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Greater Staffing Flexibility Needed to Improve Management

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to participate in the Subcommittee's hearing on staffing levels at the Department of Housing and Urban Development (HUD). My testimony is based on our recent report on staffing levels for HUD's Government National Mortgage Association (GNMA).[1] GNMA is a secondary mortgage market organization that guarantees securities issued by its approved mortgage originators (issuers) and backed by pools of mortgage loans insured by HUD's Federal Housing Administration (FHA) or guaranteed by the Department of Veterans Affairs (VA).

In recent years, several federal loan guaranty programs have come under scrutiny because of downturns in the real estate market and allegations of mismanagement and fraud. Some of these programs have incurred significant losses, such as the $2.5 billion lost by FHA in fiscal year 1991. The federal government was obligated to pay the lenders for losses on defaulted mortgages that FHA had insured. Concerned about the ability of GNMA to oversee its issuers and the large amount of mortgage-backed securities outstanding ($416 billion as of August 30, 1993), the Subcommittee on Housing and Urban Affairs, Senate Committee on Banking, Housing, and Urban Affairs asked us to (1) provide information on how GNMA has evolved to accomplish its mission, (2) identify recent management problems experienced by GNMA in overseeing its issuers, and (3) examine GNMA's response to its management problems.

In summary, GNMA's basic mission of supporting affordable housing has remained the same over time. However, the way it operates has changed substantially. In its early years, GNMA was primarily involved in subsidizing interest rates on mortgage loans to benefit low- and moderate-income borrowers. Subsequently, in the 1970s GNMA pioneered the mortgage-backed security (Ginnie Maes), which attracted investment capital to the mortgage market that could be loaned to homebuyers for FHA-insured and VA-guaranteed mortgages. Ginnie Maes have been successful in attracting capital that has helped finance about 14 million American homes.

In the mid-1980s, GNMA began experiencing difficulties in monitoring the financial health of its issuers. Because of weaknesses in its oversight of issuers, GNMA could not respond promptly to declines in regional real estate markets and other factors that financially weakened some of its issuers. As a result, since fiscal year 1987, GNMA, while remaining profitable, has become the manager of about $22.4 billion in assets (mortgages) acquired from issuers that were unable to pay investors, thereby increasing the federal government's exposure

[1]Government National Mortgage Association: Greater Staffing Flexibility Needed to Improve Management (GAO/RCED-93-100, June 30, 1993).

to loss. While the extent of the losses that GNMA has sustained or will sustain is not yet known, GNMA increased its loss reserve (estimate of probable future losses) to $629 million in fiscal year 1989--up from $44.8 million 3 years earlier--primarily because of issuers' defaults.

Beginning in 1989, GNMA began improving its oversight capability and taking steps to minimize potential losses. It developed a comprehensive management information system and started regular reviews of the hundreds of issuers that sell Ginnie Maes. Most of these improvements were made by hiring numerous contractors, because HUD's staffing limitations prevent GNMA from hiring additional employees. This inflexibility in staffing has created other concerns for GNMA managers. They have not been able to adequately monitor their contractors' activities and have been unable to respond to changing market conditions by creating new products that could lower financing costs for FHA and VA homebuyers.

Before I discuss the results of our GNMA review in detail, let me briefly outline the history of GNMA and explain how it operates.

HISTORY AND OPERATIONS OF GNMA

In 1968, the Federal National Mortgage Association (Fannie Mae), then a part of HUD, was partitioned into two entities. GNMA was created as a government-owned corporation[2] within HUD responsible for activities such as providing federal subsidies to borrowers to make housing more affordable and implementing a mortgage-backed securities program primarily for FHA and VA mortgages. GNMA's programs help provide financing for single-family, multifamily, and manufactured homes. Fannie Mae became a government-sponsored, but privately owned corporation, which today helps provide a secondary mortgage market for residential mortgages financed entirely by private sources.

GNMA's 781 issuers (mortgage bankers, savings institutions, and other financial intermediaries) are responsible for administering the mortgage pools backing the securities, including collecting mortgage payments from borrowers and making monthly payments to the owners of the guaranteed securities. Issuers pay various fees to GNMA to cover its costs and offset its future payments of claims under the guaranty. In the event that the issuer defaults in making timely payments of principal and interest to investors, GNMA makes the payment and takes over the issuer's entire GNMA portfolio.

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[2]Government corporations are federally chartered entities usually created to serve public functions of a predominantly business nature.

GNMA operates like other organizational units of HUD in that its administrative, budgetary, and staffing decisions are integrated with those of HUD programs. However, as a government corporation, GNMA reimburses HUD for all of its personnel and administrative expenses. In fiscal year 1991 alone, GNMA's revenues exceeded its expenses by $367.6 million. GNMA's president, who reports directly to the Secretary of HUD, oversees a staff of about 70 people.

GNMA'S ACTIVITIES HAVE CHANGED SUBSTANTIALLY

GNMA's earliest activities included operating a variety of mortgage purchase programs under the authority of its Special Assistance Functions. These programs were designed to help provide mortgage financing for affordable housing not being financed by the private sector and to counter declines in mortgage lending. Under some of these initiatives, GNMA purchased below-market interest rate mortgages from lenders and sold them to private investors at their market value. GNMA subsidized the difference between the purchase and selling prices. The subsidies enabled builders to obtain funds to finance affordable housing and offer lower financing costs to homebuyers and lower rents to tenants. Because of the perceived high cost of these subsidies, the Special Assistance Functions were terminated in 1983; in 1985, the Congress forgave $12.7 billion in borrowings for GNMA from the U.S. Treasury to cover the accumulated cost of these initiatives.

In 1970, GNMA pioneered the mortgage-backed security, which has since become its primary means of assisting people with low and moderate incomes to obtain housing. The mortgage-backed security program involves GNMA-approved issuers that pool FHA and VA mortgage loans into securities guaranteed by GNMA and sold to investors. For a fee paid by issuers, GNMA guarantees that investors will receive timely monthly payments of principal and interest, no matter how the borrower or the issuer performs. Funds provided through the sale of Ginnie Maes are returned to the mortgage market and may be used to offer new loans to FHA and VA borrowers.

Because Ginnie Mae securities are backed by the full faith and credit of the federal government, they are attractive to investors. By 1980, GNMA had guaranteed 44,500 mortgage pools; by 1991, the number of guaranteed mortgage pools had grown to 270,947. Through 1991, the program has guaranteed a total of about $702 billion in mortgage-backed securities representing almost 14 million homes. While GNMA's mortgage-backed securities program grew dramatically through the 1980s, GNMA's net revenues (after expenses) also grew totaled about $1.4 billion for the 5 year period ending in fiscal year 1991.

MANAGEMENT PROBLEMS INCREASE GNMA'S EXPOSURE TO FINANCIAL LOSSES

During the 1980s, GNMA began to experience problems in overseeing the financial health of its issuers. Some GNMA issuers began to sustain losses brought on by economic distress and a resulting decline in regional real estate markets, a flawed FHA mortgage program design, and changes in VA's home loan mortgage guaranty practices. Other GNMA issuers failed to pay investors because the issuers mismanaged program funds. These four factors contributed to increased issuer defaults that exposed GNMA to greater financial losses and posed difficult management challenges.

Issuers' Financial Health Caused Problems for GNMA Management

While GNMA had few concerns about issuer defaults in the early years of the program, as the number of defaults grew they began to pose serious problems for GNMA. First, GNMA had to manage these portfolios by (1) collecting principal and interest payments from borrowers, (2) making payments to owners of the securities, and (3) awarding servicing contracts to firms, known as subservicers, that manage the portfolios. Second, issuers' defaults highlighted GNMA's need to develop ways to track delinquencies and foreclosures so that GNMA could respond promptly to early-warning signals about issuers that were experiencing financial difficulties.

GNMA officials told us that until recently they could not track important information on the financial health of issuers because they did not have adequate management information systems. Moreover, HUD's Office of Inspector General (OIG) reported in October 1989 that GNMA was not adequately monitoring its issuers' financial condition, in part because of staffing limitations.[3] The report pointed out two cases in which GNMA was forced to provide more than $20 million to cover issuers' losses because of its inadequate monitoring of poorly performing issuers. The report also criticized GNMA for continuing to allow two of its approved issuers to pool mortgages after FHA had stopped doing business with these issuers because they were no longer in compliance with FHA requirements. These issuers were responsible for 2,300 mortgage pools worth about $3 billion. The OIG report concluded that these and similar situations were increasing the government's potential exposure to loss.

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[3] Internal Audit of Review of Procedures for Issuer Monitoring, Office of Inspector General (90-A0-171-0001, Oct. 4, 1989).

Factors Contributing to Issuers' Defaults That Added to GNMA's Management Burden

Of the four factors that contributed to increasing issuers' defaults, declining regional real estate markets were considered by GNMA officials to be the major factor. During the mid- to late 1980s, an increasing number of borrowers began defaulting on their mortgages in economically distressed regions, particularly in the oil-producing states such as Texas and Oklahoma. When borrowers were unable to repay their mortgage loans, the issuers who pooled these mortgages became responsible for making payments to investors. The increased number of foreclosures and resulting losses weakened some issuers, causing them to also default. GNMA, in honoring its guaranties to investors, acquired these issuers' portfolios of defaulted mortgages, replenished funds in certain accounts, and hired subservicers to temporarily run the portfolios. The number of defaults by issuers peaked at 19 in calendar year 1989. In total, GNMA acquired portfolios of defaulted mortgages valued at about $22.4 billion from its issuers between fiscal years 1987 through 1993. About half of this portfolio, $11.5 billion, was acquired by GNMA in calendar year 1989.

Another factor that contributed to increased issuer defaults was FHA's multifamily coinsurance program, which provided mortgage insurance for multifamily rental housing projects initiated as a joint venture between FHA and private lenders. Loans valued at more than $10 billion were coinsured through the program. The program functioned on a risk-sharing basis in which private lenders assumed approximately 20 percent, and FHA 80 percent, of the responsibility for potential losses incurred through defaulted mortgages.

Flaws in the program's operational structure and other problems contributed to a high default rate and subsequent losses to FHA totaling about $2.4 billion through the end of fiscal year 1992. FHA officials and an independent accounting firm concluded that a major flaw in the structure of the program was that it allowed private lenders to pool coinsured mortgages into securities guaranteed by GNMA. When an individual lender defaulted on a coinsured loan, FHA was to pay the lender approximately 80 percent of the losses on the mortgage. However, if a lender that had pooled coinsured loans into Ginnie Maes defaulted, the GNMA guaranty rendered the federal government responsible for the lender's losses. Virtually all coinsured mortgages were pooled into securities guaranteed by GNMA, making it responsible for the 20 percent of all losses. However, GNMA is reimbursed by FHA for these losses. Therefore, in effect, the federal government became responsible for 100 percent of the losses. HUD issued final regulations terminating the program in October 1990.

VA's no-bid policy on property losses also had a similar effect on some of GNMA's issuers. The no-bid policy is a loss-limiting option that allows VA to take back the property or leave it with the lender, depending on which action is more in VA's financial interest. VA decides which option to follow after estimating and comparing the cost of taking possession of and reselling a foreclosed property with the cost of leaving the property with the lender and paying the lender the VA guaranteed portion of the mortgage loan. The VA guaranty program ranges from 25 to 50 percent of the loan amount, depending on the amount of the original loan, up to a maximum of $46,000. VA's no-bid policy stems from the fact that VA guarantees only a portion of the mortgage and not the entire mortgage. When VA leaves properties with issuers, the issuers are responsible for the losses incurred above those guaranteed by VA. Because issuers' resources are reduced by such losses, the probability the issuer will default increases. When issuers default, GNMA is responsible for the portion of the losses not guaranteed by VA.

The last factor that contributed to GNMA issuer defaults occurred during the late 1980s, when GNMA took possession of a number of portfolios from issuers whom it placed in default because of fraud and mismanagement of program funds. For example, in 1989 one issuer with a $7.1 billion portfolio mismanaged funds, forcing GNMA to fulfill its guaranty and make about $35.4 million in payments owed to investors. In 1987, a principal of another issuer pleaded guilty to charges stemming from the embezzlement of $11.4 million in federally insured mortgage funds in the largest GNMA fraud case prosecuted. GNMA had to make $15.5 million in payments to investors in this case.

While FHA and VA assumed responsibility for most of the losses on the foreclosed mortgages they had insured or guaranteed, GNMA's costs increased as a result of issuer defaults. Once an issuer defaults, GNMA is responsible, as the cases discussed above describe, for making cash payments to investors for any shortfalls in the funds remitted by borrowers for mortgage principal and interest payments. In addition, GNMA incurred costs for payments of taxes and insurance, as well as costs associated with managing and disposing of portfolio properties, and paid all expenses associated with acquiring clear title to such properties. According to a GNMA official, the total costs incurred by GNMA will not be known until these assets are sold. However, primarily as a result of default expenses, GNMA was required to increase its loss reserves from $44.8 million in fiscal year 1986 to $629 million in fiscal year 1989 to pay for possible losses.

MANAGEMENT PROBLEMS ADDRESSED, BUT STAFFING ISSUE REMAINS

Since fiscal year 1988, GNMA has taken several steps to improve its oversight of the mortgage-backed security program and dispose of assets acquired from defaulted issuers. Most of these actions were implemented by contractors hired by GNMA, since GNMA could not hire a sufficient number of employees because of HUD's staffing constraints. This increased reliance on contractors, coupled with HUD's staffing constraints, has caused concerns in HUD and GNMA. HUD is concerned about whether GNMA can monitor its contractors. GNMA is concerned about its ability to respond to future management challenges, such as developing new programs to benefit low- and moderate-income homebuyers.

Management Improvements Made by GNMA

In the late 1980s and early 1990s, GNMA developed and implemented an early-warning system to detect poorly performing issuers before they defaulted. It also created an issuer assistance group to conduct special reviews of issuers identified as poor performers and take steps to correct the problems. During the same period, GNMA also enhanced its monitoring of issuers by reviewing them annually for compliance. Another step taken by GNMA was to create an office of asset management to manage and dispose of the assets acquired from issuers that had defaulted.

Since the late 1980s, the number of issuer defaults and the value of assets acquired from such defaults have declined substantially. The number of issuer defaults declined from a high of 19 in calendar year 1989 to 5 in 1992. Between 1987 and 1992, GNMA sold the servicing rights to $6.8 billion in mortgage portfolios acquired from defaulted issuers.

Staffing Issue Remains Unresolved

GNMA developed and implemented most of these improvements by contracting for staff because it lacked authority to hire its own employees. According to GNMA, in fiscal year 1991 it spent $61.8 million on contracts for services, utilizing about 566 full-time-equivalent contractor personnel. Contractors now perform virtually all of GNMA's administrative and management information functions. For instance, GNMA's new early-warning system was developed and is being operated by the largest contractor. This contractor also conducts annual reviews of all GNMA issuers. GNMA has also hired additional contractors to help it dispose of acquired assets.

GNMA's managers have little flexibility in determining how to use their resources. Even though GNMA is a government corporation that reimburses HUD for its personnel and other costs and operates at a profit to the federal government, its staffing level is restricted by staffing ceilings imposed by HUD and the Office of Management and Budget (OMB). HUD's staffing level decreased dramatically from 17,041 in 1980 to 13,032 in 1991. According to HUD's OIG, HUD programs are at considerable risk of abuse and loss, in part because of insufficient staff to perform necessary functions, such as monitoring, to prevent, detect, or correct problems.[4] According to GNMA's past President, HUD cannot increase GNMA's staff without reducing staffing levels elsewhere in HUD. GNMA would like to use revenues it generates to increase its staffing levels without regard to HUD's staffing limitations, according to this official.

While HUD has at times increased GNMA's staffing levels, it has at other times denied requests for staffing increases from GNMA and proposed to cut GNMA's existing staffing level. GNMA's staff was increased from 55 to a high of 69 in fiscal year 1991 to help GNMA respond to increases in issuers' defaults. However, when GNMA requested 11 additional positions for fiscal year 1993, OMB approved HUD's plan, which reduced GNMA's existing staff to 60 by cutting 9 staff. According to a GNMA official, GNMA's accounting firm notified HUD that it might issue a qualified opinion[5] on GNMA's financial statements if GNMA's staff was cut. The reason cited was that any reduction in staff would reduce GNMA's ability to monitor issuers, thereby increasing GNMA's financial risk. According to a HUD official, HUD amended GNMA's staffing allocation and restored eight of the nine positions HUD had planned to cut.

Staffing constraints limit the ability of GNMA to oversee its contractors. GNMA's largest contractor told us that GNMA does not have the resources to adequately review the contractor's work. According to a report issued by HUD's OIG in November 1989, HUD and GNMA have little assurance that critical program functions are properly performed and that subservicers' claims for services and costs are reasonable or valid.[6] HUD's OIG reported that this monitoring weakness may have caused GNMA to reimburse subservicers for improper expenses. In its fiscal

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[4]Statement of John J. Connors, Deputy Inspector General, Department of Housing and Urban Development, before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, May 4, 1993.

[5]A qualified opinion in this case means that except for the effects of the staffing cut, GNMA's principal financial statements present fairly, in all material respects, its financial position, among other things.

[6]Review of Government National Mortgage Association's Office of Asset Management, Office of Inspector General (90-A0-171-0003, Nov. 22, 1989).

years 1990 and 1991 financial statement reports, GNMA's accounting firm concluded that this problem was a "material" weakness partly attributable to personnel constraints imposed by HUD.[7] In September 1991, GNMA hired a contractor to monitor its other contractors. However, in a March 1993 report on fiscal year 1992 operations, GNMA's accounting firm reported that "material" weaknesses continue to exist in GNMA's monitoring of contractors, in part because of constraints on GNMA's staffing levels. According to GNMA's most recent president, GNMA needs more in-house staff to monitor its contractors. He added, however, that increasing the number of staff is not an option for GNMA because of HUD's staffing constraints.

GNMA and HUD officials have expressed concerns about GNMA's staffing situation. GNMA officials believe that more staff are needed to monitor contractors, develop computer systems, and make long-range plans. In March 1992, the Deputy Secretary of HUD asked for a review of staffing and other issues affecting GNMA's operations. Because OMB also plays a major role in budget and staffing decisions, HUD's Deputy Secretary asked OMB to participate in the study. OMB helped HUD monitor the contractor that HUD hired to conduct the staffing study. According to the staffing study report, which was released on January 5, 1993,[8] GNMA requires approximately 5 to 11 additional staff for the following reasons:

-- The economy has been the worst since the late 1970s, thereby increasing the risk of issuers' failing and thus of GNMA having to fulfill its guaranties.

-- GNMA's work load has increased significantly more than its staffing levels over the last 5 years.

-- GNMA's increasing work load, combined with the effort it has had to expend to procure and monitor contract services, have resulted in GNMA's inability to effectively focus on areas of risk and exposure.

According to the study, the additional staff should be deployed throughout GNMA. However, their efforts should be focused (1) monitoring and overseeing issuers, (2) managing and disposing of defaulted portfolios, and (3) overseeing and managing contractors to identify areas for possible savings.

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[7]According to the accounting firm, material weaknesses are those control weaknesses that can significantly impair the fulfillment of an agency's mission, deprive the public of needed services, and/or violate statutory or regulatory requirements.

[8]GNMA Capacity Study, KPMG Peat Marwick (Jan. 5, 1993).

In addition, GNMA would like to take advantage of new opportunities to benefit low- and moderate-income homebuyers. For example, GNMA officials would like to implement a program offering another type of mortgage-backed security called a Real Estate Mortgage Investment Conduit (REMIC),[9] which could lower interest rates for FHA and VA borrowers. In the last few years, REMICs have become an important and profitable investment product for several secondary mortgage market agencies. In 1991, Fannie Mae issued over $23 billion in REMICs backed by Ginnie Maes. HUD was concerned that, inasmuch as GNMA does not have the in-house expertise or staff to manage such a program, it would be forced to hire additional contractors to develop and run the program. In this regard, HUD's staffing study estimated the staffing impact on GNMA of adding a REMIC program. The report stated that GNMA would need five professional staff in addition to those already recommended by the study to manage its current work load. Also, other offices in HUD would require four to six staff to support a GNMA REMIC program, according to the study.

HUD announced in March 1993 that GNMA would begin developing and managing a REMIC program in fiscal year 1994. HUD requested three additional staff for this program in its budget submission for fiscal year 1994, but it did not ask for additional staff to address management problems related to insufficient staff. As of October 25, 1993, GNMA had not yet initiated the REMIC program.

CONCLUSIONS AND RECOMMENDATIONS

In conclusion, GNMA has successfully supported financing for low- and moderate-income housing and at the same time generated revenues--$1.4 billion during a recent 6-year period after paying its operating costs. However, despite GNMA's status as a government-owned corporation and the potentially large federal liability inherent in its operations--$416 billion--GNMA's managers have limited authority in adding personnel to manage their assets.

What GNMA does have is flexibility to obtain contractor personnel. Consequently, when GNMA began to experience problems in monitoring its issuers and issuers began to default on payments to investors, GNMA had to rely on--as it continues to rely on--contractors to develop and operate management information systems, manage and dispose of acquired mortgage portfolios, and monitor issuers. While contractors are needed for carrying out many of GNMA's functions, GNMA must have the core capability--a sufficient number of trained and experienced staff--to properly manage and be accountable for its work.

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[9]REMICs are composed of mortgage-backed securities that have been divided into multiple-class securities with different maturities, interest rates, and prepayment risks.

However, HUD's recent staffing study concluded that GNMA does not have sufficient staff to properly manage its current work load and would need yet more staff to implement new initiatives. Providing additional staff to GNMA by taking such staff from other HUD programs could adversely affect HUD programs in that HUD currently has insufficient staff resources to perform necessary functions, according to HUD's OIG.

GNMA's staffing needs need to be considered without regard to HUD's personnel limitations. If GNMA's staffing needs continue to be tied to HUD's personnel ceilings, the agency may not be able to focus on areas of risk and exposure to the extent it should and may experience difficulties in responding to future management challenges. Moreover, GNMA could experience difficulties competing in a changing secondary mortgage market.

To ensure that GNMA has the flexibility to manage its growing work load, respond to changing markets, and create new products, we recommended in our June 30, 1993, report that the Secretary of HUD and the Director, OMB, work together to consider GNMA's staffing needs and provide for those needs without regard to personnel limitations imposed on HUD. We also recommended that the Secretary of HUD report to the Congress within 60 days of the issuance of our report on the options that it and OMB have considered and the actions they have taken to provide GNMA with the resources it needs to operate in a business-like manner while reducing the overall financial risk to the federal government. The Secretary and the Director have not yet responded to our recommendations.

We also suggested in our report that Congress should monitor HUD's and OMB's efforts to resolve GNMA's staffing problems. If HUD and OMB do not resolve this problem, we suggested the Congress may wish to consider directing them to provide GNMA with the necessary staff without regard to HUD's personnel budget.

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In addition, your office asked us to address any staffing concerns that we may have identified in ongoing work. In work that we are performing at your request, we are finding, among other things, that HUD is the landlord for a huge inventory of multifamily properties that is managed by about 128 full-time HUD staff whose salary expenses amount to about $5.8 million annually. HUD was never intended to play the part of a landlord, and has never been adequately staffed to do so.

Mr. Chairman, this concludes my prepared statement. I will be happy to answer any questions you or the other members may have.

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