 1990s and the effect of the various policy options will depend heavily on actual economic conditions during the next decade. If house prices appreciate at a rate of 5 to 9 percent per year, and overall economic conditions remain generally favorable, the Fund's cash balance will likely be adequate to cover anticipated losses during the next 10 years. However, the Fund will not perform nearly as well if the recent trend of lower rates of house appreciation continues through the 1990s. For example, if the rate of house price appreciation is less than 4 percent, the Fund will likely not be able to survive without U.S. Treasury assistance even if overall economic conditions remain generally favorable. Of the proposals we analyzed, increasing the mortgage ceiling would have the greatest effect on the Fund's cash balance.

Besides the overall cash position of the Fund and the effect of the various policy options, of equal importance is the question of the Fund's actuarial soundness. Increasing the mortgage ceiling will have a positive effect on cash balances; however, it will also increase the government's financial risk in the form of additional insurance-in-force. This raises serious concerns, particularly if the Fund is not actuarially sound.

We analyzed the cash position of the Fund under four different economic scenarios. In three scenarios, we assumed economic conditions were generally favorable, while applying various rates of annual house price appreciation to each scenario--7 to 9 percent, 5 to 7 percent, and 2 to 4 percent. In the fourth scenario, economic conditions in the 1990s were assumed to approximate those experienced in the 1980s.

Assuming generally favorable economic conditions, that house prices increase at about 7 to 9 percent annually, and that the mortgage ceiling is allowed to increase with the annual increase in house prices - assumptions which constitute our base case - the Fund's cash balance will grow from $6.2 billion at the beginning of 1989 to an estimated $8.8 billion in 1998 (see exhibit I). At the same time, however, the Fund's insurance-in-force will more than double from $271 billion in 1989 to $685 billion by the end of 1998. If our other base case assumptions remain unchanged but house prices are assumed to increase at rates of 5 to 7 percent per year, as some experts are now predicting, the Fund's cash balance will remain positive but will decline to an estimated $3.9 billion by the end of 1998.

If economic conditions instead approximate those experienced during the 1980s (which included a period early in the decade of high interest rates and high unemployment rates) and the mortgage ceiling is still allowed to increase with the annual rate of house price appreciation, the Fund's cash balance will also remain positive but will decline to an estimated $3.8 billion by the end of 1998.

Under economic scenarios having generally favorable economic conditions but lower house price appreciation rates, the Fund would likely insure fewer loans and lower loan amounts. It would thus receive less income from premiums. As a result, its cash balance would decline--in some cases becoming negative by the end of fiscal

year 1998. For example, at an annual 2-4 percent house price appreciation rate, the Fund will be unable to maintain a positive cash balance without Treasury assistance if no policy change is made or if any of the proposals we reviewed are adopted, even if economic conditions remain generally favorable.

If the Congress decides not to raise FHA's mortgage ceiling above the $101,250 loan limit, the Fund's cash balance would fall to an estimated $3 billion in 1998 even under favorable economic conditions. This would occur because FHA's share of the mortgage market, under a constant loan limit, decreases as house prices appreciate above the FHA maximum limit. The decreased market share, in turn, would add less premium income to the Fund to cover future potential claims. Without increases in the maximum allowable loan limit, both the Fund's cash balance and home purchase options for homebuyers will decrease.

Of the three proposals GAO analyzed, increasing the mortgage ceiling to 95 percent of a state's median house price would have the greatest effect on the Fund's balance and would also assist in generating the most new business when compared with GAO's estimated base case. The reduced downpayment and ARM proposal are estimated to have a relatively small effect on the Fund's cash position.

Under generally favorable economic conditions and annual house price appreciation rates of 7 to 9 percent, the 95-percent mortgage ceiling proposal, we estimated, will result in a cash balance of $14.4 billion. This would be an increase in the Fund's cash balance of $8.2 billion by the end of 1998, and is $5.7 billion higher than the balance we estimated if the mortgage ceiling rises only at the annual rate of house price appreciation. Because of the substantial increase in the FHA mortgage ceiling, however, the amount of insurance-in-force will more than triple to $886 billion by 1998. Under the other economic scenarios, the

effects of raising the mortgage ceiling to 95-percent of a state's median house price are generally similar.

What does this tell us? It tells us that while increases in the FHA's mortgage ceiling to account for house price increases are necessary to prevent the deterioration of the Fund's balance and to allow FHA to maintain its current share of the housing market, there is a need to proceed with caution on how high to raise the mortgage ceiling. If the Fund is not actuarially sound, we believe the Congress should not raise the mortgage ceiling to the 95 percent level because this action may subject the federal government to enormous costs over the life of the new insurance that will be created. We believe that a decision to raise the mortgage ceiling, under these conditions, should be made in conjunction with a decision on how to resolve the problem of actuarial soundness so that the potential financial risks assumed by the federal government in the long run are adequately considered. If, on the other hand, the Fund is actuarially sound, we believe the Congress should consider raising the mortgage ceiling to 95 percent of a state's median house price because doing so will have a positive effect on the Fund's cash position and will allow homebuyers in high priced states to participate more actively in the FHA program.

In the statement which follows, I provide a more detailed discussion of our assumptions, methodology, and results. In addition, I will comment briefly on the role of FHA in the national mortgage market and summarize the comments we received from academia, government, and housing industry representatives on FHA's role. We expect to issue a report containing a more complete discussion of the policy changes' financial impacts and related FHA management issues during the summer.

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. Our work dealt only with the MMI Fund, which basically insures single-family homes.

GAO'S ANALYSIS OF MMI FUND POSITION

The MMI Fund is FHA's largest fund with $271 billion of insurance-in-force as of September 30, 1989. As a result of a full financial audit, we determined that the MMI Fund had a loss 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 homebuyer 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 foreclosed loans that 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 in 1986 and 1987 are entering the period in which historical evidence suggests that high claim rates could occur. Thus, foreclosures may remain 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 ($44.9 and $82.6 billion, respectively), foreclosures 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 OPTIONS

Our analysis focused on the cash position of the Fund at the end of each fiscal year, during the period 1989 to 1998. It shows that the cash position of the Fund is influenced by FHA loan insurance 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.

-- Claim rates are lower for higher valued mortgages (within the 1989 FHA loan limit of $101,250).

-- 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 for several policy options. These included the following: a base case in which the mortgage ceiling is raised in accordance with house price increases to enable FHA to maintain its market share; a more substantial increase in the mortgage ceiling; a reduction in downpayment requirements; and allowing FHA to guarantee ARMs with higher caps on the annual and lifetime interest rate increases.

To make these projections, we used forecasted values of economic variables developed by Data Resources, Incorporated (DRI)

in the fall of 1989. 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 9.4 to 10.3 percent; the unemployment rate does not exceed 5.5 percent; and housing prices, except for fiscal year 1989 which showed an annual increase of about 4 percent, increase at 7 to 9 percent annually over the 1989-1998 period.[2] The forecast values that were used are shown in exhibit III.

Base Case Analysis

In our base case analysis, we used the 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 properties increasing in price so that they can no longer qualify for FHA insurance. The base case further assumes that the proportion of ARMs will remain at its current level in the FHA portfolio and that current downpayment requirements will remain unchanged. Under authority granted by Congress, HUD raised the maximum loan limit to $124,875 for the period January 12, 1990, to September 30, 1990. Barring further congressional action, the loan limit will revert to $101,250 at the end of that period. Because of the higher loan limit's introduction late in the our review period and its possible short duration, we have used the $101,250 limit in our base case calculations throughout this statement.

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[2] DRI's most recent projections show housing prices for the 1989-98 period increasing at about 6 percent annually. According to the National Association of Realtors, median house prices rose 7.4 percent annually over the 21-year period from 1968-88, although they rose by only 4.6 percent per year from 1979-88.

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 I. The projections show the cash position of the Fund increasing by the end of 1998 to an estimated $8.8 billion. Under these economic conditions, the volume of insurance-in-force for FHA is estimated to increase from $271 billion in fiscal year 1989 to $685 billion in fiscal year 1998. Thus, the Fund in 1998 will have greater potential exposure to loss.

This base case scenario can be compared to an analysis of the Fund's projected cash balance if the Congress decides not to raise FHA's mortgage ceiling above the $101,250 loan limit. This projection showed that if the ceiling remained at $101,250, the Fund's cash balance would, based on our projections, fall to $3 billion by 1998. This projection again uses DRI's trend economic forecast. This decrease would occur because a constant mortgage ceiling would over time reduce the volume of newly-insured FHA loans in housing markets where home prices are increasing. This would cause a drop in premium revenues while claims continue to be paid. As a result, the Fund's cash balance would begin to decline by 1995.

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

In our analysis of the effect of increasing the mortgage ceiling, we allow the ceiling to increase in the first year to 95 percent of each state's median house price and thereafter increase each year at the same rate at which house prices appreciate. Setting a higher ceiling in this manner expands FHA's business in very high price states, such as California and Connecticut (see exhibit IV). FHA would be able to write substantially more insurance 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 would have higher future liabilities. Second, our analysis of the loans insured by FHA showed that the foreclosure 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 foreclosure rates and experience lower percentage losses when they are foreclosed.

Using DRI's trend economic forecast, we projected 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. This compares with a projected 1998 cash balance of $8.8 billion in our base case, indicating that with this policy change the 1998 cash balance would be expected to be $5.7 billion higher than in the base case.[3] At the same time, the amount of insurance-in-force would reach $886 billion by fiscal year 1998 under this proposal. 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 generally favorable economic conditions and sizeable increases in house prices projected under the DRI trend forecast. (See exhibit I.)

However, several factors that might reduce the positive impact of this policy change on the Fund include the following:

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[3]The numbers presented here do not necessarily add due to rounding. (See exhibit I).

-- 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 downpayments 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 downpayments. Therefore, to the extent this happens, the potential risk associated with these loans would increase.

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

As part of our study, we obtained the sometimes conflicting views of officials knowledgeable about housing issues, representing government agencies, academia, and mortgage 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 and risks will be more geographically 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 Downpayment Requirement

FHA currently requires a downpayment 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 $50,000 or less, in which case the required downpayment is 3 percent. We evaluated the proposal that FHA reduce its downpayment requirements by requiring 3 percent down for amounts at or below $50,000 and 5 percent down for amounts over $50,000.

For example, under this proposal, a $100,000 mortgage would require a minimum downpayment equaling 4 percent--3 percent on the first $50,000 and 5 percent on the second $50,000. If this alternative is adopted and the mortgage ceiling is still increased annually according to the annual increase in house prices, 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 the 1998 cash balance from the base case. (See exhibit I.)

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 compared with the base case 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 foreclosure 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 substantially from those of fixed-rate loans.

IMPACT UNDER LESS OPTIMISTIC ECONOMIC FORECASTS

DRI's trend economic forecast reflects generally favorable economic conditions and housing price appreciation rates that exceed the inflation rate--factors that are very favorable to the cash position of the Fund.

To test the sensitivity of our results to DRI's 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 medium housing price appreciation scenario in which house prices rise at 2 percent per year less than DRI's fall 1989 forecast. This produces price increases in the range of 5 to 7 percent annually, which are consistent with short-term forecasts produced by the National Association of Realtors and DRI's more recent 10-year forecast. We also constructed a low housing price appreciation scenario in which house prices rise at 5 percent per year less than forecast by DRI last fall. 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 early 1980s, interest rates rose to 15 percent and unemployment levels reached 10 percent. House price appreciation stayed below 3 percent per year until 1986.

Under the base policy case (loan ceiling increases along with housing prices, while ARMs and downpayment requirements remain unchanged), the Fund would fare substantially worse with alternative economic scenarios than under DRI's trend economic

forecast. Under the low housing price appreciation scenario, the Fund's cash balance would be depleted by 1996. Under the other two alternative economic scenarios, the Fund balance would shrink to less than $4 billion. Medium house price appreciation would result in a $4.9 billion reduction in the 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 generally similar to their effects under the trend economic forecast. As shown in exhibit I, under the 1980s economic conditions scenario, increasing the loan ceiling would produce a larger 1998 cash balance than would be obtained under the base case with these economic conditions, although the difference is fairly small. At house price appreciation rates ranging from 2 to 4 percent a year, the Fund would have an estimated $2.9 billion deficit by 1998 compared to an estimated $5.0 billion deficit for the base case. That same policy change, in contrast, would increase the Fund's projected balance to $14.4 billion under DRI's trend economic condition, compared to a projected $8.8 billion for the base case.

Under all economic scenarios, revising the downpayment requirement would lower the Fund's balance relative to the base case, while the increased use of ARMs shows results nearly equal to the base case for all economic conditions.

VIEWS ON WHAT FHA'S ROLE IN THE HOUSING MARKET SHOULD BE

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, policy makers 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 1970s 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 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 mortgages.

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 part of our work, we solicited views on the impact of the proposed changes from knowledgeable representatives of government agencies, academia, and industry organizations. Examples of the favorable views expressed to us follow:

-- FHA should perform the same fundamental role in the 1990s that it has performed throughout its history--to provide homeownership opportunities for low- and moderate-income families. With higher home prices, it will be essential to help first-time, lower income families. But, providing this help should be done without a government subsidy.

-- There is little evidence that PMIs will provide insurance to those families who can afford a downpayment of only 5 percent or less to purchase a home. Therefore, the need continues for FHA to assist these families. 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 the 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 refocus 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 the bases exist for formulating policies that take into account the potential impacts on the financial viability of the MMI Fund.

FHA'S MANAGEMENT PROBLEMS

In November 1989 we testified that 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, downpayment 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 were the need for (1) more effective monitoring of existing underwriting standards and procedures, (2) improved internal controls, (3) more diligent follow-up of audit findings, and (4) a HUD Chief Financial Officer and FHA Controller.

The new management at HUD under Secretary Kemp has taken specific steps to address and to strengthen FHA's financial position. These include

-- establishing a Chief Financial Officer for HUD and a controller within FHA,

-- stepping up monitoring and enforcement activities,

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

-- publishing annual audited financial statements,

-- improving the efficiency and effectiveness of HUD audit resolution and follow-up process,

-- establishing a task force 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.

We are currently reviewing HUD's progress in implementing these management initiatives and plan to issue a report later this year.

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In conclusion, Mr. Chairman, if overall economic conditions remain generally favorable and house prices appreciate at a rate of 5 to 9 percent annually, the Fund's cash balance will remain positive under our base case and will be higher if the mortgage ceiling is raised. However, the additional insurance-in-force that this policy change will generate may expose the federal government to potentially greater financial risks. If the Fund is not actuarially sound, these risks may subject the federal government to enormous costs over the life of the new insurance that will be created, unless the problem of actuarial soundness is addressed.

Lower house price appreciation rates like those we are experiencing today will have a negative impact on the Fund if they continue. For example, if during the 1990s the annual rate is less than 4 percent, the Fund will likely not be able to survive without U.S. Treasury assistance even if economic conditions remain generally favorable.

On the basis of our analysis, we believe that while increases in the FHA's mortgage ceiling to account for house price increases are necessary to prevent the deterioration of the Fund's balance

and to allow FHA to maintain its current share of the housing market, there is a need to proceed with caution on how high to raise the mortgage ceiling. If the Fund is not actuarially sound, we believe the Congress should not raise the mortgage ceiling to the 95 percent level because this action may subject the federal government to enormous costs over the life of the new insurance that will be created. We believe that a decision to raise the mortgage ceiling, under these conditions, should be made in conjunction with a decision on how to resolve the problem of actuarial soundness so that the potential financial risks assumed by the federal government in the long run are adequately considered. If, on the other hand, the Fund is actuarially sound, we believe the Congress should consider raising the mortgage ceiling to 95 percent of a state's median house price because doing so will have a positive effect on the Fund's cash position and will allow homebuyers in high priced states to participate more actively in the FHA program. These issues will be addressed further in our upcoming report.

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 by Economic Scenario

End of Fiscal Year Cash Balance ($Million)

Policy Scenario	1989	1990	1991	1992	1993	1994	1995	1996	1
Trend Economics									
FHA Maintains 1988 Market Share	$5,586	$5,800	$5,361	$5,457	$6,443	$6,970	$7,192	$7,585	$
FHA Increases Loan Ceiling	$5,608	$6,525	$6,784	$7,493	$9,149	$10,254	$10,983	$11,940	$1
FHA Reduces Downpayment Requirement	$5,586	$5,789	$5,309	$5,345	$6,269	$6,704	$6,800	$7,048	$
FHA Provides 2/6 ARMs	$5,589	$5,806	$5,401	$5,492	$6,384	$6,895	$7,184	$7,645	$
1980s Economics									
FHA Maintains 1988 Market Share	$5,586	$5,555	$6,058	$7,070	$8,095	$8,506	$7,258	$7,181	$
FHA Increases Loan Ceiling	$5,609	$6,152	$7,078	$8,418	$9,690	$10,269	$8,729	$8,727	$
FHA Reduces Downpayment Requirement	$5,586	$5,544	$6,021	$7,003	$7,999	$8,351	$6,977	$6,786	$
FHA Provides 2/6 ARMs	$5,589	$5,560	$6,009	$6,800	$7,477	$7,355	$6,126	$6,079	$
Medium House Price Appreciation									
FHA Maintains 1988 Market Share	$5,586	$5,779	$5,139	$4,789	$5,324	$5,275	$4,775	$4,382	$
FHA Increases Loan Ceiling	$5,608	$6,491	$6,523	$6,734	$7,859	$8,277	$8,134	$8,123	$
FHA Reduces Downpayment Requirement	$5,586	$5,769	$5,085	$4,671	$5,140	$4,990	$4,356	$3,807	$
FHA Provides 2/6 ARMs	$5,589	$5,785	$5,179	$4,824	$5,253	$5,177	$4,740	$4,416	$
Low House Price Appreciation									
FHA Maintains 1988 Market Share	$5,586	$5,748	$4,705	$3,674	$3,479	$2,376	$456	($1,510)	($
FHA Increases Loan Ceiling	$5,608	$6,440	$6,032	$5,489	$5,768	$4,956	$3,138	$1,179	
FHA Reduces Downpayment Requirement	$5,586	$5,737	$4,649	$3,548	$3,279	$2,063	($100)	($2,198)	($
FHA Provides 2/6 ARMs	$5,589	$5,753	$4,747	$3,711	$3,394	$2,249	$391	($1,498)	($

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

1998 End of Year Cash Position

FHA Increases Loan Ceiling vs. Base Case

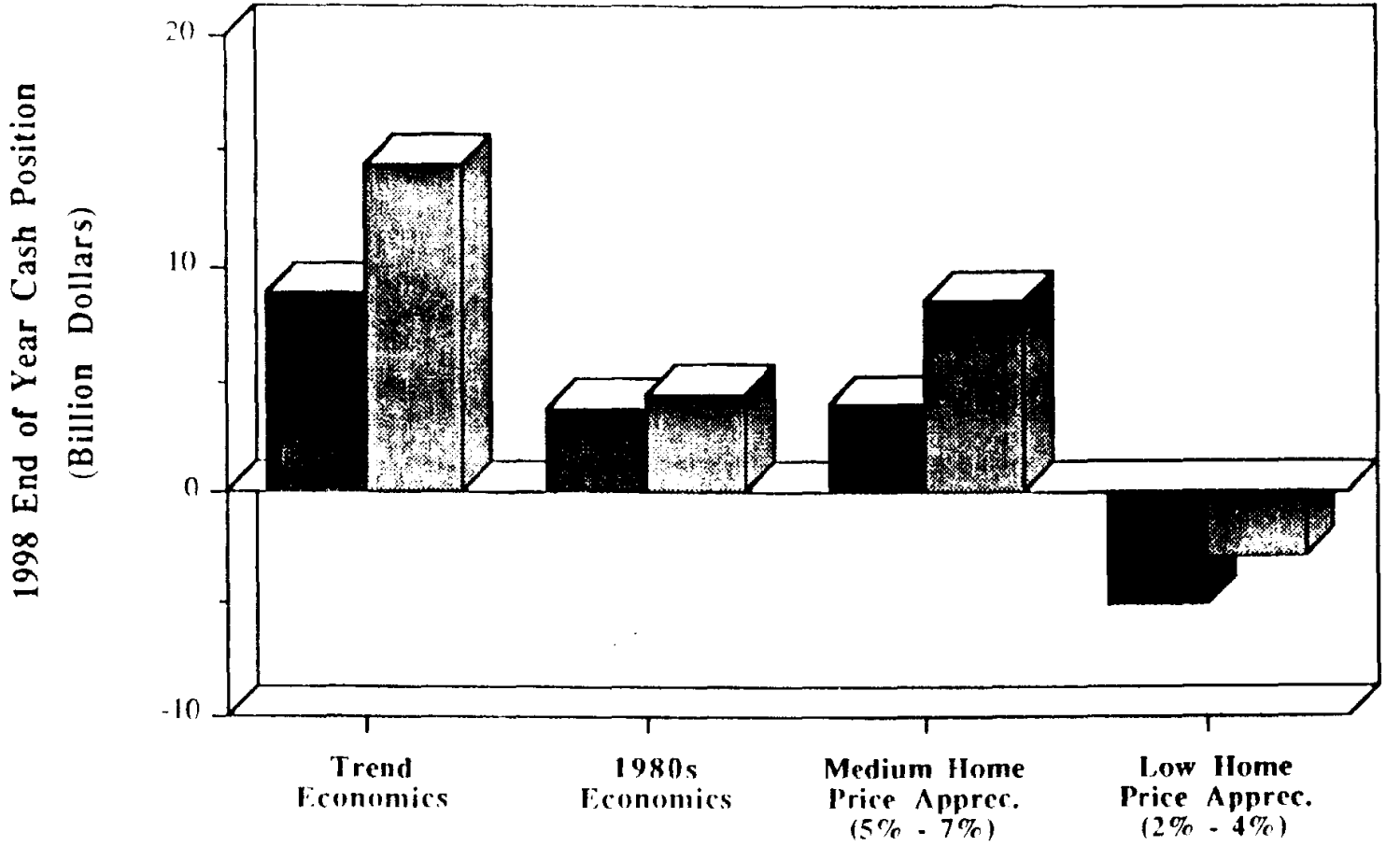

EXHIBIT 11

Summary of Economic Variables

Economic Variables	1989	1990	1991	1992	1993	1994	1995	1996
Trend Economics								
Mortgage Interest Rate	9.88	9.44	9.66	10.26	10.02	9.74	9.66	9.61
Median House Price	$97	$104	$112	$121	$130	$141	$153	$166
Unemployment Rate	5.23	5.50	5.40	5.22	5.39	5.37	5.28	5.17
Ave. Nominal Loan Value	$74	$80	$85	$91	$99	$107	$117	$127
1980s Economics								
Mortgage Interest Rate	9.88	10.92	12.95	15.12	15.38	12.85	12.49	11.74
Median House Price	$97	$107	$117	$125	$128	$134	$139	$145
Unemployment Rate	5.23	5.83	7.16	7.78	9.87	9.33	7.41	7.20
Ave. Nominal Loan Value	$74	$81	$89	$95	$97	$102	$106	$110
Medium House Price Appreciation								
Mortgage Interest Rate	9.88	9.44	9.66	10.26	10.02	9.74	9.66	9.61
Median House Price	$97	$103	$107	$113	$120	$128	$137	$146
Unemployment Rate	5.23	5.50	5.40	5.22	5.39	5.37	5.28	5.17
Ave. Nominal Loan Value	$74	$78	$82	$86	$92	$98	$104	$111
Low House Price Appreciation								
Mortgage Interest Rate	9.88	9.44	9.66	10.26	10.02	9.74	9.66	9.61
Median House Price	$97	$100	$101	$104	$107	$111	$115	$119
Unemployment Rate	5.23	5.50	5.40	5.22	5.39	5.37	5.28	5.17
Ave. Nominal Loan Value	$74	$76	$77	$79	$82	$84	$88	$91

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

Median Home Prices by State (1988)

Alabama	$82,300	Kentucky	$59,700	North Dakota	
Alaska	$100,100	Louisianna	$81,200	Ohio	
Arizona	$100,700	Maine	$98,300	Oklahoma	
Arkansas	$71,200	* Maryland	$111,600	Oregon	
*California	$162,700	* Massachusetts	$159,000	Pennsylvania	
Colorado	$89,800	Michigan	$78,800	*Rhode Island	
*Connecticut	$171,300	Minnesota	$95,800	South Carolina	
Delaware	$83,500	Mississippi	$71,000	South Dakota	
*District of Columbia	$133,000	Missouri	$74,600	Tennessee	
Florida	$90,900	Montana	$73,900	Texas	
Georgia	$92,800	Nebraska	$65,500	Utah	
*Hawaii	$170,700	Nevada	$92,900	Vermont	
Idaho	$79,800	* New Hampshire	$134,500	* Virginia	
Illinois	$91,800	* New Jersey	$155,100	Washington	
Indiana	$59,200	New Mexico	$70,300	West Virgina	
Iowa	$63,200	* New York	$149,200	Wisconsin	
Kansas	$73,300	North Carolina	$86,000	Wyoming	

* States with median home prices above FHA's current loan ceiling.