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Impact of FHA Loan Policy Changes on Financial Losses and Homebuyers

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

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Committee on Banking, Finance, and Urban Affairs
House of Representatives

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here again to further discuss our analyses of the impact that certain proposed policy changes to the Federal Housing Administration's (FHA) Mutual Mortgage Insurance (MMI) Fund will have on the Fund's cash position. This discussion will serve to update the interim results and data of our ongoing work for Congressman Gerald Kleczka, which we presented in testimonies before this Subcommittee on November 16, 1989,[1] and the Subcommittee on Housing and Urban Affairs, Senate Committee on Banking, Housing, and Urban Affairs on June 6, 1990.[2] The results of our work will be included in a report to Congressman Kleczka.

In addition to highlighting the major results of our analyses, I will present our views on the reforms proposed by the Secretary of Housing and Urban Development (HUD) to resolve the MMI Fund's financial problems as well as on the actuarial study conducted by Price Waterhouse, which defined these problems. The proposed reforms are aimed at restoring the Fund to actuarial soundness by increasing its capital reserves.

As you know, Mr. Chairman, the MMI Fund supports single family mortgages insured by FHA. It is FHA's largest insurance fund, with a cash balance at the end of fiscal year 1988 of about $6.2 billion. This Fund is used to cover potential losses from its insurance-in-force, currently valued at about $271 billion.

Briefly stated, Mr. Chairman, the Congress and the nation face a dilemma: Can FHA operate a financially sound single family mortgage insurance program at reasonable costs and risks and still serve low- and moderate-income homebuyers, particularly first-time homebuyers, without substantially increasing burdens on them in

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

[2]Impacts of FHA Loan Policy Changes on Its Cash Position (GAO/T-RCED-90-70, June 6, 1990).

achieving that financial soundness? Because of the substantial financial and social consequences inherent in any policy changes to the MMI Fund's insurance criteria, the Congress should carefully balance desires to assist homebuyers with its expectations of the housing market's future performance, the federal government's potential financial risk in assuming responsibility for the additional amount of insurance-in-force such changes can generate, and the possible need for assistance by the U.S. Treasury in the Fund's survival.

Mr. Chairman, we support the recent efforts of Secretary Kemp and the Congress to restore financial health to the MMI Fund. We also compliment the Secretary for initiating inquiries into the financial status of the Fund and, as the scope of the problem became known, for considering several alternatives to replenish the Fund's reserve.

We believe that the Price Waterhouse study, which defined the scope of the financial problems facing the MMI Fund and the likely outcomes of alternative policy changes on these problems, is credible and accurately portrays the financial problems facing the Fund. We reached this conclusion after having met with representatives of Price Waterhouse and discussed their methodology in detail. If we had conducted a similar analysis, we may have employed different assumptions or techniques, which could have affected the numbers slightly; however, we do not believe the basic message would have changed.

The Secretary only recently announced various proposals for reform, and, subsequently, the Senate passed legislation that adopted most of the Secretary's proposals. Although we have not fully assessed these proposed policy changes, we would like to address several issues regarding the impact of these proposals on the Fund's financial condition and on potential homebuyers. These issues concern the following:

-- the financial benefits that would accrue to the MMI Fund by adopting a policy change to increase FHA's mortgage ceiling on a regular basis,

-- the financial impact on potential homebuyers of FHA's proposal to eliminate the financing of most closing costs in mortgages, and

-- the application of better management techniques in reducing losses.

Before proceeding with the details of these issues, let me briefly summarize the major results of our ongoing study of the impact of FHA loan policy changes on the MMI Fund's cash position.

IMPACT OF FHA LOAN POLICY CHANGES ON THE FUND'S CASH POSITION

The MMI Fund is presently incurring losses for several reasons--primarily high default and foreclosure rates. In our testimony before the Subcommittee on Housing and Urban Affairs, Senate Committee on Banking, Housing, and Urban Affairs on June 6, 1990, we pointed out that our analysis shows that the future cash position of the Fund will depend heavily on two factors--policy changes to the MMI Fund's insurance criteria and the actual economic conditions that prevail in the next decade. After considering both of these factors, we concluded in that prior testimony that one proposed policy change--increasing the FHA mortgage ceiling on a regular basis to account for increases in house prices--is necessary to prevent the deterioration of the Fund's cash balance and to allow FHA to maintain its current share of the housing market. However, we also concluded that there is a need to proceed with caution on how high to raise the mortgage ceiling. Several factors influenced our cautionary advice.

Of the proposed policy changes we analyzed, raising the mortgage ceiling to 95 percent of a state's median house price would have the greatest positive effect on the Fund's cash balance. However, raising the mortgage ceiling will also generate the most new business for FHA, thereby increasing the government's financial risk in the form of additional insurance-in-force. In the June 6, 1990, testimony, we illustrated this relationship through an economic scenario in which we estimated that raising the ceiling to 95 percent of a state's median house price would increase the Fund's cash balance by $8.2 billion by 1998. However, at the same time, this policy change would more than triple the amount of insurance-in-force, to $886 billion. The increased financial risks that such a policy change poses were further intensified by indications from FHA that the Fund may not be actuarially sound if it continues to operate as it has in the past.

Consequently, we suggested that if the Fund is not actuarially sound, 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 would be created. Instead, we suggested 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.

FHA SOLVENCY PROBLEMS CONFIRMED AND CORRECTIVE ACTIONS PROPOSED

Our words of caution took on a more compelling meaning when Secretary Kemp testified before the Subcommittee on Housing and Urban Affairs, Senate Committee on Banking, Housing, and Urban Affairs on June 6, 1990. He pointed out that the Fund, while currently financially solvent, has been steadily eroding from a net worth in constant 1989 dollars of $7.8 billion in 1980 to $2.6 billion in 1989 and eventually will have a negative net worth unless something is done to replenish the Fund's reserve on a continuing basis. The Secretary reached this conclusion based on the results of the actuarial study conducted by Price Waterhouse for FHA.

To restore the Fund to actuarial soundness, the Secretary proposed several reforms aimed at increasing the Fund's capital reserves--establishing minimum capital standards for the Fund and a premium structure sufficient to cover expected and normal operating losses. Specifically, the reforms are (1) setting a risk-related premium structure, with higher premiums for loans with lower downpayments; (2) ending the practice of financing most closing costs in mortgages; (3) further reforming management throughout FHA, particularly in the areas of property disposition and in accounting systems to prevent fraud in the future; (4) discontinuing paying distributive shares for future business, but continuing to pay them on past business; and (5) holding mortgage limits at present levels.

The proposed set of policy changes announced by Secretary Kemp provides one way to minimize financial risks and potentially resolve the MMI Fund's financial problems. Subsequent to the Secretary's announcement, the Senate passed legislation (S. 566) on June 27, 1990, that adopted reforms in line with the Secretary's proposals. The proposed legislative reforms are (1) establishing capital requirements for the Fund; (2) setting a risk-related premium structure, with higher premiums for loans with lower downpayments; (3) limiting the principal obligation for FHA loans to no more than 98 percent of the appraised value of the property or 97 percent in the case of an appraised value in excess of $50,000; (4) discontinuing paying distributive shares on past and new business until the Fund is actuarially sound; and (5) conducting an annual actuarial study of the Fund. Although we have not fully assessed these proposals, we support these efforts, particularly the concept of risk-related premiums, and the goals these policy changes are directed at achieving.

IMPACT ON THE FUND'S FINANCIAL CONDITION AND HOMEBUYERS

While we support these efforts, there are three issues concerning the impact of the proposed policy changes on the Fund's financial condition and on potential homebuyers that I would like to discuss: the financial benefits of raising the mortgage limit, the impact on homebuyers from no longer financing most closing costs, and the application of better management to reduce losses.

Financial Benefits of Raising FHA's Mortgage Ceiling on a Regular Basis

FHA's proposals are based on holding mortgage ceiling limits at the present level ($124,875), while our analyses and the actuarial study by Price Waterhouse show that the MMI Fund could benefit financially by raising mortgage ceiling limits on a regular basis.

In regard to raising the mortgage ceiling, Secretary Kemp has stated that, "The Price Waterhouse analysis concludes that, contrary to popular impression, raising the loan limits will not help the MMI fund." However, Price Waterhouse's report points out that under certain conditions, which are discussed below, raising FHA's mortgage ceiling could benefit the Fund.

This observation is similar to the conclusions we reached in our analyses of the cash position of the MMI Fund. Namely, while increasing the FHA mortgage ceiling would increase the government's financial risk in the form of additional insurance-in-force, it would have a positive effect on FHA's cash balances. Another way to look at this issue is to ask what would happen to the Fund if the Congress would decide not to raise FHA's mortgage ceiling above the $101,250 limit in effect before 1990 and to which it will revert after September 30, 1990, barring further congressional action. Under this condition, the Fund's cash balance would fall to an estimated $3 billion in 1998 from the fiscal year 1989 level of $6.2 billion, even under favorable economic conditions and rapidly appreciating house prices. The Fund's 1998 cash balance would be less than $3 billion--and might even disappear altogether--if the recent trend of lower rates of house price appreciation would continue through the 1990s.

The Price Waterhouse study demonstrates the value of raising mortgage ceilings by combining such a policy change with other policy changes. The report points out that the Fund's equity position would be enhanced by increasing the loan limit to 95 percent of a state's median house price and, at the same time, requiring a 10-percent downpayment on that part of the loan exceeding $101,250 and charging a premium of 1.5 percent of the loan amount up front and 0.5 percent annually on the remaining loan balance. Price Waterhouse estimates that the result would be an increase of $78 million in the Fund's equity above the amount of equity that would have been realized by not raising the ceiling. While $75 million of this amount would be needed to meet the proposed capital requirement of 1.25 percent on the new insurance business this policy change would create, the remaining $3 million could be used to help build the capital reserve or, depending on how the program is restructured, to cover losses on more risky loans to first-time homebuyers.

Mr. Chairman, once reforms are instituted and FHA determines that the Fund is actuarially sound, raising the loan ceiling while increasing the amount of insurance-in-force should improve the financial position of the MMI Fund slightly because such a change would allow FHA to build equity faster than if the ceiling is not raised. For these reasons, among others, we suggested in our June 6, 1990, testimony that the Congress consider raising the mortgage ceiling to 95 percent of a state's median house price if the Fund is actuarially sound.

Impact on Homebuyers of Eliminating the Financing of Most Closing Costs

The proposed policy change to eliminate the financing in FHA insured mortgages of most closing costs and, instead, require that these costs be paid in cash at settlement could help improve the Fund's financial soundness, but could also mean that a number of potential FHA homebuyers may be forced out of the market or have to delay their home purchases. For example, when buying a $75,000 home, a FHA borrower must currently have a minimum downpayment of about $3,363 in cash (assuming that closing costs, equal to about 3 percent of the purchase price, are financed in the mortgage), but if, as proposed by FHA, the buyer is required to pay two-thirds of the closing costs in cash, the total amount of cash needed at settlement would increase by $1,431--an increase of 43 percent over the current minimum downpayment. While this may not seem like a lot to some people, 41 percent of FHA's borrowers in fiscal year 1989, or about 215,000 homeowners, paid less than 5 percent down. For many of these homebuyers, the increased amount of cash needed could have kept them out of the housing market or delayed their purchase.

Better Management to Reduce the Fund's Losses

Mr. Chairman, the losses being incurred by the MMI Fund do not result only from economic factors, such as the rising number of defaults in economically stressed regions and the sale of foreclosed properties at less than the outstanding mortgage values.

They also result from poor program management and waste, fraud, and abuse. The full extent of losses attributable to these factors is not yet known. However, as we pointed out in our June testimony, a number of financial management problems exist that the top management of HUD and FHA need to address to keep future losses under control, no matter what changes are made to the ceiling limits, premium rates, or closing costs requirements. HUD's Inspector General and GAO have been reporting on these management problems since the early 1980s.

Secretary Kemp has taken specific steps to address management problems and strengthen FHA's financial position, which we detailed in our previous testimony before this Subcommittee. Since then Secretary Kemp has outlined further steps he plans to take to address FHA management problems in the areas of property disposition, underwriting practices, monitoring of lenders, and reforms to accounting systems to prevent fraud in the future. Any success achieved by the Secretary in reducing FHA's losses through better management will improve the financial health of the MMI Fund.

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In conclusion, Mr. Chairman, while we face the dilemma of placing added burdens on potential FHA homebuyers in order to help restore the Fund's financial soundness, the MMI Fund has not yet reached the point of requiring assistance from the U.S. Treasury. Therefore, there is still time to take action to reform the program and reverse the trend towards insolvency before federal financial assistance becomes necessary. In deciding on what reforms are appropriate to achieve this goal, the Congress should not only carefully balance desires to assist homebuyers with the federal government's potential financial risk and liability, but it should also base these reforms on its expectations of the housing market's future performance.

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