

GAO

Testimony

Before the Subcommittee on Housing Opportunity and
Community Development, Committee on Banking,
Housing and Urban Affairs
U.S. Senate

For Release
on Delivery
Expected at
10:30 a.m. EDT
Tuesday
June 2, 1998

HOMEOWNERSHIP

Achievements of and Challenges Faced by FHA's Single-Family Mortgage Insurance Program

Statement of Judy A. England-Joseph, Director
Housing and Community Development Issues,
Resources, Community, and Economic
Development Division



Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the single-family mortgage insurance program of the U.S. Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA). FHA insured about 740,000 mortgages representing over \$61 billion in single-family mortgage insurance during fiscal year 1997—ending the fiscal year with a total of about \$361 billion in single-family mortgage insurance outstanding.

Many changes have occurred in the single-family housing finance system since FHA was established in 1934 to insure housing loans made by private lenders. These changes include the advent of modern private mortgage insurance, the development of a secondary mortgage market, and the emergence of a number of public- and private-sector initiatives designed to expand affordable housing opportunities for home buyers. Given these developments, an ongoing debate has centered on whether there is still a need for FHA's single-family mortgage insurance program and, if so, what changes, if any, need to be made to the program. Critics of FHA contend that other housing finance players, such as the private mortgage insurers, are filling the need once filled exclusively by FHA. Supporters of FHA argue that its single-family program, which has insured at least 24 million home mortgages since its inception, remains the only way for some families to become homeowners and should be expanded.

My statement will discuss (1) the achievements of FHA's home mortgage insurance program, including the extent that home buyers use FHA insurance, the characteristics of these home buyers—including whether they were first-time home buyers—and how many of them might also qualify for private mortgage insurance; (2) how the insurance terms available through FHA's principal single-family mortgage insurance program compare with private mortgage insurance and guaranties from the U.S. Department of Veterans' Affairs; (3) other federal activities that promote affordable homeownership; and (4) challenges faced by FHA in ensuring the financial health of its Mutual Mortgage Insurance Fund—the insurance fund supporting most FHA-insured single-family mortgages.

My statement today is based primarily on reports we issued over the last 2 years. I will conclude with a brief discussion of the results of our recent work on two other FHA programs—the multifamily and Title I home improvement insurance programs. Although we designated HUD a high-risk area in 1994, my statement does not cover management challenges faced

by FHA's single-family operations, which we addressed in three recent testimonies, including one on May 7, 1998, before this Subcommittee.¹

In summary:

- FHA is a major participant in the single-family housing market. Of the approximately 3.8 million home purchase loans made in fiscal year 1996, FHA insured 16 percent. While most of these mortgages were not insured, about 39 percent, or about 1.5 million, were insured. FHA insured 42 percent of all insured home purchase loans in 1996 and fulfilled an even larger role in some specific market segments, particularly low-income home buyers and minorities.² However, most borrowers were able to obtain a home purchase mortgage, including low-income borrowers and minorities, without insurance by either FHA, the private mortgage insurers, or the Department of Veterans' Affairs.³ While about a third of the loans FHA insured in 1995 might have qualified for private mortgage insurance, the other two-thirds probably would not have qualified, on the basis of the loan-to-value—the mortgage amount as a percentage of the value of the home—and qualifying ratios of the loans FHA insured.
- The FHA and Department of Veterans' Affairs programs permit borrowers to make smaller down payments and have higher total-debt-to-income ratios than allowed by private mortgage insurers. FHA's program differs from both the private mortgage insurers' and the Department of Veterans' Affairs programs in that it allows closing costs to be financed in the mortgage, insures loans only up to a maximum amount of \$170,362 while private mortgage insurers and the Department of Veterans' Affairs permit insurance of larger loans, and provides nearly full insurance coverage to lenders.
- In addition to FHA and the Department of Veterans' Affairs, the federal government promotes affordable homeownership through programs run by HUD, the U.S. Department of Agriculture's Rural Housing Service, the

¹HUD Management: Information and Issues Concerning HUD's Management Reform Efforts (GAO/T-RCED-98-185, May 7, 1998), Homeownership: Management Challenges Facing FHA's Single-Family Housing Operations (GAO/T-RCED-98-121, Apr. 1, 1998), and Home Improvement: Weaknesses in HUD's Management and Oversight of the Title I Program (GAO/T-RCED-98-177, Apr. 30, 1998).

²"Low-income" refers to a borrower with an income no greater than 80 percent of the median income in the Metropolitan Statistical Area where the borrower is located.

³Although the Department of Veterans' Affairs actually guarantees mortgages rather than insuring them, this testimony uses the term "mortgage insurance" to refer to the mortgage guaranty provided by the Department of Veterans' Affairs as well as the mortgage insurance provided by FHA and private mortgage insurers. The Department of Veterans' Affairs' guaranty is available only to U.S. veterans and their families.

Federal Home Loan Bank System,⁴ state housing finance agencies, and the Neighborhood Reinvestment Corporation. Although these other federal programs share FHA's mission to assist households who may be underserved by the private mortgage market, none reach as many households as FHA. Several of these other programs assist home buyers by combining their assistance with FHA mortgage insurance. The federal government also promotes homeownership among home buyers who might otherwise be underserved through requirements placed upon the Federal National Mortgage Association, Federal Home Loan Mortgage Corporation,⁵ and certain lenders.

- Although FHA's single-family program is financially self-sufficient, there are challenges facing FHA today, including reducing the losses it incurs on foreclosed properties, maintaining financial self-sufficiency in the face of economic and other factors that could adversely affect future program costs, and resolving year 2000 computing risks.

Before I discuss these issues in greater detail, let me briefly explain how FHA's single-family mortgage insurance program operates.

FHA's Single-Family Mortgage Insurance Program

About 3.8 million borrowers took out mortgages in 1996 for purchasing homes, according to information collected through requirements contained in the Home Mortgage Disclosure Act (HMDA).⁶ While most of these mortgages were not insured, about 39 percent, or about 1.5 million, were insured. FHA's share of the home purchase mortgage market was 16 percent in fiscal year 1996, the private mortgage insurers' (PMIS) share was 17 percent, and the Department of Veterans' Affairs (VA) share was 5 percent. Lenders usually require mortgage insurance when a home buyer has a down payment of less than 20 percent of the value of the home. In these cases, the loan-to-value (LTV) ratio of the mortgage is higher than 80 percent. Most lenders require mortgage insurance for these loans because they are more likely to default than loans with lower LTV ratios. If a loan with mortgage insurance defaults, the lender may foreclose on the loan and collect all or a portion of the losses from the insurer.

Virtually all single-family mortgage insurance is provided by PMIS, FHA, and VA. In general, PMIS operate standard programs for typical borrowers and

⁴The Federal Home Loan Bank System is a federally chartered, privately owned system of 12 banks that exist to facilitate the extension of mortgage credit.

⁵Government-sponsored enterprises that provide a secondary market for many home mortgages.

⁶This figure is based on mortgages reported by lenders through HMDA. However, the number of mortgages written in 1996 is somewhat higher because HMDA collects information on most but not every mortgage.

special affordable programs for qualified borrowers who have fewer down payment funds and need increased underwriting flexibility.⁷ FHA provides most of its single-family mortgage insurance through the Section 203(b) program. The Section 203(b) program has not required any federal funds to operate because FHA has collected enough revenue from insurance premiums and foreclosed property sales to cover claims and other expenses. FHA also operates some smaller, specialized single-family mortgage insurance programs. A primary goal of FHA's single-family programs is to assist households that may be underserved by the private market. VA provides insurance through its Home Loan Guaranty Program to U.S. veterans and their families.

FHA, VA, and PMIS provide lenders with guidelines for deciding whether or not a mortgage is eligible for mortgage insurance. In addition, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) establish their own guidelines for the loans they will purchase in the secondary mortgage market. A borrower's ability to repay the mortgage is often evaluated by computing the ratios of the borrower's total debt burden and housing expenses to his/her income (referred to as "qualifying ratios"). The "total-debt-to-income ratio" compares all of the borrower's long-term debt payments, including housing expenses, with his/her income. The "housing-expense-to-income ratio" compares the borrower's expected housing expenses with his/her income.

The HMDA database contains information on mortgages insured through FHA's principal single-family mortgage insurance program—the Section 203(b) program—and loans insured through FHA's smaller single-family mortgage insurance programs, but does not distinguish between them. Consequently, sections of this testimony on FHA's market share, the characteristics of FHA borrowers, and the borrowers who may have qualified for private mortgage insurance pertain to all single-family loans insured by FHA.

FHA Achievements in Insuring Single-Family Mortgages

FHA has been a major player in single-family home financing for over 60 years and it remains so today—particularly in certain market segments. Between 1986 and 1990, FHA was the largest insurer of single-family mortgages. The factors contributing to FHA's large market share during these years may include an increase in FHA's maximum loan limit in 1988 and economic downturns in some areas of the country that decreased the

⁷Underwriting is the process of analyzing a borrower's willingness and ability to repay a loan.

availability of private mortgage insurance. Except for FHA's loan limit,⁸ the terms, such as maximum LTV ratio, under which FHA and VA mortgage insurance are available do not generally vary across different geographic locations, according to program guidelines. However, PMI companies may change the conditions under which they will provide new insurance in a particular geographic area to reflect the increased risk of losses in an area experiencing economic hardship. By tightening up the terms of the insurance they would provide, PMIs may have decreased their share of the market in economically stressed regions of the country.

However, throughout the period from 1991 through 1996, the PMIs had a greater share of all insured single-family mortgage originations than FHA or VA. This change may be a result, in part, of increased premiums for FHA insurance implemented as a result of the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508). By 1996, the PMIs' share of insured home purchase mortgages was 44 percent, FHA's was 42 percent, and VA's was 13 percent.

FHA Is an Important Source of Mortgage Insurance in Certain Markets

In our report on FHA's role,⁹ we found that in 1994, FHA-insured home purchase loans were concentrated to a greater extent on low-income and minority borrowers, first-time home buyers, and borrowers with higher LTV ratios than those with loans insured by private mortgage-insurers. In addition, solely on the basis of our analysis of the LTV and qualifying ratios of borrowers who obtained loans in 1995, 66 percent of FHA's borrowers might not have qualified for private mortgage insurance for the loans they received. However, it is important to note that as with home buyers in general, most low-income and minority home buyers who obtained mortgages in fiscal year 1996 did not have insured mortgages.

Recent HMDA, Mortgage Insurance Companies of America (MICA), and HUD data show that FHA-insured loans continue to be concentrated to a greater extent on borrowers with these same characteristics than those with loans

⁸FHA's loan limit may differ among geographic areas to reflect differentials in the cost of housing. The maximum loan amount permitted under FHA's program for single-family homes in the highest-cost areas of the continental United States is currently set at \$170,362. In its fiscal year 1999 budget, HUD stated it would seek legislation to increase the maximum mortgage amount insurable under the FHA single-family program to \$227,150 in all areas of the country.

⁹Homeownership: FHA's Role in Helping People Obtain Home Mortgages (GAO/RCED-96-123, Aug. 13, 1996).

insured by private mortgage-insurers. Specifically, we estimate based on HMDA, MICA, and HUD data for loans in 1996 that:¹⁰

- FHA insured 23 percent of the 984,495 home purchase loans made to low-income home buyers, and such home buyers represented about 39 percent of FHA-insured loans. We also estimate that FHA insured more of these loans than the PMIS (14 percent) or VA (5 percent).
- FHA insured 30 percent of all loans made to minority home buyers, and such home buyers represented about 31 percent of FHA-insured loans. FHA insured more loans for minority borrowers in 1996 than the PMIS (14 percent) and substantially more than the VA (6 percent).
- About 74 percent of FHA-insured loans in 1996 were made to first-time home buyers. FHA insured a higher percentage of loans for first-time home buyers than its overall share of the insured home purchase market.
- While 63 percent of FHA-insured loans made in 1996 had LTV ratios exceeding 95 percent, only about 7 percent of conventional loans below the maximum FHA loan limit had LTV ratios exceeding 95 percent in 1997.

FHA's Insurance Fund Exceeds Statutory Reserve Targets

Another major achievement of FHA's single-family mortgage insurance program has been to restore the financial health of the Mutual Mortgage Insurance Fund (the Fund)—the insurance fund supporting 91 percent of the dollar value of FHA-insured single-family mortgages outstanding as of the end of fiscal year 1997. According to Price Waterhouse's 1998 actuarial study, the Fund had an economic value/reserves¹¹ of about \$11.3 billion as of September 30, 1997. Over time, insurance premiums and other income have more than covered costs. The \$11.3 billion estimate represents an improvement of about \$14 billion from the lowest level reached by the Fund—a negative \$2.7 billion economic value/reserves estimated by Price Waterhouse at the end of fiscal year 1990. Price Waterhouse also reported that the Fund's capital reserve ratio (economic value/reserves as a percentage of value of outstanding loans) was 2.81 percent surpassing the legislative target for reserves (a 2-percent capital ratio by November 2000).¹² In addition, Price Waterhouse reported that the Fund

¹⁰HMDA data were adjusted to compare with MICA data on PMI loans. HMDA data include approximately 93 percent of all FHA-insured home purchase loans. MICA's data, however, include nearly all loans insured by PMIs. To determine the relative share of the market of loans in the HMDA database held by FHA and PMIs, HMDA data were increased by a relevant percentage. Also, some MICA and HMDA data were deleted because it was not valid or of poor quality.

¹¹The current assets available to the Fund, plus the net present value of all future cash inflows and outflows expected to result from mortgages insured under the Fund.

¹²The Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508), enacted in November 1990, required the Secretary of HUD to endeavor to ensure a capital ratio of 2 percent by November 2000 and maintain that ratio or a higher one at all times thereafter.

will meet the legislative target for fiscal year 2000. They estimate that by then the Fund will have a capital ratio of 3.21 and economic value/reserves of about \$15.7 billion.

Single-Family Mortgage Insurance Terms Offered by FHA, PMIs, and VA Are Different

In our 1996 report on FHA's role, we reported that the FHA, PMIS, and VA mortgage insurance programs differed in terms of maximum LTV ratios and mortgage amounts, the financing of closing costs, and the amount that each will pay lenders to cover the losses associated with foreclosed loans, according to the guidance prepared by the insurers for lenders. Specifically, in our 1996 report, we reported that while both FHA and VA could insure loans with effective LTVs ratios that exceed 100 percent (due to the financing of closing costs or other fees), PMIS did not offer insurance for loans with LTVs ratios greater than 97 percent. Recently, both Fannie Mae and Freddie Mac announced the introduction of conventional 97 percent LTV mortgage products that offer many of the advantages of FHA's single-family program. Both programs—Fannie Mae's "Flexible 97 Mortgage" and Freddie Mac's "Alt 97 Mortgage"—allow down payments as low as 3 percent that can be funded through gifts, unsecured loans from relatives, or grants from nonprofits or local governments.

With regard to limits on loan size, FHA today may insure loans only up to a maximum of \$170,362 in certain areas with high housing costs, while PMIS and VA permit insurance of larger loans. In connection with settlement costs, FHA allows borrowers to finance most closing costs, but PMIS and VA do not. However, both FHA and VA allow borrowers to finance their insurance premiums. Finally, while FHA protects lenders against nearly 100 percent of the loss associated with a foreclosed mortgage, PMIS and VA limit their coverage to a portion of the mortgage balance. PMIS generally cover only 20 to 35 percent, and VA covers only 25 to 50 percent of the mortgage balance, even if a loss exceeds that amount.

With regard to underwriting standards used by FHA, PMIS, and VA, we reported that while there was some differences in qualifying ratios, the guidance provided by the insurers showed few other clear differences in the underwriting standards for borrowers. Each of the insurers permits the lenders to consider compensating factors, such as a large down payment, when a borrower does not meet the qualifying ratios. In addition, although lenders must apply established credit standards, each of the insurers relies on the individual judgment and interpretation of the lenders in evaluating the credit history of borrowers. Since the issuance of our 1996 report, automated underwriting systems that evaluate mortgage applications have

been developed which can reduce processing time significantly. Under a joint effort with Freddie Mac, HUD has approved Freddie Mac's Loan Prospector automated underwriting system to underwrite FHA loans.

The Federal Government Promotes Affordable Homeownership in Many Other Ways

Besides FHA's Section 203(b) and VA's single-family loan programs, the federal government is involved in many other efforts to make homeownership affordable. In our 1996 report on FHA's role, we reported that HUD at that time operated three grant programs—the Community Development Block Grant program, the HOME Investment Partnership program, and Housing Opportunities for People Everywhere—that promote affordable homeownership. The Federal Home Loan Bank System (FHLBank System) has its Affordable Housing Program and Community Investment Program, which provide subsidies, subsidized advances, or other advances to member institutions to be used to fund affordable housing projects and loans to home buyers. The Department of Agriculture's Rural Housing Service operates a subsidized direct loan program for low- and very-low-income rural Americans and a guaranteed loan program for moderate-income rural Americans. The state housing finance agencies, through the use of federal tax-exempt mortgage revenue bonds, provide financing for affordable homeownership. The Neighborhood Reinvestment Corporation, through its network of local development organizations and its secondary market organization, promotes affordable homeownership primarily through second mortgages and home buyer education. These programs provide assistance in the form of grants, direct loans, guaranties, interest subsidies, and other forms.¹³

We also reported that there are several important distinctions between FHA's single-family mortgage insurance programs and these other federal programs. First, FHA serves more homeowners than the other programs combined. In 1995, about 570,000 households took out insured loans through FHA's programs while about 500,000¹⁴ homeowners may have been reached by the other programs. In addition, at least half of the other programs require federal funds, while FHA's Section 203(b) program does not. Furthermore, the other programs are generally targeted at borrowers with low incomes or at borrowers who are otherwise underserved by the private market to a greater extent than FHA's program. FHA's Section 203(b) program is not restricted to low-income or otherwise underserved

¹³In addition, the Federal Deposit Insurance Corporation has a small affordable housing program and administers the former Resolution Trust Corporation's affordable housing program.

¹⁴It is difficult to estimate the total number of homeowners assisted because individuals may benefit from more than one program. The number presented here is overstated by an unknown amount.

borrowers. In fact, diversifying risk by serving a wide variety of borrowers may have actually helped the program operate without federal funds, according to industry officials.

Several of the other federal programs assist low- and moderate-income home buyers by combining their assistance with FHA mortgage insurance. A substantial portion of the mortgages made through state housing finance agencies and HUD's Housing Opportunities for People Everywhere program were insured by FHA in 1994. Similarly, private mortgage insurance may also be combined with assistance from federal housing programs. For example, one private mortgage insurer that we reviewed provided insurance for mortgages assisted through a Neighborhood Reinvestment Corporation program.

The federal government also promotes homeownership by requiring major housing finance players to address housing finance needs. Specifically, Fannie Mae and Freddie Mac have legislatively-set goals for affordable homeownership related to their purchase of mortgages made to low- and moderate-income borrowers and in areas of low- and moderate-income. In addition, banks and thrifts are encouraged to lend in all areas of the communities they serve, including low- and moderate-income areas, through the Community Reinvestment Act.¹⁵ The federal government also promotes homeownership for the entire general public through federal tax provisions, such as the home mortgage interest deduction. The Joint Committee on Taxation estimates that, for 1995, the mortgage interest deduction alone was the second largest tax expenditure that the government provides to individuals, totaling an estimated \$53.5 billion—exceeding the total tax expenditures given to corporations.¹⁶

¹⁵In addition, the FHLBank System operates a Community Support Program that, among other things, requires FHLBank members to meet standards of community investment or service in order to maintain continued access to long-term FHLBank System advances. Among other information, a member is required to provide the public disclosure portion of the member's most recent CRA evaluation and a description of how the member assists first-time home buyers.

¹⁶A "tax expenditure" is a reduction in individual and corporate income tax liabilities that result from special tax provisions or regulations that provide benefits to particular taxpayers.

Challenges Faced by FHA's Single-Family Mortgage Insurance Fund

While FHA's Fund is financially healthy and has surpassed the legislative target for reserves, there are challenges facing FHA today, including reducing the losses it incurs on foreclosed properties, maintaining financial self-sufficiency in the face of economic and other factors that could adversely affect future program costs, and resolving year 2000 computing risks. The greater the extent that FHA can improve the efficiency of its lending operations, the greater its ability to maintain financial self-sufficiency in an uncertain future and meet the needs of lower-income borrowers through either increasing the number of borrowers served or reducing the cost of their mortgage insurance.

Losses Incurred by FHA on Foreclosed Single-Family Properties Are Large

Each year, mortgage lenders foreclose on a portion of the FHA-insured mortgages that go into default and file insurance claims with HUD for their losses. Although FHA has always received enough in premiums from borrowers and other revenues to more than cover these losses, losses totaled about \$12.8 billion in 1994 dollars, or about \$24,400 for each foreclosed and subsequently sold single-family home over the 19-year period ending in 1993. According to a Price Waterhouse analysis, cumulative foreclosure rates as of September 30, 1997, ranged from a low of 4 percent of the loans FHA insured in the mid-1970s to 19 percent of the loans insured in fiscal year 1981, for loans insured between fiscal years 1975 and 1991. Losses sustained by FHA on foreclosures are financed by the Fund, thereby ultimately reducing the Fund's ability to withstand economic downturns, and possibly resulting in higher premiums for FHA borrowers.

The impact that foreclosures can have on the financial health of the Fund was demonstrated during the 1980s. Until that time, the Fund remained relatively healthy. However, in the 1980s losses were substantial primarily because foreclosure rates were high in economically stressed regions, particularly in the Rocky Mountain and Southwest regions. By the end of fiscal year 1990, the Fund's economic value/reserves were estimated at about a negative \$2.7 billion. If the Fund were unable to finance program and administrative costs, the U.S. Treasury would have to directly cover lenders' claims and administrative costs.

More recently, claims paid by FHA in fiscal year 1997 were higher than expected. Actual claim payments for single-family insured loans totaled \$4.5 billion, much higher than the \$2.4 billion projected for fiscal year 1997 in the fiscal year 1998 budget. Similarly, actual property acquisitions, properties sold, and the end of fiscal year 1997 inventory level of

single-family properties owned by HUD were much higher than projected in the fiscal year 1998 budget. Actual property acquisitions were \$4.25 billion compared with \$1.9 billion projected, properties sold were \$3.8 billion compared with \$2.5 billion projected, and the September 30, 1997, inventory of properties totaled \$2 billion compared with \$880 million projected. HUD attributed these problems in part to increasing claims, especially those from adjustable-rate-mortgages (ARMs). Notwithstanding these unexpected financial results, the present value of estimated cash inflows to FHA's single-family mortgage insurance program exceed the present value of cash outflows by \$1.8 billion for fiscal year 1997.

With regard to FHA's ability to manage risks associated with defaults, annual audits of FHA's financial statements have identified weaknesses in FHA's ability to manage risks associated with troubled single-family insured mortgages.¹⁷ The audit report on FHA's fiscal year 1997 financial statements¹⁸—the most recent available—identified a material internal control weakness applicable, in varying degrees, to both the single-family and multifamily programs. Specifically, the report stated that FHA must place more emphasis on early warning and loss prevention for insured mortgages by, among other things, focusing its quality assurance enforcement actions on the accuracy of delinquency and default data submitted to FHA. According to the report, FHA does not have adequate systems, processes, or resources to effectively identify and manage risks in its insured portfolios. Timely identification of troubled insured mortgages is a key element of FHA's efforts to target resources on insured high-risk mortgages. Troubled insured mortgages must be identified before FHA can institute loss mitigation techniques that can reduce eventual claims. The report notes that although the single-family insured mortgage portfolio is large, automated monitoring of insured mortgages using statistical and trend analysis can be used effectively.

Other Factors That Could Affect the Financial Health of the Fund

As we have reported,¹⁹ the Fund's ability to maintain the target ratio will depend on many economic, program-related, and other factors that will affect the financial health of the Fund in the future. These factors include

¹⁷The Chief Financial Officers Act of 1990 required HUD and some other agencies to report annually to the Congress on their financial status and any other information needed to fairly present the agencies' financial position and results of operations. To meet part of this requirement, HUD's Office of Inspector General contracts with a public accounting firm to conduct annual audits of FHA's financial statements.

¹⁸Federal Housing Administration Audit of Fiscal Year 1997 Financial Statements, prepared by KPMG Peat Marwick LLP for the Office of Inspector General (98-FO-131-0003, Mar. 9, 1998).

¹⁹Mortgage Financing: FHA Has Achieved Its Home Mortgage Capital Reserve Target (GAO/RCED-96-50, Apr. 12, 1996).

(1) economic conditions, (2) uncertainty surrounding the projections of the performance of FHA's streamlined refinanced²⁰ and ARM loans, and (3) risks associated with the demand for FHA's loans. We also reported in May 1997,²¹ that reducing FHA's insurance coverage to the level permitted for VA home loans would likely reduce the Fund's exposure to financial losses, thereby improving its financial health.

Estimates of economic value/reserves of the Fund are sensitive to future economic conditions, particularly house price appreciation rates. The Fund will not perform as well if the economic conditions that prevail over the next 30 years replicate those assumed in pessimistic economic scenarios. Price Waterhouse's estimate of the Fund's economic value/reserves for its pessimistic economic scenario is about \$2.4 billion, or 21 percent, less than its estimate of \$11.3 billion as of September 30, 1997.

Also, the substantial refinancing of FHA's loans and the growth in the number of FHA ARMs insured in recent years has created a growing class of FHA borrowers whose future behavior is more difficult to predict than the typical FHA borrower's. FHA's streamlined refinanced mortgages and ARMs accounted for about 32 percent of the dollar value of FHA's loans outstanding at the end of fiscal year 1997—streamlined refinanced mortgages accounted for about 15 percent of the value of the outstanding loans and ARMs for about 17 percent. FHA has little experience with streamlined refinanced mortgages and ARMs and the tendency for such loans to be foreclosed and/or prepaid.

Because FHA insured properties for which mortgages were streamlined refinanced were not required to be appraised, the initial LTV ratio of these loans—a key predictor of the probability of foreclosure—is unknown.²² The impact of these loans on the financial health of the Fund is probably positive, since they represent preexisting FHA business whose risk has been reduced through lower interest rates and lower monthly payments. However, the lack of experience with these loans increases the uncertainty associated with their expected foreclosure rates.

²⁰FHA's streamlined refinanced mortgages are those for which an FHA-insured mortgage loan has been repaid from the proceeds of a new FHA-insured loan using the same property as security. Borrowers often refinance mortgage loans to lower their monthly principal and interest payments when interest rates decline. Appraisals and credit checks are not required by FHA on these loans, and borrowers cannot obtain cash from the transaction except for minor adjustments not exceeding \$250 at closing.

²¹Homeownership: Potential Effects of Reducing FHA's Insurance Coverage for Home Mortgages (GAO/RCED-97-93, May 1, 1997).

²²Also, FHA's data do not indicate whether there are any existing second mortgages on these properties.

This refinancing activity also raises questions about the credit-quality of the loans that were not refinanced despite the fall in interest rates. Since, under these circumstances, most borrowers who could refinance would find it to their financial advantage to do so, those borrowers who did not refinance may not have been able to qualify for a new loan. This suggests that future foreclosure rates on these loans, which originated in previous years when interest rates were higher, may be greater than forecasted. As additional years of experience with these loans are gained, their effect on the Fund's financial status will become more certain.

In addition, new developments in the private mortgage insurance and secondary mortgage markets may increase the average risk of future FHA-insured loans. Home buyers' demand for FHA-insured loans depends, in part, on the alternatives available to them. Some PMIS have begun offering mortgage insurance coverage on conventional mortgages with a 97-percent LTV ratio, which brings their terms closer to FHA's 97.75-percent LTV ratio on loans for properties exceeding \$50,000 in appraised value. In addition, as discussed previously, Fannie Mae and Freddie Mac recently announced the introduction of conventional 97 percent LTV mortgage products that offer many of the advantages of FHA's single-family loans.

While potential home buyers may 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,²³ this action by PMIS, Fannie Mae, and Freddie Mac could reduce the demand for FHA-insured mortgage loans. In particular, by lowering the required down payment, PMIS and others might attract some borrowers who might have otherwise insured their mortgages with FHA. If by selectively offering these low down payment loans, the conventional market is able to attract FHA's lower-risk borrowers, such as borrowers with better-than-average credit histories or payment-to-income ratios, new FHA loans may become more risky on average. If this effect is substantial, the economic value/reserves of the Fund may be adversely affected, and it may be more difficult for the Fund to maintain a 2-percent capital ratio.

Lastly, FHA insures private lenders against nearly all losses resulting from foreclosures on single-family homes it insures. However, VA under its single-family mortgage guaranty program covers only 25 to 50 percent of the original loan amount against losses incurred when borrowers default on loans, leaving lenders responsible for any remaining losses. In our

²³Because FHA will finance the up-front portion of the premium, the effective LTV ratio on FHA-insured loans can be higher than 100 percent.

May 1997 report, we concluded that reducing FHA's insurance coverage to the level permitted for VA home loans would likely reduce the Fund's exposure to financial losses, thereby improving its financial health. As a result, the Fund's ability to maintain financial self-sufficiency in an uncertain future would be enhanced. However, reducing FHA's insurance coverage does pose trade-offs affecting lenders, borrowers, and FHA's role such as diminishing the federal role in stabilizing markets. Borrowers most likely affected would be low-income, first-time, and minority home buyers and those individuals purchasing older homes.

To illustrate the financial impact of reducing FHA's insurance coverage, our report pointed out that if insurance coverage on FHA's 1995 loans were reduced to VA's levels and a reduction in FHA lending volume assumed, the economic value of the loans we estimate would be \$52 million to \$79 million greater than our estimate assuming no coverage and volume reductions. Reducing FHA's insurance coverage would likely improve the financial health of the Fund because the reduction in claim payments resulting from lowered insurance coverage would more than offset the decrease in premium income resulting from reduced lending volume.

The amount of savings that would be realized by reducing FHA's insurance coverage would depend on future economic conditions, the volume of loans made, the relationship of the number of higher-risk and lower-risk borrowers that would leave the program, and whether some losses may be shifted from FHA to the Government National Mortgage Association.

FHA Faces Year 2000 Risks

The financial health of FHA's Fund could also be adversely affected by Year 2000 computing risks. In March 1998, we testified²⁴ on the nation's Year 2000 computing crisis as well as our initial assessment of HUD's Year 2000 program. The upcoming change of century is a sweeping and urgent challenge for public and private-sector organizations.²⁵ We reported that, among other things, HUD is behind schedule on a number of its mission-critical systems. While the delays on some of these systems are of only a few days, some are experiencing delays of 2 months or more. This is significant because HUD is reporting that 5 of its mission-critical systems

²⁴Year 2000 Computing Crisis: Strong Leadership Needed to Avoid Disruption of Essential Services (GAO/T-AIMD-98-117, Mar. 24, 1998).

²⁵For the past several decades, automated information systems have typically represented the year using two digits rather than four in order to conserve electronic data storage space and reduce operating costs. In this format, however, 2000 is indistinguishable from 1900 because both are represented only as 00. As a result, if not modified, computer systems or applications that use dates or perform date- or time-sensitive calculations may generate incorrect results beyond 1999.

have “failure dates”—the first date that a system will fail to recognize and process dates correctly—between August 1, 1998, and January 1, 1999.

In this regard, we reported that HUD’s system for processing claims made by lenders on defaulted single-family-home loans is 75 days behind schedule for renovation. The system is now scheduled to be implemented on November 4—only 58 days shy of January 1, 1999, the date that HUD has determined the current system will fail. In fiscal year 1997, this system processed, on average, a reported \$354 million of lenders’ claims each month for defaulted insured loans. If this system fails, these lenders will not be paid on a timely basis; the economic repercussions could be widespread.

To better ensure completion of work on mission-critical systems, HUD officials have recently decided to halt routine maintenance on five of its largest systems. Further, according to Year 2000 project officials, if more delays threaten key implementation deadlines for mission-critical systems, they will stop work on nonmission-critical systems in order to focus all resources on the most important ones. We concurred with HUD’s plans to devote additional attention to its mission-critical systems.

Recent GAO Work on Other FHA Programs

Before closing, Mr. Chairman, I will discuss two other FHA issues that I understand are of interest to the Subcommittee.

In April 1998, we reported on our review of two risk-demonstration programs aimed at facilitating the financing of affordable multifamily housing and HUD’s administration of them.²⁶ The two risk-sharing demonstration programs established by the Housing and Community Development Act of 1992 offer incentives to financial institutions to facilitate the financing of affordable multifamily housing and to make that financing available in a timely manner. One program provides credit enhancement²⁷ to state and local housing finance agencies, while the other provides reinsurance²⁸ to qualified financial institutions.

²⁶Housing Finance: FHA’s Risk-Sharing Programs Offer Alternatives for Financing Affordable Multifamily Housing (GAO/RCED-98-117, Apr. 23, 1998).

²⁷A credit enhancement, such as mortgage insurance, transfers some of the risk of loss from the lender to the credit enhancer. When the federal government assumes a portion of a lender’s risk under a risk-sharing agreement, the lender may derive benefits, such as a higher bond rating, that may be passed on to borrowers and tenants in the form of lower costs.

²⁸Reinsurance is a form of credit enhancement that occurs after the original financing has taken place. Like mortgage insurance, it increases a loan’s security by committing the federal government to pay a portion of any losses incurred through default.

We reported that the credit enhancement program is meeting these goals. As of September 1997, the 32 participating state and local housing finance agencies had reserved²⁹ about 84 percent of the risk-sharing units allocated to these agencies through March 1996. Most of the insured loans are financing properties that serve more low-income households than required, apparently because the credit enhancement is being used with other subsidies, particularly low-income housing tax credits. While it is still too soon to evaluate the financial performance of the insured loans, the available financial indicators reflect sound underwriting standards. Participation in the credit enhancement program has enabled the housing finance agencies to leverage their reserves and insure loans more quickly. According to the participating agencies, the program would be improved if it were made permanent and the current limits on the number of available risk-sharing units were lifted. These changes, they said, would enable them to market the program and manage their resources for multifamily programs more effectively.

Activity in the reinsurance program has been so limited that the program remains largely untested. Only one institution—Fannie Mae—has participated extensively in the program, and one lender—Banc One Capital Funding Corporation—has originated over half of the loans that Fannie Mae has reinsured. Banc One’s activity has demonstrated that the risk-sharing reinsurance program can expand participation in mortgage lending, including lending for smaller properties in rural areas—an unmet capital need, according to HUD’s studies. However, for a variety of reasons, HUD’s other risk-sharing partners have reserved few or none of their risk-sharing units. Opportunities to expand participation include reallocating unused units to Fannie Mae and allowing the use of risk-sharing reinsurance (1) with 18-year balloon mortgages—an option that is currently available only to Fannie Mae—and (2) with loan pools as well as individual loans.

Participation in the demonstration programs has enabled HUD to facilitate the financing of affordable multifamily housing while limiting its loss exposure through risk sharing. Participation has also allowed HUD to increase the efficiency and reduce the costs of its operations through delegation, compared with FHA’s traditional multifamily programs. HUD has retained responsibility for monitoring its risk-sharing partners’ performance, but its data system for monitoring the progress of credit

²⁹Because insurance authority is provided in risk-sharing units rather than dollars, HUD allocates a fixed number of units to a participating financial institution, and the institution then reserves these units for properties whose loans it decides to insure or reinsure. For each property, the number of risk-sharing units reserved is equal to the number of dwelling units.

enhancement projects is unreliable. HUD is aware of the system's problems and plans to resolve them in the course of overhauling all of its management information systems. HUD has also retained responsibility for overseeing its risk-sharing partners' compliance with the demonstration programs' requirements; however, our review identified one default that was not reported to HUD headquarters for over a year. HUD recognizes that effective oversight is critical, particularly if one or both of the demonstration programs are made permanent and lenders' activity increases.

Our report makes recommendations designed to encourage greater activity in the reinsurance program and to improve HUD's monitoring and oversight of the federal government's risk-sharing partners. HUD agreed with our recommendations and said that it was taking or planned to take steps to implement them.

We also testified recently on the preliminary results of our assessment of certain aspects of HUD management and oversight of its loan insurance program for home improvements under Title I of the National Housing Act.³⁰ We reported that our preliminary analysis shows that HUD is not collecting the information needed for managing the program and provides limited oversight of lenders' compliance with program regulations. We reported that HUD collects little information when loans are made on program borrowers, properties, and loan terms, such as the borrower's income and the address of the property being improved. Moreover, HUD does not maintain information on why it denies loan claims or why it subsequently approves some for payment.

HUD also provides limited oversight of lenders' compliance with program regulations, conducting only four on-site lender reviews in fiscal year 1997 of the approximately 3,700 program lenders. Regarding the need for oversight of lenders' compliance, we reported that loan claim files submitted by lenders to HUD following loan defaults often do not contain required loan documents, including the certifications signed by the borrower that the property improvement work has been completed. In addition, some claims were paid by HUD even though there were indications that lenders did not comply with required underwriting standards when insuring the loan.

³⁰Home Improvement: Weaknesses in HUD's Management and Oversight of the Title I Program (GAO/T-RCED-98-177, Apr. 30, 1998).

As a result of the management and oversight weaknesses we observed, we reported that our preliminary work indicates that HUD does not know who the program is serving, if lenders are complying with program regulations, and whether certain potential program abuses are occurring, such as violations of the \$25,000 limitation on the amount of Title I loan indebtedness for each property. HUD officials attributed these weaknesses to the program's being lender-operated, limited staff resources, and HUD's assignment of monitoring priorities. We plan to report on the results of our assessment this summer.

In closing, Mr. Chairman, FHA is a prominent player in the home mortgage loan market, particularly for low-income and minority borrowers, first-time home buyers, and borrowers with high LTV ratios. The mortgage loan terms offered by FHA as well as VA still differ in important ways from those offered by PMIS. Solely on the basis of the LTV and qualifying ratios of borrowers, many FHA borrowers in 1995 may not have been able to obtain or could have been delayed in obtaining a home mortgage without the more lenient terms offered by FHA. Also, FHA has been able to serve such borrowers without the need for any federal funds.

While FHA's Mutual Mortgage Insurance Fund, which supports nearly all of FHA's single-family mortgages, is financially healthy and is projected to continue to improve at least in the near term, improving FHA's efficiency over its single-family mortgage insurance operation would enhance the Fund's ability to maintain financial self-sufficiency in an uncertain future and meet the needs of lower-income borrowers through either increasing the number of borrowers served or reducing the cost of insurance for those FHA serves. This is important because forecasts to determine whether FHA will have the funds it needs to cover its losses over the 30-year life of an FHA mortgage are uncertain. Loan performance will depend on a number of economic and other factors over that period, such as uncertainty surrounding the projections of the performance of FHA's streamlined refinanced and ARM loans.

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

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are \$2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. VISA and MasterCard credit cards are accepted, also. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

**U.S. General Accounting Office
P.O. Box 37050
Washington, DC 20013**

or visit:

**Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC**

**Orders may also be placed by calling (202) 512-6000
or by using fax number (202) 512-6061, or TDD (202) 512-2537.**

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (202) 512-6000 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

For information on how to access GAO reports on the INTERNET, send an e-mail message with "info" in the body to:

info@www.gao.gov

or visit GAO's World Wide Web Home Page at:

<http://www.gao.gov>

**United States
General Accounting Office
Washington, D.C. 20548-0001**

**Bulk Rate
Postage & Fees Paid
GAO
Permit No. G100**

**Official Business
Penalty for Private Use \$300**

Address Correction Requested
