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FEDERAL HOUSING ADMINISTRATION

Proposed Reforms Will Heighten the Need for Continued Improvements in Managing Risks and Estimating Program Costs

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Highlights

Highlights of GAO-06-868T, a testimony before the Subcommittee on Housing and Transportation, Committee on Banking, Housing, and Urban Affairs, United States Senate

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Why GAO Did This Study

The Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA) has faced several challenges in recent years, including rising default rates, higher-than-expected program costs, and a sharp decline in program participation. To help FHA adapt to market changes, HUD has proposed a number of changes to the National Housing Act that would raise FHA's mortgage limits, allow greater flexibility in setting insurance premiums, and reduce down-payment requirements. Implementing the proposed reforms would require FHA to manage new risks and estimate the costs of program changes. To assist Congress in considering issues faced by FHA, this testimony provides information from recent reports GAO has issued that address FHA's risk management and cost estimates. Specifically, this testimony looks at (1) FHA's development and use of its mortgage scorecard, (2) FHA's consistent underestimation of program costs, (3) instructive practices for managing risks of new mortgage products, and (4) weaknesses in FHA's management of risks related to loans with down-payment assistance.

www.gao.gov/cgi-bin/getrpt?GAO-06-868T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact William B. Shear at (202) 512-8678 or shearw@gao.gov.

What GAO Found

Recent trends in mortgage lending have significantly affected FHA, including increased use of automated tools (e.g., mortgage scoring) to underwrite loans, increased competition from lenders offering low-and no-down-payment products, and a growing proportion of FHA-insured loans with down-payment assistance. Although FHA has taken steps to improve its risk management, in a series of recent reports, GAO identified a number of weaknesses in FHA's ability to manage risk and estimate program costs during this period of change. For example:

- The way that FHA developed and uses its mortgage scorecard, while generally reasonable, limits how effectively it assesses the default risk of borrowers.
- With one exception, FHA's reestimates of program costs have been less favorable than originally estimated, including a $7 billion reestimate for fiscal year 2003.
- FHA has not consistently implemented practices used by other mortgage institutions to help manage the risks associated with new mortgage products.
- FHA has not developed sufficient standards and controls to manage risks associated with insuring a growing proportion of loans with down-payment assistance.

GAO made several recommendations in its recent reports, including that FHA (1) incorporate the risks posed by down-payment assistance into its mortgage scorecard, (2) study and report on the impact of variables not in its loan performance models that have been found to influence credit risk, and (3) consider piloting new mortgage products. FHA has taken actions in response to GAO's recommendations, but additional improvements in managing risk and estimating program costs will be important if FHA is to successfully implement its proposed program changes.

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to share information and perspectives with the committee as it considers issues facing the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA). FHA provides insurance for single-family home mortgages made by private lenders and in fiscal year 2005 insured about 480,000 mortgages, representing $58 billion in mortgage insurance. The insurance program is supported by the Mutual Mortgage Insurance Fund (Fund), which is financed through insurance premiums that FHA charges to borrowers. According to HUD's estimates, FHA's mortgage insurance program is currently a negative subsidy program, meaning that the Fund is self-financed and currently operates at a profit. However, the program has faced several challenges in recent years, including rising default rates, higher-than-expected program costs, and a sharp decline in program participation due, in part, to increased competition from conventional mortgage providers.

To help FHA adapt to market changes, HUD has proposed a number of changes to the National Housing Act that would, among other things, raise FHA's maximum mortgage limits, give the agency flexibility to set insurance premiums based on the credit risk of borrowers, and reduce down-payment requirements from the current 3 percent to potentially zero. However, to implement this legislative proposal, FHA would have to manage new risks and accurately estimate the costs of program changes. For example, to set risk-based insurance premiums, FHA would need to understand the relationships between borrower and loan characteristics and the likelihood of default, as well as how the premiums would affect the Fund's financial condition. Further, reducing the down-payment requirements for certain borrowers (and thus increasing the loan-to-value ratios) has important implications for the risks of these loans. Loans with low or no down payments carry greater risk, partly because the higher the loan-to-value ratio, the less cash borrowers will have invested in their homes and the more likely that they may default on mortgage obligations, especially during times of economic hardship.[1]

My testimony today discusses four reports that we issued since 2005 that examined different aspects of FHA's ability to manage risks and estimate

[1]Loan-to-value ratio is the loan amount divided by the sales price or appraised value of the property.

program costs. Specifically, I will discuss (1) FHA's development and use of a mortgage scorecard to assess the default risk of borrowers, (2) FHA's consistent underestimation of subsidy costs for its single-family insurance program and particularly large subsidy reestimate for fiscal year 2003, (3) practices that could be instructive for FHA in managing the risks of new mortgage products, and (4) weaknesses in how FHA has managed risks associated with growth in the proportion of loans with down-payment assistance.

In preparing these reports, we reviewed and analyzed information concerning FHA's approach to developing its mortgage scorecard and the scorecard's benefits and limitations; FHA's estimates of subsidy costs and the factors underlying the agency's subsidy reestimates; steps mortgage industry participants take to design and implement low- and no-down-payment mortgage products; and the standards and controls FHA uses to manage the risks of loans with down-payment assistance. We interviewed officials at FHA, the U.S. Department of Agriculture, and U.S. Department of Veteran Affairs (VA); and staff at selected mortgage providers, private mortgage insurers; Fannie Mae and Freddie Mac; the Office of Federal Housing Enterprise Oversight; selected state housing finance agencies; and nonprofit down-payment assistance providers. We conducted this work in Boston, Massachusetts, and Washington, D.C., from January 2004 through February 2006 in accordance with generally accepted government auditing standards.

In summary, our past work identified a number of weaknesses in FHA's ability to manage risk and estimate program costs:

- While generally reasonable, the way that FHA developed and uses its mortgage scorecard—an automated tool that evaluates the default risk of borrowers—limits the scorecard's effectiveness. FHA and its contractor used variables that reflected borrower and loan characteristics to create the scorecard, as well as an accepted modeling process to test the variables' accuracy in predicting default. However, the data used to develop the scorecard were 12 years old by the time that FHA began using the scorecard in 2004, and the mortgage market has changed significantly since then. In addition, the scorecard does not include certain key variables that could help explain expected loan performance such as the source of the down payment.

- FHA's subsidy reestimates reflect a consistent underestimation of the costs of its single-family insurance program. For example, as of the end of fiscal year 2003, FHA submitted a $7 billion reestimate for the Fund, reflecting a reduction in estimated profits. Increases in the expected level of insurance claims—potentially stemming from changes in underwriting guidelines, among other factors—were a major cause of the $7 billion reestimate.

- Some of the practices of other mortgage institutions offer a framework that could help FHA manage the risks associated with new products such as no-down-payment mortgages. For example, mortgage institutions may limit the volume of new products issued—that is, pilot a product—and sometimes require stricter underwriting on these products. While FHA has utilized pilots or demonstrations when making changes to its single-family mortgage insurance, it generally has done so in response to a legislative requirement and not on its own initiative. Moreover, FHA officials have questioned the circumstances under which pilot programs were needed and also said that they lacked sufficient resources to appropriately manage a pilot.

- FHA has not developed sufficient standards and controls to manage risks associated with the growing proportion of loans with down-payment assistance. Unlike other mortgage industry participants, FHA does not restrict homebuyers' use of down-payment assistance from nonprofit organizations that receive part of their funding from home sellers. However, our analysis of a national sample of FHA-insured loans found that the probability that loans with seller-funded nonprofit down-payment assistance would result in an insurance claim was 76 percent higher than comparable loans without such assistance.

On the basis of our findings from the four reports I have summarized, we made several recommendations designed to improve FHA's risk management and cost estimates. For example, to improve its assessment of borrowers' default risk, we recommended that FHA develop policies for updating the scorecard, incorporate the risks posed by down-payment assistance into the scorecard, and explore additional uses for this tool.

To more reliably estimate subsidy costs, we recommended that FHA study and report in the annual actuarial review of the Fund the impact of variables not in the agency's loan performance models (used in estimating subsidy costs) that have been found in other studies to influence credit risk.[2] In light of the risks that new mortgage products present and in

[2]Since 1990, the National Housing Act has required an annual and independent actuarial analysis of the economic net worth and soundness of the Fund. 12 U.S.C. Section 1711 (g).

recognition of established risk management practices, we also suggested that Congress consider (1) limiting the initial availability of any new single-family insurance product it might authorize and (2) directing FHA to consider using various techniques for mitigating risks for a no-down-payment product, or products about which the risks were not well understood.

FHA has taken actions in response to some of our recommendations. For example, FHA agreed to consider incorporating a variable for down-payment assistance in its mortgage scorecard. To more accurately assess subsidy costs, an FHA contractor is considering the specific variables that we recommended FHA include in its annual actuarial review and incorporated the source of down payment in the 2005 actuarial review of the Fund. FHA also has agreed to improve its oversight of down-payment assistance lending, including modifying its information systems to document assistance from seller-funded nonprofits.

While these actions represent improvements in FHA's risk management, additional improvements will be important if FHA is to successfully implement some of the program changes HUD has proposed. Accordingly, consideration of this proposal should include serious deliberation of the associated risks and the capacity of FHA to mitigate them.

Background

Congress established FHA in 1934 under the National Housing Act (P.L. 73-479) to broaden homeownership, shore up and protect lending institutions, and stimulate employment in the building industry. FHA's single-family program insures private lenders against losses (up to almost 100 percent of the loan amount) from borrower defaults on mortgages that meet FHA criteria. In 2004, more than three-quarters of the loans that FHA insured went to first-time homebuyers, and more than one-third of these loans went to minorities. From 2001 through 2005, FHA insured about 5 million mortgages with a total value of about $590 billion. However, FHA's loan volume fell sharply over that period, and in 2005 FHA-insured loans accounted for less than 4 percent of the single-family mortgage market, compared with about 13 percent a decade ago. Additionally, default rates for FHA-insured mortgages have risen steeply over the past several years, a period during which home prices have appreciated rapidly and default rates for conventional and VA-guaranteed mortgages have been relatively stable.

FHA determines the expected cost of its insurance program, known as the credit subsidy cost, by estimating the program's future performance.[3] Similar to other agencies, FHA is required to reestimate credit subsidy costs annually to reflect actual loan performance and expected changes in estimates of future loan performance. FHA's mortgage insurance program is currently a negative subsidy program, meaning that the present value of estimated cash inflows to the Fund exceed the present value of estimated cash outflows. FHA has estimated that the loans it expects to insure in 2007 will have a subsidy rate of -0.37, a rate closer to zero (the point at which estimated cash inflows equal estimated cash outflows) than any previous estimate. The economic value, or net worth, of the Fund that supports FHA's insurance depends on the relative size of cash outflows and inflows over time. Cash flows out of the Fund for payments associated with claims on defaulted loans and refunds of up-front premiums on prepaid mortgages. To cover these outflows, FHA receives cash inflows from borrowers' insurance premiums and net proceeds from recoveries on defaulted loans. If the Fund were to be exhausted, the U.S. Treasury would have to cover lenders' claims directly.

Two major trends in the conventional mortgage market have significantly affected FHA.[4] First, in recent years, members of the conventional mortgage market (such as private mortgage insurers, Fannie Mae, and Freddie Mac) increasingly have been active in supporting low- and even no-down-payment mortgages, increasing consumer choices for borrowers who may have previously chosen an FHA-insured loan. Second, to help assess the default risk of borrowers, particularly those with high loan-to-value ratios, the mortgage industry has increasingly used mortgage scoring and automated underwriting systems.[5] Mortgage scoring is a technology-based tool that relies on the statistical analysis of millions of previously originated mortgage loans to determine how key attributes such as the borrower's credit history, property characteristics, and terms of the mortgage affect future loan performance. As a result of such tools, the mortgage industry is able to process loan applications more quickly and

[3]Pursuant to the Federal Credit Reform Act of 1990, HUD must annually estimate the credit subsidy cost for its loan insurance programs. Credit subsidy costs are the net present value of estimated payments it makes less the estimated amounts it receives, excluding administrative costs.

[4]Conventional mortgages do not carry government insurance or guarantees.

[5]Underwriting refers to a risk analysis that uses information collected during the origination process to decide whether to approve a loan.

consistently than in the past. In 2004, FHA implemented a mortgage scoring tool, called the FHA Technology Open to Approved Lenders (TOTAL) Scorecard, to be used in conjunction with existing automated underwriting systems.

HUD's legislative proposal is intended to modernize FHA, in part, to respond to the changes in the mortgage market. The proposal, among other things, would authorize FHA to change the way it sets insurance premiums, insure larger loans, and reduce down-payment requirements. The proposed legislation would enable FHA to depart from its current, essentially flat, premium structure and charge a wider range of premiums based on individual borrowers' risk of default. Currently, FHA also requires homebuyers to make a 3 percent contribution toward the purchase of a property. HUD's proposal would eliminate this contribution requirement and enable FHA to offer some borrowers a no-down-payment product. FHA is subject to limits in the size of the loans it can insure. For example, for a one-family property in a high-cost area, the FHA limit is 87 percent of the limit established by Freddie Mac. The legislative proposal would raise this limit to 100 percent of the Freddie Mac limit.

The Way FHA Developed and Uses TOTAL Limits the Scorecard's Effectiveness in Assessing the Default Risk of Borrowers

If Congress authorizes the reforms HUD has proposed, FHA's ability to assess the default risk of borrowers will take on increased importance because FHA would be adjusting insurance premiums based on its assessments of the credit risk of borrowers and insure potentially larger and riskier mortgages with low or no down payments. A primary tool that FHA uses to assess the default risk of borrowers who apply for FHA-insured mortgages is its TOTAL scorecard.

Age of Data, Lack of Key Variables, and Lack of Policy for Updating TOTAL Could Limit Its Effectiveness

In reports we issued in November 2005 and April 2006, we noted that while FHA's process for developing TOTAL generally was reasonable, some of the choices FHA made in the development process could limit the scorecard's effectiveness.[6] FHA and its contractor used variables that reflected borrower and loan characteristics to create TOTAL, as well as an accepted modeling process to test the variables' accuracy in predicting default. However, we also found that:

- The data used to develop TOTAL were 12 years old by the time FHA implemented the scorecard. Specifically, when FHA began developing TOTAL in 1998, the agency chose to use 1992 loan data, which would be old enough to provide a sufficient number of defaults that could be attributed to a borrower's poor creditworthiness. However, FHA did not implement TOTAL until 2004 and has not subsequently updated the data used in the scorecard. Best practices of private-sector organizations call for scorecards to be based on data that are representative of the current mortgage market—specifically, relevant data that are no more than several years old. In the past 12 years, significant changes—growth in the use of down-payment assistance, for example—have occurred in the mortgage market that have affected the characteristics of those applying for FHA-insured loans. As a result, the relationships between borrower and loan characteristics and the likelihood of default also may have changed.

- TOTAL does not include certain key variables that could help explain expected loan performance. For example, TOTAL does not include a variable for the source of the down payment. However, FHA contractors, HUD's Inspector General, and our work have all identified the source of a down payment as an important indicator of risk, and the use of down-payment assistance in the FHA program has grown rapidly over the last 5 years. Further, TOTAL does not include other important variables—such as a variable for generally riskier adjustable rate loans—included in other scorecards used by private-sector entities.

- Although FHA has a contract to update TOTAL by 2007, the agency did not develop a formal plan for updating TOTAL on a regular basis. Best practices in the private sector and reflected in bank regulator guidance call for having formal policies to ensure that scorecards are routinely

[6] GAO, *Mortgage Financing: HUD Could Realize Additional Benefits from its Mortgage Scorecard,* GAO-06-435 (Washington, D.C.: April 13, 2006). GAO, *Mortgage Financing: Additional Action Needed to Manage Risks of FHA-Insured Loans with Down Payment Assistance*, GAO-06-24 (Washington, D.C.: November 9, 2005).

updated. Without policies and procedures for routinely updating TOTAL, the scorecard may become less reliable and, therefore, less effective at predicting the likelihood of default.

To improve TOTAL's effectiveness, we recommended, among other things, that HUD develop policies and procedures for regularly updating TOTAL and more fully consider the risks posed by down-payment assistance when underwriting loans by including the presence and source of down-payment assistance as a loan variable in the scorecard. In response, FHA agreed to consider incorporating a variable for down-payment assistance in TOTAL.

HUD Could Realize Additional Benefits from an Expanded Use of TOTAL

Despite potential limitations in the use of TOTAL, HUD still could realize additional benefits from the scorecard, if, like private-sector lenders and mortgage insurers, it put TOTAL to other uses. Based on its current use of TOTAL, FHA lenders and borrowers have seen two added benefits—less paperwork and more consistent underwriting decisions. However, private lenders and mortgage insurers put their scorecards to other uses, including to help price products based on risk and launch new products. For example, to set risk-based prices, private-sector organizations use scorecards to rank the relative risk of borrowers and price products according to that ranking. By increasing their use of scorecards, these organizations are able to broaden their customer base and improve their financial performance. Adopting these best practices from the private sector could generate similar kinds of benefits for FHA, particularly if FHA were to implement risk-based pricing.

To the extent that conventional mortgage lenders and insurers are better able than FHA to use mortgage scoring to identify and approve relatively low-risk borrowers and charge fees based on default risk, FHA may face adverse selection—that is, conventional providers may approve lower-risk borrowers in FHA's traditional market segment, leaving relatively high-risk borrowers for FHA. Accordingly, the greater the effectiveness of TOTAL, the greater the likelihood that FHA will be able to effectively manage the risks posed by borrowers seeking FHA-insured loans.

To improve how FHA benefits from TOTAL, we recommended that the agency explore additional uses for the scorecard, including using it to implement risk-based pricing of mortgage insurance and to develop new products. These actions could enhance FHA's ability to effectively compete in the mortgage market. In response to our recommendations, FHA indicated that it planned to explore these uses for TOTAL.

FHA's Reestimates Reflect Consistent Underestimation of Program Costs, Primarily Because of Higher Claims than Initially Estimated

If implemented, HUD's legislative proposal could affect the Fund's cash inflows and outflows and, as a result, significantly affect the credit subsidy costs of the insurance program. For example, changes in FHA's insurance premiums could affect the revenues FHA receives, and changes in the composition and riskiness of the loan portfolio (as a result of larger loans or more loans with no down payments) could affect the size and number of insurance claims FHA pays.

As previously noted, FHA, like other federal agencies, is required to reestimate credit subsidy costs annually to reflect actual loan performance and expected changes in estimates of future loan performance. FHA has estimated negative credit subsidies for the Fund since 1992, when federal credit reform became effective. However, as we reported in September 2005, with the exception of the 1992 reestimate, FHA's subsidy reestimates have been less favorable than the original estimates.[7] In particular, FHA's $7 billion reestimate for fiscal year 2003 was more than twice the size of any other reestimate from fiscal years 2000 through 2004.

The $7 billion reestimate for fiscal year 2003 had three main components. The first component was the $3.9 billion difference between FHA's fiscal year 2003 estimates of the net present value of future cash flows and the estimates it made one year earlier. Most of this difference stemmed from changes in FHA's estimates of claims and, to a lesser extent, prepayments (the payment of a loan before its maturity date). That is, FHA changed its estimate of future loan performance based on its observation of actual loan performance during fiscal year 2003 and revised economic assumptions. The second component was the $2.1 billion difference between estimated and actual cash flows occurring during fiscal year 2003. Underestimation of claims (net of recoveries on claims) and an overestimation of net fees (insurance premium receipts less premium refunds) for loans made prior to fiscal year 2003 largely account for the difference. The third component was an interest adjustment on the reestimate required by Office of Management and Budget guidance that increased the total reestimate by $1.1 billion.

Several recent policy changes and trends may have contributed to changes in the expected claims underlying the $7 billion reestimate. For example:

[7] GAO, *Mortgage Financing: FHA's $7 Billion Reestimate Reflects Higher Claims and Changing Loan Performance Estimates,* GAO-05-875 (Washington, D.C.: Sep. 2, 2005).

- Revised underwriting guidelines made it easier for borrowers who are more susceptible to changes in economic conditions—and therefore more likely to default on their mortgages—to obtain an FHA-insured loan.

- Competition from conventional mortgage providers could have resulted in FHA insuring more risky borrowers.

- FHA insured an increasing number of loans with down-payment assistance, which generally have a greater risk of default.

- FHA's loan performance models did not include key variables that help estimate loan performance, such as credit scores, and as of September 2005, the source of down payment.

The major factors underlying the surge in prepayment activity that also contributed to the reestimate were declining interest rates and rapid appreciation of housing prices. These trends created incentives and opportunities for borrowers to refinance using conventional loans.

To more reliably estimate program costs, we recommended that FHA study and report on how variables found to influence credit risk, such as payment-to-income ratios, credit scores, and down-payment assistance would affect the forecasting ability of its loan performance models. We also recommended that when changing the definitions of key variables, FHA report the impact of such changes on the models' forecasting ability. In response, FHA indicated, among other things, that its contractor was considering the specific variables that we had recommended FHA include in its annual actuarial review and had incorporated the source of down-payment assistance in the 2005 actuarial review of the Fund.

Practices Used by Other Mortgage Institutions Could Help FHA Manage Risks from Low- or No-Down-Payment Products

If Congress authorized FHA to insure mortgages with smaller or no down payments, practices used by other mortgage institutions could help FHA to design and implement these new products. In a February 2005 report, we identified steps that mortgage institutions take when introducing new products.[8] Specifically, mortgage institutions often utilize special requirements when introducing new products, such as requiring additional credit enhancements (mechanisms for transferring risk from one party to another) or implementing stricter underwriting requirements, and limiting how widely they make available a new product.

Mortgage Institutions Require Additional Credit Enhancements, Stricter Underwriting, and Higher Premiums for Low- and No-Down-Payment Products

Some mortgage institutions require additional credit enhancements on low- and no-down-payment products, which generally are riskier because they have higher loan-to-value ratios than loans with larger down payments. For example, Fannie Mae and Freddie Mac mitigate the risk of low- and no-down-payment products by requiring additional credit enhancements such as higher mortgage insurance coverage. Although FHA is required to provide up to 100 percent coverage of the loans it insures, FHA may engage in co-insurance of its single-family loans. Under co-insurance, FHA could require lenders to share in the risks of insuring mortgages by assuming some percentage of the losses on the loans that they originated (lenders would generally use private mortgage insurance for risk sharing).

Mortgage institutions also can mitigate the risk of low- and no-down-payment products through stricter underwriting. Institutions can do this in a number of ways, including requiring a higher credit score threshold for certain products, requiring greater borrower reserves, or requiring more documentation of income or assets from the borrower. Although the changes FHA could make are limited by statutory standards, it could benefit from similar approaches. The HUD Secretary has latitude within statutory limitations to change underwriting requirements for new and existing products and has done so many times. For example, FHA expanded its definition of what could be included as borrower's effective income when calculating payment-to-income ratios. However, FHA officials told us that they were unlikely to mandate a credit score threshold or borrower reserve requirements for a no-down-payment

[8] GAO, *Mortgage Financing: Actions Needed to Help FHA Manage Risks from New Mortgage Loan Products,* GAO-05-194 (Washington, D.C.: Feb. 11, 2005).

product because the product was intended to serve borrowers who are underserved by the conventional market, including those who lack credit scores and have little wealth or personal savings.

Finally, mortgage institutions can increase fees or charge higher premiums to help offset the potential costs of products that are believed to have greater risk. For example, Fannie Mae officials stated that they would charge higher guarantee fees on low- and no-down-payment loans if they were not able to require higher insurance coverage.[9] FHA, if authorized to implement risk-based pricing, could set higher premiums on FHA-insured loans understood to have greater risk.

We recommended that if FHA implemented a no-down-payment mortgage product or other new products about which the risks were not well understood, the agency should (1) consider incorporating stricter underwriting criteria such as appropriate credit score thresholds or borrower reserve requirements and (2) utilize other techniques for mitigating risks, including the use of credit enhancements. In response, FHA said it agreed that these techniques should be evaluated when considering or proposing a new FHA product.

Before Fully Implementing New Products, Some Mortgage Institutions May Limit Availability

Some mortgage institutions initially may offer new products on a limited basis. For example, Fannie Mae and Freddie Mac sometimes use pilots, or limited offerings of new products, to build experience with a new product type. Fannie Mae and Freddie Mac also sometimes set volume limits for the percentage of their business that could be low- and no-down-payment lending. FHA has utilized pilots or demonstrations when making changes to its single-family mortgage insurance but generally has done so in response to legislative requirement rather than on its own initiative. For example, FHA's Home Equity Conversion Mortgage insurance program started as a pilot that authorized FHA to insure 2,500 reverse mortgages.[10] Additionally, some mortgage institutions may limit the origination and servicing of new products to their better lenders and servicers. Fannie Mae and Freddie Mac both reported that these were important steps in introducing a new product.

[9] Fannie Mae and Freddie Mac charge fees for guaranteeing timely payment on mortgage backed securities they issue. The fees are based, in part, on the credit risk they face.

[10] Under this program, homeowners borrow against equity in their home and receive payments from their lenders.

We recommended that when FHA releases new products or makes significant changes to existing products, it consider similar steps to limit the initial availability of these products. FHA officials agreed that they could, under certain circumstances, envision piloting or limiting the ways in which a new product would be available, but pointed to the practical limitations of doing so. For example, FHA officials told us that administering the Home Equity Conversion Mortgage pilot program was difficult because of the challenges of equitably selecting a limited number of lenders and borrowers. FHA generally offers products on a national basis and, if they did not, specific regions of the county or lenders might question why they were not able to receive the same benefit. FHA officials told us they have conducted pilot programs when Congress has authorized them, but they questioned the circumstances under which pilot programs were needed, and also said that they lacked sufficient resources to appropriately manage a pilot. However, if FHA does not limit the availability of new or changed products, the agency runs the risk of facing higher claims from products whose risks may not be well understood.

FHA Has Not Implemented Sufficient Standards and Controls to Manage Risks Associated with the Growing Proportion of Loans with Down-Payment Assistance

HUD's legislative proposal would represent a significant change to the agency's single-family mortgage insurance program and presents new risk management challenges. In our November 2005 report examining FHA's actions to manage the new risks associated with the growing proportion of loans with down-payment assistance, we found that the agency did not implement sufficient standards and controls to manage the risks posed by these loans.[11]

[11] GAO-06-24.

The Percentage of Loans with Down-Payment Assistance in FHA's Portfolio Has Been Increasing and These Loans Do Not Perform as Well as Similar Loans without Assistance

Homebuyers who receive FHA-insured mortgages often have limited funds and, to meet the 3 percent borrower investment FHA currently requires, may obtain down-payment assistance from a third party, such as a relative or a charitable organization (nonprofit) that is funded by property sellers. The proportion of FHA-insured loans that are financed in part by down-payment assistance from various sources has increased substantially in the last few years, while the overall number of loans that FHA insures has fallen dramatically. Money from nonprofits funded by seller contributions has accounted for a growing percentage of that assistance. From 2000 to 2004, the total proportion of FHA-insured purchase loans that had a loan-to-value ratio greater than 95 percent and that also involved down-payment assistance, from any source, grew from 35 to nearly 50 percent. Approximately 6 percent of FHA-insured purchase loans in 2000 received down-payment assistance from nonprofits (the large majority of which were funded by property sellers), but by 2004 nonprofit assistance grew to about 30 percent.

We and others have found that loans with down-payment assistance do not perform as well as loans without down-payment assistance. We analyzed loan performance by source of down-payment assistance, using two samples of FHA-insured purchase loans from 2000, 2001, and 2002—a national sample and a sample from three Metropolitan Statistical Areas (MSA) with high rates of down-payment assistance.[12] Holding other variables constant, our analysis indicated that FHA-insured loans with down-payment assistance had higher delinquency and claim rates than similar loans without such assistance. For example, we found that the probability that loans with nonseller-funded sources of down-payment assistance would result in insurance claims was 49 percent higher in the national sample and 45 percent higher in the MSA sample than it was for comparable loans without assistance. Similarly, the probability that loans with nonprofit seller-funded, down-payment assistance would result in insurance claims was 76 percent higher in the national sample and 166 percent higher in the MSA sample than it was for comparable loans without assistance. The poorer performance of loans with nonprofit seller-funded, down-payment assistance may be explained, in part, by the sales prices of the homes bought with such assistance. More specifically, our analysis indicated that FHA-insured homes bought with seller-funded

[12]The data (current as of June 30, 2005) consisted of purchase loans insured by FHA's 203(b) program, its main single-family program, and its 234(c), condominium program. The three MSAs were Atlanta, Indianapolis, and Salt Lake City.

nonprofit assistance were appraised and sold for about 2 to 3 percent more than comparable homes bought without such assistance. The difference in performance also may be partially explained by the homebuyer having less equity in the transaction.

Stricter Standards and Additional Controls Could Help FHA Manage the Risks Posed by Loans with Down-Payment Assistance

FHA has implemented some standards and internal controls to manage the risks associated with loans with down-payment assistance, but stricter standards and additional controls could help FHA better manage risks posed by these loans while meeting its mission of expanding homeownership opportunities. Like other mortgage industry participants, FHA generally applies the same underwriting standards to loans with down-payment assistance that it applies to loans without such assistance. One important exception is that FHA, unlike others, does not limit the use of down-payment assistance from seller-funded nonprofits. Some mortgage industry participants view assistance from seller-funded nonprofits as a seller inducement to the sale and, therefore, either restrict or prohibit its use. FHA has not viewed such assistance as a seller inducement and, therefore, does not subject this assistance to the limits it otherwise places on contributions from sellers. However, due in part to concerns about loans with nonprofit seller-funded, down-payment assistance, FHA has proposed legislation that could help eliminate the need for such assistance by allowing some FHA borrowers to make no down payments for an FHA-insured loan.

FHA has taken some steps to assess and manage the risks associated with loans with down-payment assistance, but additional controls may be warranted. For example, FHA has contracted for two studies to assess the use of such assistance with FHA-insured loans and conducted ad hoc performance analyses of loans with down-payment assistance but has not routinely assessed the impact that the widespread use of down-payment assistance has had on loan performance. Also, FHA has targeted its monitoring of appraisers to those that do a high volume of loans with down-payment assistance, but FHA has not targeted its monitoring of lenders to those that do a high volume of loans with down-payment assistance, even though FHA holds lenders, as well as appraisers, accountable for ensuring a fair valuation of the property it insures.

Our report made several recommendations designed to better manage the risks of loans with down-payment assistance generally, and more specifically from seller-funded nonprofits. Overall, we recommended that in considering the costs and benefits of its policy permitting down-payment assistance, FHA also consider risk-mitigation techniques such as including down-payment assistance as a factor when underwriting loans or more closely monitoring loans with such assistance. For down-payment assistance providers that receive funding from property sellers, we recommended that FHA take additional steps to mitigate the risks of these loans, such as treating such assistance as a seller contribution and, therefore, subject to existing limits on seller contributions. In response, FHA agreed to improve its oversight of down-payment assistance lending by (1) modifying its information systems to document assistance from seller-funded nonprofits and (2) requiring lenders to inform appraisers when assistance is provided by seller-funded nonprofits. In addition, HUD has proposed a zero down-payment program as an alternative to seller-funded, down-payment assistance.

In May 2006, the Internal Revenue Service issued a ruling stating that organizations that provide seller-funded, down-payment assistance to home buyers do not qualify as tax-exempt charities. FHA permitted these organizations to provide down-payment assistance because they qualified as charities. Accordingly, the ruling could significantly reduce the number of FHA-insured loans with seller-funded down payments.

Observations

The risks FHA faces in today's mortgage market are growing. For example, the agency has seen increased competition from conventional mortgage and insurance providers, many of which offer low- and no-down-payment products and that may be better able than FHA to identify and approve relatively low-risk borrowers. Additionally, FHA is insuring a greater proportion of loans with down-payment assistance. These loans are more likely to result in insurance claims than loans without such assistance.

To effectively manage the risks posed by FHA's existing products, we have concluded from our prior work that the agency must significantly improve its risk management and cost estimation practices. We are encouraged by a variety of steps FHA has taken to enhance its capabilities in these areas, such as developing and implementing a mortgage scorecard and improving its loan performance models. However, FHA needs to take additional steps, such as establishing policies and procedures for updating TOTAL scorecard on a regular basis, more fully considering the risks posed by down-payment assistance when underwriting loans, developing a framework for introducing new products in a way that mitigates risk, and studying and reporting on the impact of variables found to influence credit risk that are not currently in the agency's loan performance models.

HUD's legislative proposal could help FHA serve more low-income and first-time homebuyers, but also would introduce additional risks to the Fund. Consideration of this proposal should include serious deliberation of the associated risks and the capacity of FHA to mitigate them.

Mr. Chairman, this concludes my prepared statement. I would be happy to answer any questions at this time.

Contacts and Acknowledgments

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