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MORTGAGE FINANCING

Financial Health of FHA's Home Mortgage Insurance Program Has Improved

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GAO/T-RCED-94-255

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here again to present the results of our latest assessment of the actuarial soundness of the Mutual Mortgage Insurance Fund (Fund) that we are conducting at the request of this Subcommittee. We presented a similar assessment of the Fund through fiscal year 1991 in a testimony before this Subcommittee on July 27, 1993.[1] Our testimony today will present the results of our ongoing assessment of the actuarial soundness of the Fund as of the end of fiscal years 1992 and 1993. The results of our work will be included in a report to the Subcommittee within the next few months.

As you know, the Fund is administered by the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA). It provides insurance currently valued at about $269 billion for private lenders against losses on single-family mortgages. During the 1980s, the Fund, which historically had been financially self-sufficient, began to experience substantial losses primarily because foreclosure rates on homes supported by the Fund were high in economically stressed regions. In order to place the Fund on an actuarially sound basis, legislative reforms, such as requiring FHA borrowers to pay more in insurance premiums, were made in November 1990.

Concerned about the current financial health of FHA's Fund and the impact of reforms, this Subcommittee asked us to determine whether the Fund has sufficient financial reserves to meet estimated future losses resulting from the payment of claims on foreclosed mortgage loans. Specifically, we were asked to (1) estimate, under different economic scenarios, the economic net worth[2] of the Fund as of the end of fiscal year 1993; (2) assess the progress made by the Fund in achieving the legislatively prescribed capital ratios; and (3) compare our estimate with the estimate prepared for FHA by Price Waterhouse.

In summary, although there is uncertainty associated with any forecast, the economic value of FHA's Fund clearly has improved significantly in recent years, and the Fund is on the way to accumulating sufficient capital reserves to be considered actuarially sound under the law. As of September 30, 1993, the Fund had capital resources of about $9.7 billion which were sufficient to cover the $4.8 billion in expenses we estimate the Fund will incur in excess of anticipated revenues over the life of the loans outstanding at that time. The remaining $4.9 billion represents the Fund's economic net worth or capital--an

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[1]Homeownership: Actuarial Soundness of FHA's Single-Family Mortgage Insurance Program (GAO/T-RCED-93-64, July 27, 1993).

[2]The current cash available to the Fund, plus the net present value of all future cash inflows and outflows expected to result from outstanding mortgages in the Fund.

improvement of about $7.6 billion from the lowest level reached by the Fund just 3 years ago. Legislative and other program changes have helped restore the Fund's financial health, but favorable prevailing and forecasted economic conditions in fiscal year 1993 were primarily responsible for this improvement.

Although the Fund has made a substantial financial improvement recently, we estimate it fell about $3 billion short of achieving the legislative mandate for capital reserves by the November 1992 deadline. However, it surpassed the 1992 mandate for capital reserves by the end of fiscal year 1993. Whether the Fund can sustain this progress and attain the legislative target for reserves of 2 percent by November 2000, thereby achieving actuarial soundness under the law, and maintain that ratio thereafter, will depend on many economic and program factors that will affect the financial health of the Fund this year and over the next 6 years.

While there are some differences in the economic modeling techniques used and the assumptions made, our estimate of the economic value of the Fund ($4.9 billion) is similar to that of Price Waterhouse ($4.6 billion).

Before I present our assessment of the Fund's actuarial soundness in detail, let me briefly outline the purpose of FHA's single-family mortgage insurance program's Fund and the history of its financial condition.

PURPOSE AND FINANCIAL HISTORY OF FHA'S FUND

FHA was established in 1934 under authority granted to the President by the National Housing Act (P.L. 73-479). The primary purpose of FHA's Fund is to insure private lenders against losses on mortgages financing purchases of one to four housing units. To cover these losses, FHA deposits insurance premiums from participating home buyers in the Fund. According to 12 U.S.C. 1709, the Fund must meet or endeavor to meet statutory capital ratio requirements designed to achieve actuarial soundness; that is, it must contain sufficient reserves and funding to cover estimated future losses resulting from the payment of claims on defaulted mortgages and administrative costs. A determination of actuarial soundness requires the use of an accrual basis of accounting.[3] A primary objective of accrual accounting is to report the financial position and results of an entity's operations on the basis of measurable events, regardless of whether cash has changed hands. The accrual concept is

[3]An accrual basis of accounting matches, or recognizes, the receipt of revenues and the expenditures of funds to produce that revenue in the same fiscal time period rather than in the period when they actually occur, which may be in different fiscal years.

particularly important for an entity such as FHA (or any insurance enterprise) because the actual payout or collection of cash may precede or follow by a substantial time period the event that gave rise to the cash transaction. Thus, a favorable cash position, or positive cash flow, at any given point may not reflect the true financial position of the entity.

The Fund remained relatively healthy until the 1980s, when losses were substantial, primarily because foreclosure rates were high in economically stressed regions, particularly in the Rocky Mountain and Southwest regions. For example, in fiscal year 1988 the Fund lost $1.4 billion. If the Fund were to become exhausted, the U.S. Treasury would have to directly cover lenders' claims and administrative costs.

In response to the Fund's financial problems, among other things, the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) was enacted in November 1990. This legislation contained reforms to FHA's single-family mortgage insurance program designed to place the Fund on an actuarially sound basis. The legislation, among other things, required FHA borrowers to pay more in insurance premiums over the life of the loans by adding a risk-based annual premium to the one-time up-front premium. It effectively raised the present value of the insurance premium from the then 3.8 percent of the loan amount to 5.5 to 6.8 percent, depending on the amount of the down payment made. It accomplished this change with two actions: lowering the up-front premium from 3.8 to 2.25 percent of the loan amount over a 4-year transitional period and, during the same period, phasing in a new annual premium of 0.5 percent or 0.55 percent of the loan balances: those borrowers who make higher down payments pay the annual premium for a shorter period. The legislation also mandated that FHA's Fund attain a capital ratio of 1.25 percent by November 1992 and required the Secretary of HUD to endeavor to ensure a capital ratio of 2 percent by November 2000 and maintain at least a 2 percent ratio at all times thereafter. The capital ratio was defined by the act as the ratio of the Fund's capital or economic net worth to its unamortized insurance-in-force. Other changes made by the legislation in response to the Fund's financial problems included (1) limiting the loan-to-value ratio to a maximum of 97.75 percent of appraised value on homes whose appraised value exceed $50,000 and (2) effectively suspending payment of distributive shares (distribution of excess revenues to mortgagors) until the Fund is actuarially sound.

We have concluded that in addition to economic factors, poor program management and waste, fraud, and abuse contributed to the losses sustained by FHA's Fund. The full extent of losses attributable to these factors is not known. As we have pointed out in previous testimonies and reports, some of the major management problems facing HUD concern FHA's single-family program. For example, the absence of internal controls over

FHA's single-family property disposition management systems allowed private real estate agents to steal millions of dollars in FHA funds. Moreover, we reported that a direct correlation exists between the effectiveness of internal controls, the accuracy and timeliness of financial information, and the magnitude of losses incurred by FHA as well as by other HUD programs.[4]

We and HUD's Inspector General have been reporting on these management problems since the early 1980s. HUD has taken steps to address some of these problems and to strengthen FHA's financial position in the areas of property disposition, underwriting practices, monitoring of lenders, and reforms to accounting systems to prevent fraud in the future. However, we have concluded that much work remains to be done by HUD and FHA to resolve the underlying causes of FHA's problems, such as inadequate information and financial management systems. Any success achieved by HUD and FHA in reducing FHA's losses through better management will improve the financial health of the FHA Fund.

OUR ESTIMATES OF THE FUND'S ECONOMIC NET WORTH

The Fund had amortized insurance-in-force valued at about $286 billion as of September 30, 1992, and $269 billion as of September 30, 1993. To estimate the economic net worth of, and resulting capital ratios for, these loans over their life of up to 30 years, we developed an economic model of FHA's home loan program. We generated three different economic scenarios, assuming for each a different rate of appreciation in house prices over the next 30 years. The actual economic net worth and capital ratios of the Fund--and the validity of our estimates--will depend on a number of future economic factors, including the rate of appreciation in house prices over the life of the FHA mortgages of up to 30 years. This factor is significant because, as house prices rise, the borrowers' equity increases and the probability of defaults and subsequent foreclosures decreases. The house price appreciation, interest, and unemployment rates we used were based on forecasts from DRI/McGraw-Hill, Inc., a private economic forecasting company.

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[4]See Impacts of FHA Loan Policy Changes on Its Cash Position (GAO/T-RCED-90-70, June 6, 1990); HUD Reforms: Progress Made Since the HUD Scandals but Much Work Remains (GAO/RCED-92-46, Jan. 31, 1992); and Letter to the Ranking Minority Member, Subcommittee on Housing and Community Development, House Committee on Banking, Finance and Urban Affairs (B-249052, Sept. 30, 1992).

A more detailed discussion of our modeling approach for forecasting the economic net worth of FHA's Fund appears in appendix I. We will present a complete description of our models in our report to the Subcommittee.

Economic Net Worth Estimates of FHA's Fund Under Three Scenarios

Table 1 presents our estimates of the economic net worth and resulting capital ratios for the FHA mortgage loans outstanding as of September 30, 1992, and September 30, 1993, under each of our three economic scenarios. Although future rates of appreciation in house prices are uncertain, to ensure that our estimates were conservative, we placed greater reliance on our mid-range baseline economic scenario because it assumes a slightly lower house price appreciation rate than the rate forecasted by DRI/McGraw-Hill, Inc. Under this scenario, we estimated that the Fund had an economic net worth of about $600 million and resulting capital ratio of 0.21 percent at the end of fiscal year 1992. We also estimated that the Fund had an economic net worth of about $4.9 billion and resulting capital ratio of 1.83 percent at the end of fiscal year 1993. This estimate represents an improvement of about $7.6 billion from the lowest level reached by the Fund--a negative $2.7 billion estimated by Price Waterhouse at the end of fiscal year 1990.

Under our low-case economic scenario, which assumes a lower rate of appreciation in house prices than our baseline, we estimated that the Fund's economic net worth and capital ratios would be lower. Conversely, under our high-case economic scenario, which assumes a higher rate of appreciation in house prices than our baseline, we estimated that the Fund's economic net worth and capital ratios would be greater.

Table 1: GAO's Estimates of the Economic Net Worth and Capital Ratios of FHA's Fund as of September 30, 1992, and 1993

	Estimated economic net worth (in billions of dollars)		Estimated capital ratios (percentage)	
GAO scenarios	FY 1992	FY 1993	FY 1992	FY 1993
High-case	$0.99	$5.2	0.35	1.92
Baseline case	0.60	4.9	0.21	1.83
Low-case	-0.34	4.0	-0.12	1.47

Factors Contributing to the Fiscal Year 1993 Growth in the Fund's Economic Net Worth

As shown in table 1, we estimate that the economic net worth of the Fund increased under our baseline scenario by about $4.3 billion during fiscal year 1993. This increase occurred even though during fiscal year 1993 large numbers of FHA borrowers lowered their interest rates by refinancing their mortgages conventionally, which resulted in partial refunds of their insurance premiums. The financial improvement in the Fund is attributable to several economic and program factors working together to (1) increase the estimated economic net worth of loans endorsed by FHA in fiscal year 1992 and earlier years and (2) result in our estimate of a positive contribution to economic value made by those loans endorsed by FHA in fiscal year 1993. Table 2 summarizes the factors contributing to the $4.3 billion increase in economic net worth during fiscal year 1993.

Table 2: Factors Contributing to the Increase in Economic Net Worth of FHA's Fund During Fiscal Year 1993

Economic and program factors	Fiscal year 1993 increase in economic net worth (in billion of dollars)	
Changes in value of fiscal year 1992 and earlier years' loans		
Improvement due to actual loan performance data in 1993	$1.0	
Lower forecasted foreclosures and prepayments in 1994 and beyond	0.3	
Reduction in premium refunds paid	0.5	
Interest earned on investments	0.7	
Other factors	0.3	
Total changes in value of fiscal year 1992 and earlier years' loans		$2.8
Value added by fiscal year 1993 loans		1.5
Total change in value of the Fund in fiscal year 1993		$4.3

We estimate under our baseline scenario that as of the end of fiscal year 1993, the contribution made to the economic net worth of the Fund on the basis of loans endorsed by FHA in fiscal year 1992 and earlier years increased about $2.8 billion from $0.6 billion at the end of fiscal year 1992 to $3.4 billion at the end of fiscal year 1993. This large increase accounts for about 65 percent of the increase in the Fund's economic value; the remaining 35 percent, or $1.5 billion, was attributable to the value added by fiscal year 1993 loans.

The $2.8 billion increase in the Fund's value is attributable to four primary factors. About $1 billion, or 35 percent, of this increase is attributable to updated data showing that these loans performed better in fiscal year 1993 than previously forecasted. This occurred, in part, because during fiscal year 1993 house prices increased more rapidly and the unemployment rate was lower than in previous economic forecasts. About $0.3 billion, or 11 percent, of the increase is due to our

revised forecasts for loan foreclosures and prepayments for these loans during fiscal year 1994 and beyond. These revisions resulted largely from revised assumptions of future economic conditions that, in combination, had a favorable financial effect on the Fund. About $0.5 billion, or 18 percent, of the increase occurred because our 1993 forecast takes into account that effective January 1, 1994, FHA reduced the amount of premium refunds it will pay to borrowers who pay their mortgages in full before the end of their mortgage terms. Interest earned on investments accounted for $0.7 billion, or 25 percent, of the increase; the remaining 11 percent was attributable to other factors.

We estimate, under our baseline scenario, that loans endorsed by FHA in fiscal year 1993 contributed about $1.5 billion dollars to the economic net worth of the Fund. This represents the second consecutive year in which the Fund's new loans made a substantial contribution to the Fund's economic value.[5]

Our analysis of the loans endorsed by FHA in fiscal year 1993 also shows the importance of the program changes made by the Congress and FHA in recent years to the Fund's economic value. Beginning on July 1, 1991, FHA borrowers were subject to the higher premium payments mandated by the Omnibus Budget Reconciliation Act of 1990. We estimate that if FHA borrowers in fiscal year 1993 had to pay only the pre-act premiums, the economic net worth of the Fund at the end of fiscal year 1993 would have been about $4.1 billion, or $.8 billion (16 percent) less than our baseline estimate of $4.9 billion. Similarly, we estimate that if FHA had not revised its premium refund schedule, the economic net worth of the Fund at the end of fiscal year 1993 would have been about $4.4 billion, or $0.5 billion (10 percent) less than our baseline estimate of $4.9 billion.[6]

SUBSTANTIAL PROGRESS MADE TOWARD ACTUARIAL SOUNDNESS

While FHA's Fund did not achieve the November 1992 mandated capital ratio of 1.25 percent of amortized insurance-in-force, it exceeded this ratio by the end of fiscal year 1993 (1.83 percent), making significant progress during that year toward achieving the November 2000 capital ratio of 2 percent needed for

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[5]We estimate that loans endorsed by FHA in fiscal year 1992 contributed about $1.2 billion to the economic value of the Fund.

[6]Our estimate of the effect of the change in the premium refund schedule takes into account the effect of a smaller refund on the likelihood of foreclosures and prepayments as well as on the size of the refunds.

actuarial soundness. However, whether the Fund will be able to achieve the capital ratio by November 2000 and maintain that ratio thereafter will depend on a number of factors that will prevail this year and over the next 6 years. These factors include (1) economic conditions; (2) program changes, such as those that affect the FHA premium; and (3) the demand for FHA loans. We did not attempt to project the economic net worth and capital ratio of the Fund to the year 2000 because these factors are likely to change, as happened recently when FHA reduced the up-front insurance premium that FHA borrowers must pay on their mortgages.

As shown in table 1, our estimates are sensitive to future economic conditions, particularly house price appreciation rates. The Fund will not perform as well if actual economic conditions that prevail over the next 30 years replicate those we assumed in our low-case economic scenario. Our estimate of economic value for our low-case economic scenario is about $0.9 billion, or 18 percent, less than our baseline scenario. Under economic scenarios having generally favorable economic conditions but lower rates of appreciation in house prices, such as our low-case economic scenario, FHA's Fund would likely experience higher claims. As a result, economic value would decline.

Similarly, HUD recently reduced the up-front insurance premium that FHA borrowers must pay on their mortgages. FHA reduced the up-front premium charged FHA buyers to 2.25 percent of the loan amount, down from 3 percent. We estimate that had the 2.25 percent premium, rather than 3 percent, been in effect in fiscal year 1993 and the demand for FHA mortgages was unchanged, the economic value of the Fund would have declined by about $460 million, or 9 percent, from our baseline estimate.

A decline in home buyers' demand for FHA-insured loans could also adversely affect the economic value of the Fund and the attainment of the November 2000 capital ratio. Home buyers' demand for FHA-insured loans depends, in part, on the alternatives available to them. For example, higher loan-to-value ratios result in reducing the cash needed by borrowers to purchase a home. Some private mortgage insurers recently announced a plan to offer mortgage insurance coverage on conventional 97-percent loan-to-value ratio mortgages, which brings their terms closer to FHA's 97.75-percent loan-to-value ratio on loans for properties exceeding $50,000 in appraised value. While potential home buyers must consider many other factors when financing their mortgages--such as the fact that FHA will finance the up-front premium as part of the mortgage loan--this action by private mortgage insurers could reduce the demand for FHA-insured mortgage loans.

PRICE WATERHOUSE'S ESTIMATES OF THE FUND'S ECONOMIC NET WORTH

Price Waterhouse has performed annual actuarial reviews of the Fund for FHA since 1990. In its most recent report dated June 6, 1994, Price Waterhouse reported that the Fund had an economic net worth of about $4.6 billion compared to GAO's estimate of $4.9 billion and a resulting capital ratio of 1.44 percent of the unamortized insurance-in-force as of the end of fiscal year 1993 compared to GAO's estimate of 1.83 percent of the amortized insurance-in-force. It also reported last year that the Fund's capital ratio at the end of fiscal year 1992 (0.43 percent) did not meet the 1.25 percent capital ratio established by legislation for 1992. Price Waterhouse's latest report also projects that the Fund will meet the year 2000 capital ratio of 2 percent of the unamortized insurance-in-force with a capital ratio of 3.40 percent and that the economic net worth of the Fund will be $15.3 billion. These projections are based on forecasted economic assumptions and the assumption that FHA does not change its premium and refund policies.

Although our estimate of the Fund's economic value exceeds Price Waterhouse's estimate by about 6 percent, in view of the uncertainty associated with any forecast of the performance of the Fund's loans over their life of up to 30 years, these estimates can be considered roughly equivalent. Each of us used somewhat different modeling techniques and assumptions that account for some of the $300 million difference. However, in general our model and Price Waterhouse's use similar statistical techniques and rely on many of the same key factors, such as rates of appreciation in house prices and changes in mortgage interest rates, as important determinants of mortgage terminations and the economic value of the Fund.

While our estimates of the Fund's economic value are similar, our estimate of the Fund's capital ratio is higher than Price Waterhouse's estimate--1.83 percent compared to 1.44 percent. While some of the difference results from the slightly higher economic net worth we estimated, the primary reason for this difference is the fact that we used a lower end of fiscal year 1993 insurance-in-force amount (amortized insurance-in-force) to calculate the capital ratio than Price Waterhouse--$269 billion compared to Price Waterhouse's $317 billion of unamortized insurance-in-force. As discussed previously, the capital ratio was defined by the act as the ratio of the Fund's economic net worth to its unamortized insurance-in-force.[7]

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[7]However, the act defined unamortized insurance-in-force as the remaining obligation on outstanding mortgages, a definition generally understood to apply to amortized insurance-in-force.

The insurance-in-force amount we use differs from the amount used by Price Waterhouse primarily because we deleted loan principal payments made on mortgages to date to arrive at an amortized insurance-in-force amount of $269 billion. We calculated the capital ratio on the basis of amortized insurance-in-force and not on unamortized insurance-in-force, as did Price Waterhouse. We used amortized insurance-in-force for our calculations because FHA insured mortgages are in fact fully amortized over the 30 year life of the loans. Price Waterhouse used unamortized insurance-in-force for its calculations so as to be consistent with its previous reports and because the data on unamortized insurance-in-force are considered more reliable than the data on amortized insurance-in-force. If we had used unamortized insurance-in-force ($317 billion) in calculating the capital ratio, our estimate of the capital ratio would have been 1.55 rather than 1.83.

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In summary, Mr. Chairman, FHA's Fund made significant progress during fiscal year 1993 toward achieving the capital reserves needed for actuarial soundness under the law. Clearly, the legislative and other program changes have helped restore the Fund's financial health and reverse the trend of the late 1980s and early 1990s toward insolvency. However, it should be recognized that fiscal year 1993 was an unusually good year for FHA because actual economic conditions and forecasts of future economic conditions were favorable. Nevertheless, forecasting economic net worth and resulting capital ratios to determine whether FHA will have the funds it needs to cover its losses over the life of the loans it has insured of up to 30 years is uncertain. Loan performance, and therefore economic net worth and capital ratios, will depend on a number of economic and other factors, particularly on the rate of appreciation in house prices and program policies such as premiums charged FHA borrowers that prevail over that period. Loan performance will also be affected by the demand for FHA-insured loans, a demand that depends, in part, on the alternatives available from private mortgage insurers. It is important to carefully balance desires to assist home buyers against the government's potential financial risk and liability and expectations of the housing market's future performance.

Mr. Chairman, this concludes my statement. We would be pleased to respond to any questions that you or Members of the Subcommittee may have.

GAO'S ECONOMIC MODEL

To estimate the economic net worth of FHA's Fund as of September 30, 1992, and September 30, 1993, and its resulting capital ratios under different economic scenarios, we examined existing studies on the single-family housing programs of both HUD and the Department of Veterans Affairs (VA), academic literature on the modeling of mortgage defaults and prepayments, and previous work performed by Price Waterhouse, HUD, VA, GAO, and others on modeling government mortgage programs. On the basis of this examination, we developed economic and cash flow models that we used to prepare our estimates. For these models, we used data supplied by FHA and DRI/McGraw-Hill, a private economic forecasting company.

Our economic analysis estimated the historical relationships between certain explanatory factors and the probability of loan foreclosure and prepayment. To estimate these relationships, we used data on the performance of FHA-insured home mortgage loans originated from fiscal years 1975 through 1993. Also, using our estimates of these relationships and of economic conditions, we developed a baseline forecast of future loan performance to estimate economic net worth and the resulting capital ratio. We then developed additional estimates that assumed higher and lower future rates of appreciation in house prices; the scenario with the lower rate of house price appreciation also assumed higher unemployment.

We estimated future house prices by multiplying the initial value of the property at the time of loan origination by the DRI/McGraw-Hill forecasts of the annual increase in the median house price not adjusted for inflation. The rate of change in the median house price reflects the price of houses actually sold each year. Because new houses are larger and include more amenities than existing homes, the median sales prices of new homes will usually increase faster than the median sales prices for existing homes. In addition, the value of existing homes depreciates over time. The relevant consideration to the FHA homeowner, however, is how much the value of his or her house has increased since purchase, not how much the value of the general housing stock has changed. Because of these considerations, we adjusted the estimated rate of appreciation in existing house prices downward by 2 percent annually to account for changes in housing quality and depreciation. Also, to ensure that our estimates were conservative, we subtracted an additional 1 percent annually from DRI's forecasts. While the rates of appreciation in house prices

we used were different for each state, the average[1] rates of appreciation for each fiscal year for our baseline scenario were 1993--2 percent; 1994--4 percent; 1995 through 1996--3 percent, 1997--4 percent, 1998--3.5 percent. DRI did not forecast rates of appreciation after 1998. We used a constant 3.5 percent rate for fiscal year 1999 and beyond.

In addition, we estimated unemployment rates by using state forecasts of unemployment as reported by DRI. The national average of the DRI unemployment forecasts is 6.6 percent in fiscal year 1993, falling to 5.5 percent in fiscal year 1998.

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[1]The averages were weighted by each state's 1993 FHA market share.

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