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FEDERAL HOUSING ADMINISTRATION

Modernization Proposals Would Have Program and Budget Implications and Require Continued Improvements in Risk Management





Highlights of [GAO-07-708](#), a report to congressional requesters

Why GAO Did This Study

In recent years, the Federal Housing Administration (FHA) has experienced a sharp decline in market share. Also, the agency has estimated that, absent program changes, its Mutual Mortgage Insurance Fund (Fund) would require appropriations in 2008. To adapt to market changes, FHA has implemented new procedures and proposed the following major legislative changes: raising FHA's loan limits, allowing risk-based pricing, and lowering down-payment requirements. GAO was asked to report on (1) the likely program and budget impacts of FHA's modernization efforts; (2) the tools, resources, and risk-management practices important to FHA's implementation of the legislative proposals, if passed; and (3) other options that FHA and Congress could consider to help FHA adapt to market changes. To address these objectives, GAO analyzed FHA and Home Mortgage Disclosure Act (HMDA) data and interviewed officials from FHA and other mortgage institutions.

What GAO Recommends

While making no new recommendations, GAO re-emphasizes the need for continued management attention to prior GAO recommendations that could help address risks and challenges associated with the legislative proposals. HUD commented that the report's concerns about FHA's risk management and emphasis on the need for piloting new products were unwarranted.

www.gao.gov/cgi-bin/getrpt?GAO-07-708.

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.

FEDERAL HOUSING ADMINISTRATION

Modernization Proposals Would Have Program and Budget Implications and Require Continued Improvements in Risk Management

What GAO Found

FHA's recent changes to insurance approval and appraisal requirements have streamlined its insurance process, and FHA's major legislative proposals could affect the demand for FHA's loans, the cost and availability of insurance to borrowers, and the insurance program's budgetary costs. Based on GAO's analysis of HMDA data, the number of FHA-insured loans could have been from 9 to 10 percent greater in 2005 had the higher, proposed mortgage limits been in effect. GAO's analysis of data on 2005 FHA home purchase borrowers shows that 43 percent would have paid the same or less under the risk-based pricing proposal than they actually paid, 37 percent would have paid more, and 20 percent (those with the highest expected claim rates) would not have qualified for FHA insurance. While to be viewed with caution, FHA has made estimates indicating that the loans it expects to insure in 2008 would result in negative subsidies (i.e., net cash inflows) of \$342 million if the major legislative changes were enacted, rather than requiring an appropriation of \$143 million absent any program changes.

FHA has taken or planned steps to enhance tools and resources and adopt risk-management practices important to implementing the legislative proposals, but does not intend to use a common industry practice, piloting, to mitigate the risks of any zero-down-payment product it is authorized to offer. In response to prior GAO recommendations, FHA has taken steps to improve the loan performance and scoring models it would use in risk-based pricing. It also has identified minor changes to its information systems and staff increases needed to implement the proposals but faces long-term challenges in these areas. Additionally, the legislative proposals would introduce new risks. The proposal to lower down-payment requirements is of particular concern given the higher default rates on these loans and the difficulty of setting prices for new products whose risks may not be well known. GAO has previously indicated that Congress may want to consider requiring FHA to limit the initial availability of any new products and also recommended that FHA itself consider piloting. However, FHA has indicated that it does not plan to pilot any no-down-payment product it might offer.

Mortgage industry participants and researchers have suggested more options that Congress and FHA could consider to help FHA adapt to changes in the mortgage market, but some changes could have budget impacts and complicate oversight efforts. Some administrative changes—such as implementing a more limited form of risk-based pricing—are within FHA's existing authority. Congress also could grant FHA additional authority that would allow it to invest the Fund's current resources in information technology and human capital, but this would increase the federal government's budget deficit. Finally, Congress could contemplate other approaches to the provision of federal mortgage insurance, such as creating a government corporation. However, any fundamental changes to how the federal government provides mortgage insurance could require new oversight mechanisms and would require careful deliberation.

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Abbreviations

CBSA	core based statistical area
FHA	Federal Housing Administration
FTE	full-time equivalent
HECM	Home Equity Conversion Mortgage
HUD	Department of Housing and Urban Development
HMDA	Home Mortgage Disclosure Act
IRS	Internal Revenue Service
LTV	loan-to-value
MHC	Millennial Housing Commission

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United States Government Accountability Office
Washington, DC 20548

June 29, 2007

The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate

The Honorable Wayne Allard
United States Senate

The Department of Housing and Urban Development (HUD), through its Federal Housing Administration (FHA), has helped millions of families purchase homes by providing insurance for single-family home mortgages made by private lenders. However, FHA's single-family insurance program has faced several challenges in recent years, including rising delinquency rates and a sharp decline in the number of participating borrowers, due partly to increased competition from conventional mortgage providers.¹ As conventional providers have improved their ability to evaluate risk, FHA has begun to experience adverse selection—that is, conventional providers have identified and approved relatively lower-risk borrowers in FHA's traditional market segment, leaving relatively higher-risk borrowers for FHA. Furthermore, the agency has estimated that, absent any program changes, the program would for the first time operate with a positive subsidy in fiscal year 2008—meaning that the present value of estimated cash outflows (such as insurance claims) to FHA's Mutual Mortgage Insurance Fund (Fund) would exceed the present value of estimated cash inflows (such as borrower premiums). To avoid a positive subsidy in fiscal year 2008, FHA estimates that it would have to increase slightly the insurance premiums charged to borrowers.

To adapt to market changes, FHA has implemented new administrative procedures and proposed legislation designed to modernize its insurance processes and products. FHA's recent administrative changes include

¹The conventional market comprises mortgages that do not carry government insurance or guarantees. For more information on the decline in FHA's share of the mortgage market and the factors underlying this trend, see GAO, *Federal Housing Administration: Decline in the Agency's Market Share Was Associated with Product and Process Developments of Other Mortgage Market Participants*, GAO-07-645 (Washington, D.C.: June 29, 2007).

allowing higher-performing lenders to endorse, or approve, loans for FHA insurance without prior review by FHA and adopting conventional market appraisal requirements. The legislative proposals would, among other things, raise FHA's 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, as we testified in June 2006, weaknesses in FHA's risk management raise questions about the agency's ability to successfully implement the proposed legislation.² Given these concerns, you asked us to evaluate FHA's modernization efforts. Specifically, this report discusses (1) the likely program and budgetary impacts of FHA's modernization efforts; (2) the tools, resources, and risk-management practices important to FHA's implementation of the legislative proposals, if passed; and (3) other options that FHA and Congress could consider to help FHA adapt to changes in the mortgage market and the pros and cons of these options.

To determine the likely program and budgetary impacts of FHA's modernization efforts, we analyzed data collected under the Home Mortgage Disclosure Act (HMDA) and from FHA's Single Family Data Warehouse (SFDW).³ Specifically, we used 2005 HMDA data (the most current available) to examine the effect of raising loan limits on demand for FHA-insured loans. We determined the number of additional loans in different geographic areas that would have been eligible for FHA insurance under the revised loan limits and, based on FHA's current market share, estimated the percentage of those loans that FHA might have insured. We estimated the effects of risk-based pricing on borrowers' eligibility for FHA insurance and the premiums they would pay by analyzing SFDW data on FHA's 2005 home purchase borrowers to determine the characteristics of borrowers that could fall into FHA's proposed pricing categories. We reviewed recent administrative changes made by FHA and interviewed FHA officials, several FHA lenders, and

²GAO, *Federal Housing Administration: Proposed Reforms Will Heighten the Need for Continued Improvements in Managing Risks and Estimating Program Costs*, [GAO-06-868T](#) (Washington, D.C.: June 20, 2006).

³HMDA requires lending institutions to collect and publicly disclose information about housing loans and applications for such loans, including the loan type and amount, property type, and borrower characteristics (such as ethnicity, race, gender, and income). These data are one of the most comprehensive sources of information on mortgage lending. Among other things, FHA's SFDW contains information on the borrower and loan characteristics of the mortgages FHA insures.

mortgage and real estate industry groups about their effects on loan and insurance processing times and costs. We also examined the potential budgetary impacts of the legislative proposals by reviewing the President's fiscal year 2008 budget and FHA's cost estimates. To evaluate the tools, resources, and risk-management practices important to FHA's implementation of the proposals, we relied on our prior work, reviewed information provided by FHA, and interviewed officials from FHA, private mortgage insurers, and the government-sponsored enterprises (GSE) Fannie Mae and Freddie Mac.⁴ To determine other options that FHA and Congress could consider, we reviewed relevant literature and interviewed FHA officials, academic experts, FHA lenders, and private mortgage insurers. Appendix I contains additional information on our scope and methodology. We conducted this work in Washington, D.C., from September 2006 to June 2007 in accordance with generally accepted government auditing standards.

Results in Brief

FHA's modernization efforts, which include completed administrative and proposed legislative changes, have streamlined the agency's insurance process and could affect the demand for FHA-insured loans, the cost and availability of insurance to borrowers, and the budgetary costs of the insurance program. In 2006, FHA made several administrative changes, such as allowing higher-performing lenders to approve FHA insurance without prior review by FHA and simplifying its appraisal process. FHA and mortgage industry officials with whom we spoke said that these changes have increased the efficiency of loan and insurance processing, making FHA products more attractive and, therefore, more likely to be used. For example, one FHA lender reported a 35 percent decrease in loan processing times and a 25 percent reduction in operating costs for its FHA business. In addition to these administrative changes, FHA has proposed legislation that would grant the agency new flexibilities intended to help address challenges, such as adverse selection, resulting from innovations and increased competition in the mortgage market. If passed, the legislative changes likely would affect borrower participation in the program and the program's budgetary costs. Based on our analysis of 2005 HMDA data, we estimate that the number of FHA-insured loans in 2005 could have been from 9 to 10 percent greater had the higher, proposed

⁴Fannie Mae and Freddie Mac are government-sponsored private corporations chartered by Congress to provide a continuous flow of funds to mortgage lenders and borrowers by purchasing mortgages from lenders and re-selling them to investors. They purchase single-family mortgages up to the conforming loan limit, which for 2006 was set at \$417,000.

mortgage limits been in effect. Although the effect of introducing risk-based premiums on the demand for FHA-insured loans is especially difficult to estimate, risk-based pricing would affect the cost and availability of FHA insurance. Specifically, risk-based pricing would decrease premiums for lower-risk borrowers and increase them for higher-risk borrowers. Our analysis of data for FHA home purchase borrowers in 2005 shows that about 43 percent of those borrowers would have paid the same or less than they actually paid, 37 percent would have paid more, and 20 percent would not have qualified for FHA insurance based on FHA's plans as of May 2007. (The same percentages hold true when risk-based pricing is compared with the higher across-the-board premiums that FHA estimates it would have to charge to avoid a positive subsidy in fiscal year 2008 absent any program changes.) The 20 percent who would not have qualified were borrowers with expected lifetime claim rates more than 2.5 times greater than the average claim rate. The legislative proposals also would have a budgetary impact, mostly reflected in subsidy costs. While to be viewed with caution, FHA has made estimates indicating that the loans it expects to insure in 2008 would result in negative subsidies of \$342 million if the major legislative changes were enacted, rather than requiring an appropriation of \$143 million absent any program changes.

FHA has taken or planned steps to enhance the tools and resources important to implementing the legislative proposals—and help address risks and challenges associated with the proposals—but does not intend to use a common industry practice, piloting, to mitigate the risks of any zero-down-payment product it is authorized to offer. To implement its risk-based pricing proposal, FHA would rely on statistical models that estimate the performance of loans and its mortgage scorecard, an automated tool that evaluates the default risk of borrowers. In response to our prior recommendations, FHA has improved the forecasting ability of its loan performance models by incorporating additional variables found to influence credit risk and is in the process of addressing a number of limitations in its mortgage scorecard that could reduce its effectiveness for risk-based pricing. For instance, as we reported in April 2006, the scorecard does not include a number of important variables included in other mortgage institutions' scorecards, such as the source of the down payment.⁵ FHA also has identified changes in information systems needed to implement the legislative proposals and has obligated or requested a

⁵GAO, *Mortgage Financing: HUD Could Realize Additional Benefits from Its Mortgage Scorecard*, GAO-06-435 (Washington, D.C.: Apr. 13, 2006).

total of \$11 million for this purpose. To address human capital needs, the President's fiscal year 2008 budget requests 21 additional staff for FHA to help analyze industry trends, align the agency's business processes with current mortgage industry practices, and promote new FHA products. Although FHA has taken actions to enhance key tools and resources, it operates in a highly competitive environment in which other market participants have greater flexibility to hire and compensate staff and invest in information technology, which enhances their ability to adapt to market changes. Additionally, the legislative proposals would introduce new risks and challenges. The proposal to lower down-payment requirements is of particular concern given the greater default risk of low-down-payment loans, housing market conditions that could put borrowers with such loans in a negative equity position, and the difficulty of setting prices for new products whose risks may not be well understood. FHA plans to take some steps, such as instituting stricter underwriting standards, to mitigate these risks and challenges. However, while other mortgage institutions use pilot programs to manage the risks associated with changing or expanding their product lines, FHA has indicated that it does not plan to pilot any zero-down-payment product it is authorized to offer and lacks the resources to do so. We have previously reported that Congress may want to consider requiring FHA to limit the initial availability of any new products and also recommended that FHA itself consider piloting.

Mortgage industry participants and researchers have suggested a number of additional administrative and legislative options that Congress and FHA could consider to help FHA adapt to changes in the mortgage market, but some changes could have budget impacts and complicate oversight efforts. Some administrative changes—such as adjusting premiums or even implementing a more limited form of risk-based pricing—are within FHA's existing authority. Congress also could consider granting FHA additional authorities that would increase the agency's operational flexibility. For example, Congress could allow FHA to invest the Fund's current resources—that is, negative subsidies that accrue in the Fund's reserves—in information technology and human capital. However, using the Fund's current resources would diminish its ability to withstand severe economic conditions and would also increase the federal government's budget deficit, all other things being equal. Additionally, Congress could expressly authorize FHA to offer and pilot new insurance products without prior congressional approval. Finally, Congress could consider various alternative approaches to the provision of federal mortgage insurance. For example, the federal government could continue to provide mortgage insurance but through a more independent government corporation, implement risk-sharing arrangements with private partners, or let market

forces determine the future need for federal mortgage insurance by making no program changes and allowing FHA's role in the mortgage market to increase or decrease according to market conditions. However, any fundamental changes to how the federal government provides mortgage insurance also could require new oversight mechanisms and would require careful deliberation.

While our report does not make any new recommendations, we make observations about the need for careful implementation of the legislative proposals, if passed. While FHA has performed considerable analysis to support its legislative proposals and has made or planned enhancements to many of the specific tools and resources that would be important to its implementation, the proposals present risks and challenges and should be viewed with caution. Continued management attention to our prior recommendations, including piloting new products and steps to improve its mortgage scorecard, could help FHA address these risks.

We provided HUD with a draft of this report. HUD commented that the draft report provided a balanced assessment but also that the report's concerns about FHA's risk management and emphasis on the need for piloting zero- or lower-down-payment products were unwarranted. HUD indicated that it had a firm basis for anticipating the performance of these products as a result of its experience with loans with down-payment assistance from nonprofit organizations funded by home sellers. While we acknowledge that this experience could inform assessment of how a zero-down-payment product would perform, the product could be utilized by a different population of borrowers than seller-funded down-payment assistance loans and may not perform similarly to these loans. Also, if authorized to offer a zero-down-payment product in the near future, FHA would be introducing it at a time when stagnating or declining home prices in some parts of the country could increase the risk of default. Because of these risks and uncertainties, we continue to believe that a prudent way to introduce a zero-down-payment product would be to limit its initial availability such as through a pilot program. We discuss HUD's comments in the agency comments section, and the agency's written comments are reproduced in appendix II.

Background

Congress established FHA in 1934 under the National Housing Act (P.L. 73-479) to broaden homeownership, protect and sustain lending institutions, and stimulate employment in the building industry. FHA insures a variety of mortgages for initial home purchases, construction and rehabilitation, and refinancing. In fiscal year 2006, FHA insured almost 426,000 mortgages

representing \$55 billion in mortgage insurance. FHA's single-family programs insure private lenders against losses from borrower defaults on mortgages that meet FHA criteria for properties with one to four housing units. FHA has played a particularly large role among minority, lower-income, and first-time homebuyers and generally is thought to promote stability in the market by ensuring the availability of mortgage credit in areas that may be underserved by the private sector or are experiencing economic downturns. In fiscal year 2006, 79 percent of FHA-insured home purchase loans went to first-time homebuyers, 31 percent of whom were minorities.

FHA is a government mortgage insurer in a market that also includes private insurers. Generally, borrowers are required to purchase mortgage insurance when the loan-to-value (LTV) ratio—the ratio of the amount of the mortgage loan to the value of the home—exceeds 80 percent. Private mortgage insurance policies provide lenders coverage on a portion (generally 20 to 30 percent) of the mortgage balance. However, borrowers who have difficulty meeting down-payment and credit requirements for conventional loans may find it easier to qualify for a loan with FHA insurance, which covers 100 percent of the value of the loan. Because the credit risk is mitigated by the federal guaranty, FHA borrowers are allowed to make very low down payments and generally pay interest rates that are competitive with prime mortgages.

FHA Insurance Requirements

Legislation sets certain standards for FHA-insured loans. FHA-insured borrowers are required to make a cash investment of a minimum of 3 percent. This investment may come from the borrowers' own funds or from certain third-party sources. However, borrowers are permitted to finance their mortgage insurance premiums and some closing costs, which can create an effective LTV ratio of close to 100 percent for some FHA-insured loans. Congress also has set limits on the size of the loans that may be insured by FHA. These limits vary by county. The limit for an FHA-insured mortgage is 95 percent of the local median home price, not to exceed 87 percent or fall below 48 percent of the Freddie Mac conforming loan limit, which was \$417,000 in 2006. Therefore, in 2006, FHA loan limits fell between a floor in low-cost areas of \$200,160 and a ceiling in high-cost areas of \$362,790. Eighty-two percent of counties nationwide had loan limits set at the low-cost floor, while 3 percent had limits set at the high-cost ceiling. The remaining 15 percent of counties had limits set between the floor and ceiling, at 95 percent of their local median home prices.

FHA's Mutual Mortgage Insurance Fund

FHA insures most of its single-family mortgages under its Mutual Mortgage Insurance Fund, which is supported by borrowers' insurance premiums. FHA has the authority to establish and collect a single up-front premium in an amount not to exceed 2.25 percent of the amount of the original insured principal obligation of the mortgage, and annual premiums of up to 0.5 percent of the remaining insured principal balance, or 0.55 percent for borrowers with down payments of less than 5 percent. Currently, FHA uses a flat premium structure whereby all borrowers pay the same 1.5 percent up-front fee and a 0.5 percent annual fee.

The Omnibus Budget Reconciliation Act of 1990 requires an annual independent actuarial review of the economic net worth and soundness of the Fund. The actuarial review estimates the economic value of the Fund as well as the capital ratio to see if the Fund has met the capital standards in the act.⁶ The analysis considers the historical performance of the existing loans in the Fund, projected future economic conditions, loss given claim rates, and projected mortgage originations. The Fund has met the capital ratio requirements since 1995, and the single-family mortgage insurance program has maintained a negative overall credit subsidy rate, meaning that the present value of estimated cash inflows from premiums and recoveries exceeds estimated cash outflows for claim payments (excluding administrative costs). However, in recent years, the subsidy rate has approached zero.

A few single-family mortgage insurance programs are insured as obligations under either the General Insurance or Special Risk Insurance Funds. These programs are Section 203(k) rehabilitation mortgages, which enable borrowers to finance both the purchase (or refinancing) of a house and the cost of its rehabilitation through a single mortgage; Section 234(c) insurance for the purchase of a unit in a condominium building; and reverse mortgages under the Home Equity Conversion Mortgage (HECM) program, which can be used by homeowners age 62 and older to convert the equity in their home into a lump sum payment, monthly streams of income, or a line of credit to be repaid when they no longer occupy the home.

⁶The economic value of the Fund is the value of the Fund's assets minus its liabilities, plus the net present value of future cash flows of the outstanding portfolio. The capital ratio is the economic value divided by the amount of unamortized insurance-in-force (the total initial loan amounts of outstanding insured loans). The Omnibus Budget Reconciliation Act of 1990 mandated that the Fund achieve a capital ratio of at least 2 percent by fiscal year 2000 and maintain that level in all future years. See P.L. 101-508, Section 2105.

Trends in the Mortgage Market and Their Impact on FHA

Two major trends in the conventional mortgage market have significantly affected FHA. First, in recent years, members of the conventional mortgage market increasingly have been active in supporting low- and no-down-payment mortgages, increasing consumer choices for borrowers who may have previously chosen an FHA-insured loan. Subprime lenders, in particular, have offered mortgage products featuring flexible payment and interest options that allowed borrowers to qualify for mortgages despite a rise in home prices.⁷ Second, to help assess the default risk of borrowers, particularly those with high LTV ratios, the mortgage industry increasingly has used mortgage scoring and automated underwriting systems. Underwriting refers to a risk analysis that uses information collected during the origination process to decide whether to approve a loan, and automated underwriting refers to the process by which lenders enter information on potential borrowers into electronic systems that contain an evaluative formula, or algorithm, called a scorecard. The scorecard algorithm attempts to measure the borrower's risk of default quickly and objectively by examining data such as application information and credit scores. (Credit scores assign a numeric value generally ranging from 300 to 850 to a borrower's credit history, with higher values signifying better credit.) The scorecard compares these data with specific underwriting criteria (e.g., cash reserves and credit requirements) to predict the likelihood of default. Since 2004, FHA has used its own scorecard called Technology Open to Approved Lenders (TOTAL). FHA lenders now use TOTAL in conjunction with automated underwriting systems to determine the likelihood of default. Although TOTAL can determine the credit risk of a borrower, it does not reject a loan. FHA requires lenders to manually underwrite loans that are not accepted by TOTAL to determine if the loan should be accepted or rejected.

Further, as we noted in a recent report, the share of home purchase mortgage loans insured by FHA has fallen dramatically, from 19 percent in 1996 to 6 percent in 2005, with almost all the decline occurring since 2001.⁸ The combination of (1) FHA product restrictions and a lack of process improvements relative to the conventional market and (2) product innovations and expanded loan origination and funding channels in the conventional market—coupled with interest rate and house price changes—provided conditions that favored conventional mortgages over

⁷Subprime borrowers typically have blemished credit, may have difficulty providing income documentation, and generally pay higher interest rates and fees than prime borrowers.

⁸[GAO-07-645](#).

FHA products. Conventional subprime loans, in particular, emerged as an alternative to FHA-insured mortgages but often at a higher ultimate cost to certain borrowers.

At the same time, FHA's financial performance has worsened. As we noted in a recent testimony, one reason for deteriorating loan performance has been the increase in FHA-insured loans with down-payment assistance from nonprofit organizations funded by home sellers.⁹ Down-payment assistance programs provide cash assistance to homebuyers who cannot afford to make the minimum down payment or pay the closing costs involved in obtaining a mortgage. From 2000 to 2006, the total proportion of FHA-insured home purchase loans with down-payment assistance from nonprofits (the large majority of which received funding from property sellers) increased from about 2 percent to approximately 33 percent.

Legislative Proposals for FHA Modernization

To help FHA adapt to recent trends in the mortgage market, in 2006 HUD submitted a legislative proposal to Congress that included changes that would adjust loan limits for the single-family mortgage insurance program, eliminate the requirement for a minimum down payment, and provide greater flexibility to FHA to set insurance premiums based on risk factors. HUD's proposal, as it currently stands, reflects revisions made by the Expanding American Homeownership Act of 2006, which was passed by the House of Representatives in July 2006. Specifically, as shown in figure 1, the proposal would increase the loan limit for FHA-insured mortgages from 95 to 100 percent of the local median home price. It would also raise the loan limit floor in low-cost areas from 48 to 65 percent of the conforming loan limit, and the ceiling in high-cost areas from 87 to 100 percent of the conforming limit.¹⁰ The proposal would also repeal the 3 percent minimum cash investment requirement and allow FHA to set premiums commensurate with the risk of the loan.¹¹ FHA would establish a premium structure allowing either a combination of upfront and annual

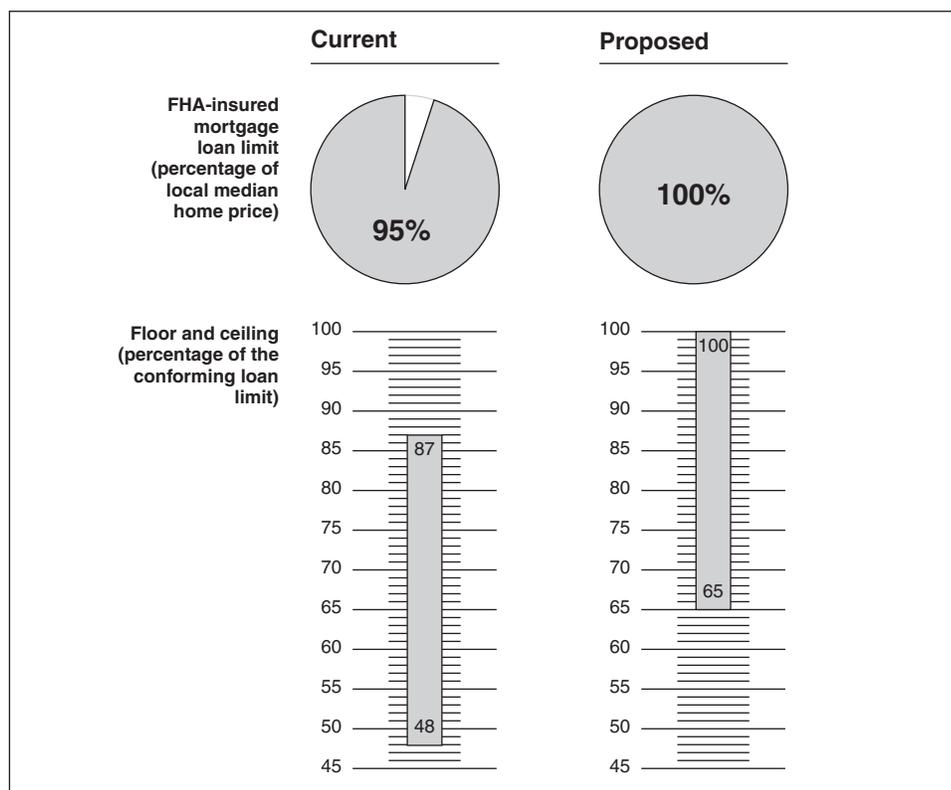
⁹GAO, *Federal Housing Administration: Ability to Manage Risks and Program Changes Will Affect Financial Performance*, [GAO-07-615T](#) (Washington, D.C.: Mar. 15, 2007).

¹⁰According to FHA, the existing loan limits are lower than the cost of new construction in many areas of the country and therefore do not allow buyers of new homes to use FHA products.

¹¹The proposal to repeal the 3 percent minimum cash investment requirement would eliminate the complicated statutory formula used to calculate down payments. This formula considers multiple variables such as the average closing costs in the state.

premiums or annual premiums alone, subject to specified maximum amounts.

Figure 1: Proposed Changes to FHA's Loan Limits



Sources: GAO, HUD.

In addition to these three major changes, the modernization proposal also contained other provisions, including:

- Permanently eliminating the limit on the number of HECM (reverse) mortgages that can be insured, setting a single nationwide loan limit for HECMs, and authorizing a HECM program for home purchases.¹²

¹²Under the program, seniors who wished to move from their current home could get a home purchase loan for a new dwelling and convert that loan into an HECM in a single transaction.

-
- Extending the permissible term of FHA-insured mortgages from 35 to 40 years.
 - Moving HECMs, Section 203(k) rehabilitation mortgages, and Section 234(c) condominium unit mortgages from the General Insurance and Special Risk Insurance Funds to the Mutual Mortgage Insurance Fund. Moving the condominium program to the Fund would simplify the origination and underwriting process for these loans because they would no longer be subject to more complex requirements for multifamily housing loans.

While FHA's planning has reflected revisions made to its original proposal by the House of Representatives in the 109th Congress, new bills introduced in the 110th Congress could further affect FHA's planning.¹³

Modernization Efforts Have Streamlined FHA Processes and Likely Would Affect Program Participation and Costs

FHA's modernization efforts, which include completed administrative and proposed legislative changes, have streamlined the agency's insurance processes and likely would affect program participation and costs. According to FHA and mortgage industry officials with whom we spoke, FHA's recent administrative changes have resulted in efficiency improvements, making FHA products more attractive to use. FHA's proposed legislation would grant the agency new leeway to help address challenges, such as adverse selection, resulting from innovations and increased competition in the mortgage market. If passed, the legislative changes likely would have a number of program and budgetary impacts. For example, we estimate that raising the FHA loan limits could increase demand for FHA-insured loans, all other things being equal. The risk-based pricing proposal would decrease premiums for lower-risk borrowers, increase them for higher-risk borrowers, and disqualify other potential borrowers. In addition, FHA estimates that the legislative proposals would have a favorable budgetary impact.

¹³See H.R. 1752, 110th Cong. (2007); H.R. 1852, 110th Cong. (2007); S. 947, 110th Cong. (2007).

Mortgage Industry Officials Report That FHA's Recent Administrative Changes Have Increased the Efficiency of Loan and Insurance Processing

FHA has taken a number of steps to make the loans it insures easier to process and bring the agency more in line with the conventional market. For example, in January 2006, FHA introduced the Lender Insurance Program, which enables higher-performing lenders to endorse all FHA loans except HECMs without a prior review by FHA.¹⁴ Prior to that time, all lenders were required to mail loan case files to FHA for review by contract staff before the loan could be endorsed for insurance. If the contractor found a problem with the case file, FHA would mail the file back to the lender for correction. Under the new program, approved lenders are allowed to perform their own pre-endorsement reviews and submit loan data electronically to FHA.¹⁵ If the loan data pass checks for accuracy and completeness, the lender is able to endorse the loan automatically. As of December 31, 2006, 405 (31 percent) of the 1,314 FHA lenders eligible for the program had been approved to participate. Between January 1, 2006, and December 31, 2006, 46 percent of FHA-insured loans were endorsed through the program.

In addition to implementing the Lender Insurance Program, FHA revised its appraisal protocols and closing cost guidelines to align them more closely with conventional standards. Specifically, the agency simplified the appraisal process by adopting appraisal forms used in the conventional market and eliminating the requirement that minor property deficiencies be corrected prior to the sale of the property. Under the revised procedures, FHA limits required repairs to those necessary to protect the health and safety of the occupants, protect the security of the property, or correct physical deficiencies or conditions affecting structural integrity. Examples of property conditions that must be repaired include inadequate access to the exterior of the home from bedrooms, leaking roofs, and foundation damage. The agency requires the appraiser to identify minor property deficiencies (such as missing handrails, cracked window glass, and minor plumbing leaks) on the appraisal form, but no longer stipulates that they be repaired. These changes went into effect for all appraisals performed on or after January 1, 2006. In January 2006, FHA also eliminated its list of "allowable" and "non-allowable" closing costs and

¹⁴FHA defines higher-performing lenders as those with 2 years of acceptable default and claim rates (at or below 150 percent of the national average). Because FHA is phasing in the Lender Insurance Program, HECMs are not yet eligible for endorsement through the program.

¹⁵As was the agency's practice prior to the Lender Insurance Program, FHA will select a sample of each lender's mortgages for post-endorsement quality checks.

other fees that may be collected from the borrower. The agency made this change because FHA lenders had advised the agency that home sellers sometimes balked at accepting a sales contract from a homebuyer wishing to use FHA-insured financing because its guidelines differed from standard practice and did not consider regional variations. Lenders may now charge and collect from borrowers those customary and reasonable costs necessary to close the mortgage.

According to FHA lenders and industry groups, these changes have increased the efficiency of loan processing, making FHA products more attractive to use. Representatives of a mortgage industry group told us that feedback from the group's members on the Lender Insurance Program had been positive.¹⁶ Similarly, the FHA lenders we interviewed stated that the program had resulted in efficiency improvements, such as reduced processing times or costs. For example, one large FHA lender estimated that participating in the program had reduced the time it took to process an FHA-insured loan by about 35 percent (or 15 to 20 days). The same FHA lender also estimated that participation in the program had reduced the operating costs (mostly printing and shipping costs) for its FHA business by about 25 percent. Additionally, the FHA lenders we interviewed and representatives of a real estate industry group noted that FHA's revised appraisal protocols and closing costs had made it easier to originate FHA loans. Representatives of the industry group noted that the revisions had shortened the time it took to close an FHA loan, which was important in a competitive market. Finally, the lenders we interviewed estimated that the administrative changes had contributed, at least in part, to recent modest increases in the number of FHA-insured loans they had made.

According to FHA officials, the Lender Insurance Program also has reduced the time it takes FHA to process insurance endorsements and led to cost savings. They estimated that it takes FHA from 2 to 3 days to endorse applications for insurance on loans that are not part of the program. For loans endorsed through the program, they noted that approval is virtually instantaneous if the loan passes quality checks. In addition to reducing insurance processing times, the program has resulted in cost savings for FHA. During the first year of the program, FHA realized a reduction in contracting costs of more than \$2 million, as its contractors

¹⁶Although the Lender Insurance Program has streamlined the processing of FHA-insured loans, the HUD Inspector General has expressed concerns that the program could increase the risk of fraud because the lenders, rather than FHA, maintain the records on loans insured through the program.

were required to perform fewer pre-endorsement reviews. FHA also saved more than \$70,000 in mailing costs during the first 9 months of the program. FHA estimates that contract costs will continue to decline as the program is expanded to include the HECM program.

Raising Loan Limits Likely Would Increase Demand for FHA Loans, but the Effect of Other Major Proposals on FHA Loan Volume Is Uncertain

Our analysis indicates that raising FHA's loan limits likely would increase the number of loans insured by FHA by making more loans eligible for FHA insurance. In some areas of the country, particularly in parts of California and the Northeast, median home prices have been well above FHA's maximum loan limits, reducing the agency's ability to serve borrowers in those markets. For example, the 2005 loan limit in high-cost areas was \$312,895 for one-unit properties, while the median home price was about \$399,000 in Boston, Massachusetts; about \$432,000 in Newark, New Jersey; \$500,000 in Salinas, California; and about \$646,000 in San Francisco, California. If the limits were increased, FHA insurance would be available to a greater number of potential borrowers. Our analysis of HMDA data indicates that the agency could have insured from 9 to 10 percent more loans in 2005 had the higher mortgage limits been in place.¹⁷ The greatest portion of this increase resulted from raising the loan limit floor in low-cost areas from 48 to 65 percent of the conforming loan limit. In particular, 82 percent of the new loans that would have been insured by FHA and 74 percent of the dollar amount of those loans in our analysis occurred in areas where the loan limits were set at the floor. Only 14 percent of the new loans (22 percent of the dollar amount of new loans) would have resulted from increasing the loan limit ceiling. Our analysis also found that the average size of an FHA-insured loan in 2005 would have increased from approximately \$123,000 to about \$132,000 had the higher loan limits been in place.

The effect of the other major legislative proposals on the demand for FHA-insured loans is difficult to estimate. Although FHA has not estimated the effect on demand, FHA officials expect that risk-based pricing would enable them to serve more borrowers. By reducing premiums for relatively lower-risk borrowers, FHA expects to attract more of these borrowers. However, increased premiums for higher-risk borrowers could reduce

¹⁷Our analysis considered the number of additional loans that would have been eligible for FHA insurance if the loan limits in 2005 had been raised to 100 percent of area median income, with a floor in low-cost areas of \$233,773 and a ceiling in high-cost areas of \$359,650. For our assumptions about the share of newly eligible loans that would likely be insured by FHA, see appendix I.

these borrowers' demand for FHA products. Additionally, some high-risk borrowers who previously would have qualified for FHA insurance would not qualify under risk-based pricing. The effect of lowering down-payment requirements on demand for FHA-insured loans is also difficult to estimate. FHA expects a new zero-down-payment product to attract borrowers who otherwise would have used down-payment assistance from nonprofit organizations funded by home sellers. However, underwriting restrictions could limit the number of borrowers who would qualify for the product.

Developments in the subprime market also may affect the demand for FHA loans. Since 2001, FHA's share of the mortgage market has declined as the subprime market has grown. However, relatively high default and foreclosure rates for subprime loans and a contraction of this market segment could shift market share to FHA. For example, one major lender we interviewed said that FHA's continued modernization efforts combined with a weakening subprime market likely would result in renewed demand for FHA products as simplified processes make it easier for lenders to originate FHA-insured loans.

Risk-Based Pricing Could Help Address Adverse Selection but Would Affect the Cost and Availability of FHA Insurance for Some Borrowers

To help address the problem of adverse selection, FHA has sought authority to price insurance premiums based on borrower risk, which would affect the cost and availability of FHA insurance for some borrowers. Currently, all FHA-insured borrowers pay an up-front premium of 1.5 percent of the original insured loan amount, and annual premiums of 0.5 percent of the remaining insured principal balance. Under this flat pricing structure, lower-risk borrowers subsidize higher-risk borrowers. In recent years, innovations in the mortgage market have allowed conventional mortgage lenders and insurers to identify and approve relatively low-risk borrowers and charge fees based on default risk. As relatively lower-risk borrowers in FHA's traditional market segment have selected conventional financing, FHA has been left with more high-risk borrowers who require a subsidy and fewer low-risk borrowers to provide that subsidy.

Partly due to this trend, the President's fiscal year 2008 budget stated that, in the absence of risk-based pricing, FHA would need to raise premiums to avoid the need for a positive subsidy. FHA officials told us that they would have to raise premiums for all borrowers to 1.66 percent up front and 0.55 percent annually. Raising premiums for all borrowers could exacerbate FHA's adverse selection problem by causing even more lower-risk borrowers to opt for more competitive conventional products rather than

FHA-insured loans, leaving FHA with even fewer lower-risk borrowers to subsidize higher-risk borrowers. Rather than raise premiums for all borrowers, FHA has proposed risk-based pricing as a solution to the adverse selection problem. Under risk-based pricing, some future FHA borrowers would pay more than the current premiums while others would pay about the same or less. As previously noted, discounting premiums could make FHA a more attractive option for relatively lower-risk borrowers.

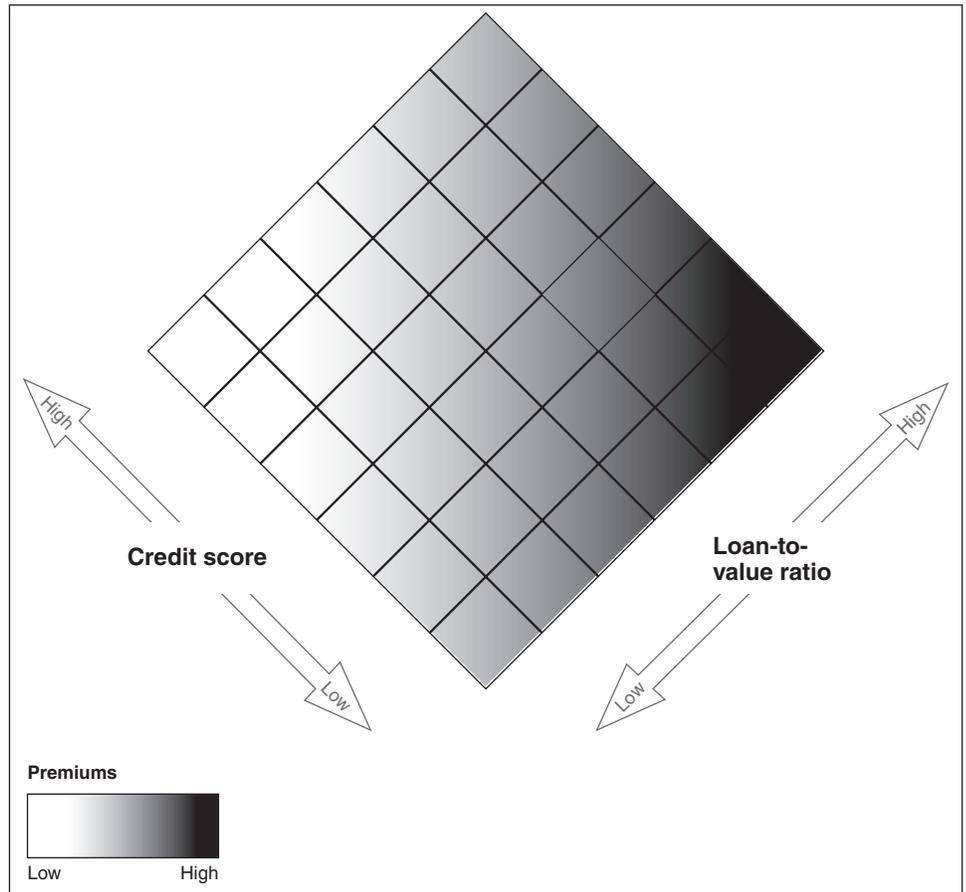
As of May 2007, FHA's risk-based pricing proposal established six different risk categories, each with a different premium rate, for purchase and refinance loans.¹⁸ FHA used data from its most recent actuarial review to establish the six risk categories and corresponding premiums based on the relative performance of loans with various combinations of LTV ratio and credit score. Borrowers in categories with higher expected lifetime claim rates would have higher premiums than those in categories with lower claim rates. Premiums would range from 0.75 percent up front and 0.50 percent annually for the lowest-risk borrowers, to 3.00 percent up front and 0.75 percent annually for the highest-risk borrowers. Although the premiums that FHA would charge borrowers in the six risk categories would be more commensurate with the risks of the loans, lower-risk borrowers would continue to subsidize higher-risk borrowers to some extent.

If FHA were granted the authority to implement its risk-based pricing proposal, the agency would publish a pricing matrix that would allow borrowers to identify their likely premiums based on their credit scores and LTV ratios. As shown in figure 2, lower borrower credit scores and higher LTV ratios would result in higher insurance premiums. However, FHA would use its TOTAL mortgage scorecard to make the final determination of a borrower's placement in a particular risk category. While TOTAL takes into account more borrower and loan characteristics than LTV ratio and credit score (such as borrower reserves and payment-to-income ratio), it was designed to predict the probability of claims or defaults that would later result in claims within 4 years of loan origination rather than lifetime claim rates. Therefore, FHA rescaled the TOTAL scores to reflect lifetime claim rates. Because of the additional risk characteristics considered by TOTAL, a borrower's TOTAL score could indicate that a borrower belongs in a higher risk category than would be

¹⁸Different pricing would apply to refinances of existing FHA-insured mortgages.

suggested by LTV ratio and credit score alone. FHA has not produced a formal estimate of how often this would occur, but plans to include this caveat in its pricing matrix.

Figure 2: Impact of Borrower Credit Scores and LTV Ratios on Insurance Premiums under FHA's Risk-Based Pricing Proposal

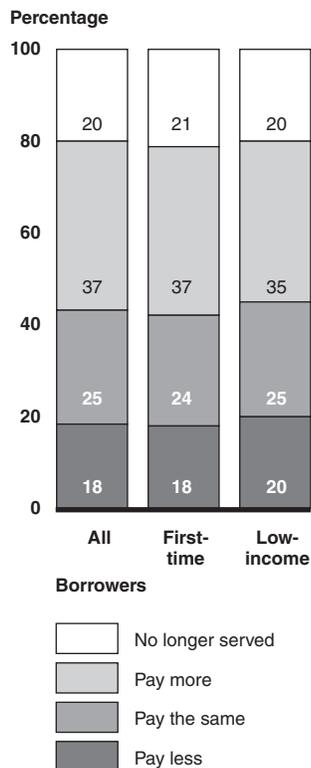


Sources: GAO, FHA.

Our analysis of how the proposed pricing structure would affect home purchase borrowers similar to those insured by FHA in 2005 found that approximately 43 percent of borrowers would have paid the same or less while 37 percent would have paid more. As discussed more fully later, 20 percent would not have qualified for FHA insurance had the risk-based pricing proposal been in effect. These percentages hold true whether comparing the proposed risk-based premiums to the current premiums of

1.5 percent up front and 0.5 percent annually or the higher premiums of 1.66 percent up front and 0.55 percent annually that, according to FHA, would be needed to maintain a negative subsidy rate in fiscal year 2008. As shown in figure 3, risk-based pricing would have had a similar impact on first-time and low-income homebuyers FHA served in 2005.

Figure 3: Impact of FHA’s Risk-Based Pricing Proposal on Borrowers’ Premiums, Including First-Time and Low-Income Homebuyers



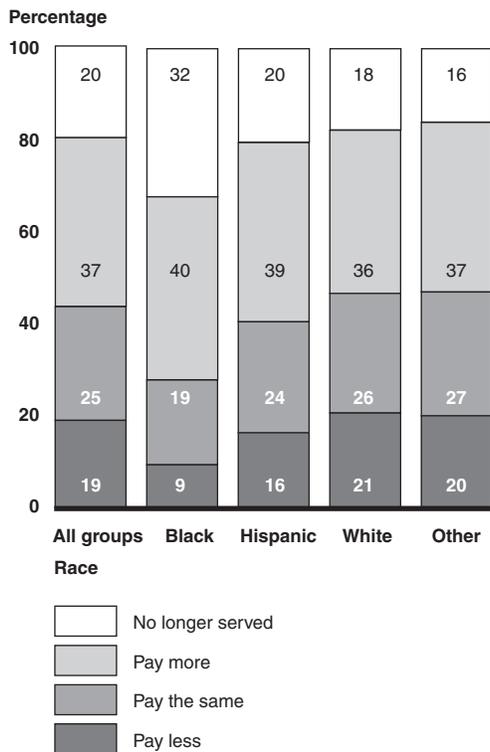
Sources: GAO, SFDW.

Note: We analyzed SFDW data on 2005 home purchase borrowers. The figure shows how these borrowers would have fared under FHA’s risk-based pricing proposal. Low-income homebuyers are those whose incomes are less than or equal to 80 percent of the area median income. The figure excludes the approximately 2 percent of borrowers for whom SFDW did not contain either an LTV ratio or credit score (the two variables FHA would use to determine risk-based premiums).

Among FHA’s 2005 borrowers, 47 percent of white borrowers and 40 percent of Hispanic borrowers would have paid the same or less under the new proposed risk-based pricing structure than they did under the present pricing structure, while 28 percent of black borrowers would have paid the same or less. A little more than one-third of borrowers in each racial

category would have paid more (see fig. 4). FHA officials concluded, in their analysis of an earlier version of the risk-based pricing proposal, that any disparate impacts of risk-based pricing using consumer credit scores would be based on valid business reasons. Specifically, they noted that, although some racial differences do exist in the distribution of credit scores and LTV ratios, these variables are strongly associated with claim rates and have become the primary risk factors used for pricing credit risk in the conventional market.

Figure 4: Impact of FHA’s Risk-Based Pricing Proposal on Premiums Paid by Different Racial Groups



Sources: GAO, SFDW.

Note: We analyzed SFDW data on 2005 home purchase borrowers. The figure shows how these borrowers would have fared under FHA’s risk-based pricing proposal. It excludes the 2 percent of borrowers for whom SFDW did not contain either an LTV ratio or credit score (the two variables FHA would use to determine risk-based premiums) and the 2.9 percent of borrowers for whom race was not disclosed. Percentages do not add to 100 due to rounding.

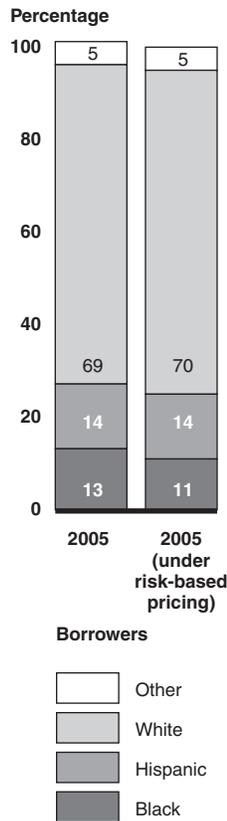
Risk-based pricing would also affect the availability of FHA insurance for some borrowers. Approximately 20 percent of FHA’s 2005 borrowers

would not have qualified for FHA mortgage insurance under the parameters of the risk-based pricing proposal we evaluated. FHA determined that the expected claim rates of these borrowers were higher than it found tolerable for either the borrower or the Fund. Those borrowers who would not have qualified had high LTV ratios and low credit scores. Their average credit score was 584, and their expected lifetime claim rates are more than 2.5 times higher than the average claim rate of all FHA loans.¹⁹ FHA officials stated that setting risk-based premiums for potential future FHA borrowers with similar characteristics would require prices higher than borrowers may be able to afford.

The overall distribution of 2005 FHA borrowers (by income, first-time borrower status, or race) would not have changed substantially had the policy not to serve borrowers with these higher expected lifetime claim rates been in place that year (all other things being equal). If the 20 percent of borrowers with the higher expected claim rates were removed from FHA's 2005 borrower pool, our analysis found that low-income homebuyers would have remained about 51 percent of the pool. First-time homebuyers would have constituted about 78 percent of the pool, compared with 79 percent when all borrowers are included. Similarly, the overall racial distribution of borrowers would have changed modestly (see fig. 5). The percentage of Hispanic borrowers would have remained about 14 percent, black borrowers would have decreased from 13 to 11 percent, and white borrowers would have increased from 69 to 70 percent.

¹⁹ Additionally, the vast majority of these borrowers (90 percent) received down-payment assistance from nonprofits, most of which received funding from property sellers.

Figure 5: Impact of FHA’s Risk-Based Pricing Proposal on Racial Distribution of FHA Borrowers



Sources: GAO, SFDW.

Note: We analyzed SFDW data on 2005 home purchase borrowers. The figure shows how these borrowers would have fared under FHA’s risk-based pricing proposal. Percentages do not add to 100 due to rounding.

All other things being equal, implementing the legislative proposals likely would have had a slightly negative impact on FHA’s ability to meet certain performance measures related to the types of borrowers it serves. HUD’s strategic plan for fiscal years 2006 to 2011 calls for the share of first-time minority homebuyers among FHA home purchase mortgages to remain above 35 percent. Our analysis shows that 34 percent of fiscal year 2005 home purchase mortgages were for first-time minority home buyers. Under risk-based pricing, a slightly lower percentage, 32 percent, would have been first-time minority home buyers. The strategic plan also calls for the share of FHA-insured home purchase mortgages for first-time homebuyers to remain above 71 percent. Our analysis shows that

79 percent of fiscal year 2005 FHA home purchase borrowers were first-time home buyers. Under risk-based pricing, 77 percent would have been first-time home buyers.

Legislative Proposals Likely Would Have a Beneficial Budgetary Impact

According to FHA's estimates, the three major legislative proposals would have a beneficial impact on HUD's budget due to higher estimated negative subsidies. According to the President's fiscal year 2008 budget, the credit subsidy rate for the Fund would be more favorable if the legislative proposals were enacted. Absent any program changes, FHA estimates that the Fund would require an appropriation of credit subsidy budget authority of approximately \$143 million. If the legislative proposals were not enacted, FHA would consider raising premiums to avoid the need for appropriations. If the major legislative proposals were passed, FHA estimates that the Fund would generate \$342 million in negative subsidies.²⁰

FHA's subsidy estimates for fiscal year 2008 should be viewed with caution given that FHA has generally underestimated the subsidy costs for the Fund. To meet federal requirements, FHA annually reestimates subsidy costs for each loan cohort dating back to fiscal year 1992.²¹ The current reestimated subsidy costs for all except the fiscal year 1992 and 1993 cohorts are higher than the original estimates. For example, the current reestimated cost for the fiscal year 2006 cohort is about \$800 million higher than originally estimated. As discussed more fully later in this report, FHA has taken some steps to improve its subsidy estimates.

²⁰These figures do not reflect FHA's proposals to eliminate the limit on the number of mortgages insured under the HECM program and move the program from the General Insurance Fund to the Mutual Mortgage Insurance Fund. According to FHA's estimates, the HECM program would generate about \$338 million in negative subsidies in fiscal year 2008. Therefore, moving the HECM program would result in negative subsidies totaling about \$680 million for the Fund.

²¹Agencies are required to reestimate subsidy costs annually to reflect actual loan performance and expected changes in estimates of future loan performance. Essentially, a cohort includes the loans insured in a given year.

FHA Has Enhanced Tools and Resources Important to Implementing Proposals but Does Not Intend to Mitigate Risks by Piloting New Products

FHA has enhanced the tools and resources it uses that would be important to implementing the legislative proposals, but has not always used industry practices that could help the agency manage the risks associated with program changes. To implement risk-based pricing, FHA would rely on historical loan-level data, models that estimate loan performance, and its TOTAL mortgage scorecard. Although FHA has improved the forecasting ability of its models by adding variables found to influence credit risk, the agency is still addressing limitations in TOTAL that could reduce its effectiveness as a pricing tool. FHA also has identified changes in information systems needed to implement the legislative proposals and requested additional staff to help promote new FHA products but faces long-term challenges in these areas. However, the legislative proposals would introduce new risks and challenges such as the difficulty of pricing loans with very low or no down payments whose risks may not be well understood. While other mortgage institutions use pilot programs to manage the risks associated with changing or expanding their product lines, FHA has indicated that it does not plan to pilot any no-down-payment product it is authorized to offer.

Credit Score Information Has Enhanced the Data FHA Would Use to Implement Proposals

Mortgage institutions use detailed information on the characteristics and performance of past loans to help predict the performance of future loans and price them correctly. Like other mortgage institutions we contacted, FHA has extensive loan-level data. These data are contained in the agency's SFDW, which FHA implemented in 1996 to assemble critical data from 12 single-family systems.²² SFDW is updated monthly and currently contains data on approximately 33 million FHA-insured loans dating back to fiscal year 1975. These data include information on the borrower (such as age, gender, race, income, and first-time home buyer status) and the loan (including whether it is an adjustable- or fixed-rate mortgage, the source and amount of any down-payment assistance, interest rate, premium rate, original mortgage amount, and LTV ratio).

FHA has added information on borrower credit scores to the loan-level data that it plans to use to assess risk and set insurance premiums if the legislative proposals were enacted. Research has shown that credit scores are a strong predictor of loan performance—that is, borrowers with higher

²²These systems contain a wide variety of data that support FHA's administration of its single-family mortgage insurance program, including information on mortgage lenders and borrowers and the financial details and performance of the loans.

scores experience lower levels of default. FHA started collecting credit score data in the late 1990s when it began allowing its lenders to use automated underwriting systems and mortgage scorecards. Upon approving the use of Fannie Mae and Freddie Mac's mortgage scorecards in fiscal year 1998, FHA began receiving credit score data for loans underwritten using these scoring tools. To develop its own mortgage scorecard, FHA purchased archived credit scoring data for loan origination samples dating back to 1992. Since implementing its TOTAL mortgage scorecard in May 2004, FHA has collected credit scores on almost all FHA borrowers.

FHA Has Made Some Improvements to Key Statistical Models, but Additional Challenges Remain

FHA would rely on both its loan performance models and TOTAL mortgage scorecard to set insurance premiums if authorized to implement risk-based pricing. Although FHA has improved the forecasting ability of its loan performance models by incorporating additional variables found to influence credit risk, FHA is still in the process of addressing a number of limitations in TOTAL that could reduce its effectiveness for risk-based pricing. The agency's actuarial review contractor developed the loan performance models to estimate the economic value of the Fund for the annual actuarial review. The models estimate lifetime claim and prepayment (the payment of a loan before its maturity date) rates based on factors such as origination year, age, interest rate, mortgage product type, initial LTV ratio, and loan amount. FHA used the projected lifetime claim and prepayment rates from the most recent actuarial review as the basis for its proposed risk-based insurance premiums.²³

FHA has improved its loan performance models by adding factors that have been found to influence credit risk. In September 2005, we reported that FHA's subsidy reestimates, which use data from FHA's loan performance models, reflect a consistent underestimation of the costs of its single-family insurance program. We recommended that FHA study and report the impact (on the forecasting ability of its loan performance models) of variables that have been found in other studies to influence credit risk, such as payment-to-income ratios, credit scores, and the

²³More specifically, FHA developed index values—the ratio of the claim and prepayment rates for borrowers in different credit score and LTV ratio groupings to the claim and prepayment rate for FHA's average borrower. (FHA used loans with down-payment assistance from seller-funded nonprofit organizations as a proxy for loans with LTV ratios of 100 percent.) FHA then applied these index values to the estimated lifetime claim and prepayment rates for the fiscal year 2008 book of business.

presence of down-payment assistance.²⁴ In response, HUD indicated that its contractor was considering the specific variables that we had recommended FHA include in its annual actuarial review of the Fund. The contractor subsequently incorporated the source of down-payment assistance in the fiscal year 2005 actuarial review and borrower credit scores in the fiscal year 2006 review.

FHA also intends to use TOTAL to determine risk-based premiums, but we have identified weaknesses in the scorecard that could limit its effectiveness as a pricing tool. As previously noted, FHA plans to use TOTAL to make the final determination regarding premium rates if authorized to implement risk-based pricing. However, we reported in April 2006 that TOTAL excludes a number of important variables included in other mortgage scoring systems.²⁵ For example, TOTAL does not distinguish between adjustable- and fixed-rate mortgages. However, adjustable-rate mortgages generally are considered to be higher risk than otherwise comparable fixed-rate mortgages because borrowers are subject to higher payments if interest rates rise. Unlike the mortgage scorecards of other institutions, TOTAL also does not include an indicator for property type (single-family detached homes or condominiums, for example).²⁶ While currently a small component of FHA's business, FHA expects that it would insure more condominium loans if the condominium program were moved to the Fund, as set forth in its legislative proposal. Additionally, TOTAL does not indicate the source of the down payment. We have reported that the source of a down payment is an important indicator of risk, and the use of down-payment assistance in the FHA program has grown substantially since 2000. Finally, our April 2006 report noted that the data used to develop TOTAL were not current and FHA had no plans to update the scorecard on a regular basis.

²⁴See GAO, *Mortgage Financing: FHA's \$7 Billion Reestimate Reflects Higher Claims and Changing Loan Performance Estimates*, [GAO-05-875](#) (Washington, D.C.: Sept. 2, 2005). While loan performance models are critical to subsidy cost estimation, other factors such as assumptions about the losses per insurance claim and economic conditions also influence subsidy estimates.

²⁵[GAO-06-435](#).

²⁶FHA indicated that variables for adjustable-rate mortgages and property type were not included in TOTAL because the risk associated with them did not differ significantly in the data sample used to develop the model. However, the modeling effort may have failed to find significant effects for these variables because of the small numbers of loans with these characteristics in the development sample.

Consistent with our recommendations concerning TOTAL, FHA developed policies and procedures that call for (1) an annual evaluation of the scorecard's predictive ability, (2) testing of additional predictive variables to include in the scorecard, and (3) populating the scorecard with more recent loan performance data. An FHA contractor is helping the agency to implement these procedures and is scheduled to issue a final report on its work in August 2007. After receiving the contractor's report, FHA will decide what changes to TOTAL are necessary. Because the magnitude of these changes has not yet been determined, FHA does not have a completion date for this effort. FHA officials indicated that they would initially implement risk-based pricing using the current version of TOTAL but would use the updated version when it became available.

FHA Has Identified Needed Changes in Information Technology but Faces Funding and Implementation Challenges

FHA has identified changes needed in its information technology to implement the legislative proposals. FHA has divided these changes into two phases. The first phase consists of simpler changes that it can make in the short term, such as revising the system used to originate FHA-insured loans to allow for down payments of less than 3 percent. FHA also would need to make other changes to the system to support the new loan limits, such as allowing the loan amount to equal 100 percent of the conforming loan limit in applicable areas. The second phase includes modifications to the computer programs that calculate the up-front and annual insurance premiums to reflect risk-based pricing and revisions related to the proposed changes to the HECM and condominium programs.

FHA has not yet obtained some of the funding needed to make the technology changes and does not have estimates for how long it would take to complete all of the changes. In fiscal year 2006, the agency obligated \$2.8 million of the \$10.9 million it estimated was needed to make all anticipated changes. Specifically, FHA plans to use funds reprogrammed from HUD's salaries and expense account and other available funds to complete the first phase of changes. FHA estimates that most of this work could be completed in a few months. The President's fiscal year 2008 budget requests an additional \$8.1 million to fund the second phase of changes needed to implement the legislative proposals. However, FHA officials told us that they did not have an implementation schedule for this phase and were waiting until the legislative proposals were approved and they had secured the funding to develop one.

Although FHA officials indicated that they could implement the legislative proposals after making these minor information technology changes, they also told us that major systems changes and integration would be needed

to bring FHA's systems up to levels comparable with other mortgage institutions. Currently, over 40 systems support FHA's single-family business activity. While a thorough evaluation of large-scale systems changes was outside the scope of our review, FHA has indicated that its systems are poorly integrated, expensive to maintain, and do not fully support the agency's operations and business requirements.²⁷ For example, the systems cannot easily share or provide critical information because they use different database platforms with varying capabilities; some of the older systems use an outdated programming language; and the creation of ad hoc systems that do not interface with other systems has resulted in duplicate data entry. However, FHA has limited resources to devote to the development of new systems for two main reasons. First, it has to compete with other divisions within HUD for information technology resources. Of the approximately \$300 million that HUD has requested for information technology development and maintenance in fiscal year 2008, about 5 percent would be for FHA's single-family operations. Second, FHA spends what resources it has primarily on systems maintenance. Of the \$19 million that FHA has budgeted for single-family information technology in fiscal year 2007, FHA officials estimate that \$15 million would be devoted to systems maintenance.

In contrast with FHA, officials from other mortgage institutions with whom we spoke indicated that they devote substantial resources to developing new systems and enhancing existing systems that help them price products and manage risk. To illustrate, officials from one mortgage institution stated that they had a \$15 million annual budget for capital improvements in information technology. Officials from another mortgage institution told us that 17 percent of the company's total expenses were related to information technology and that they recently spent about \$15 million to develop a new system to price a mortgage product for the foreign market. These and other mortgage industry officials stressed that investments in state-of-the-art information systems were critical to operating successfully in the highly competitive mortgage market.

²⁷These views are consistent with our October 2001 report on FHA's single-family information systems. See GAO, *Single-Family Housing: Current Information Systems Do Not Fully Support the Business Processes at HUD's Homeownership Centers*, [GAO-02-44](#) (Washington, D.C.: Oct. 24, 2001).

FHA Has Sought Limited Staff Increases to Help Implement Proposals, but Other Workforce Challenges Remain

According to FHA officials, the legislative proposals would not fundamentally alter how the agency administers its single-family mortgage insurance program and, therefore, would not require major increases in staff above the approximately 950 single-family housing employees it had as of March 2007. Although implementing the legislative proposals would require considerable program analysis and monitoring, much of the analysis required to develop the proposals was performed primarily by staff from FHA's Offices of Finance and Budget and Single Family Housing with assistance from several contractors, who will continue to support the implementation. FHA officials told us that marketing any new products authorized and explaining program changes to lenders would be their next major challenge if the legislative proposals were passed. They also noted that successful implementation would require them to stay abreast of developments in the mortgage market. Therefore, the President's fiscal year 2008 budget requests an additional 21 full-time equivalent (FTE) positions to help promote new FHA products, analyze industry trends, and align the agency's single-family business processes with current mortgage industry practices.

Although a detailed assessment of FHA's staffing needs was outside the scope of our review, a HUD contractor's 2004 workforce analysis suggests that FHA faces broader challenges that could affect the agency's operations going forward.²⁸ The analysis projected that FHA would have 78 fewer FTEs than needed to handle anticipated work demands by fiscal year 2008, assuming hires and transfers equal to the average numbers for 2001 through 2003. In addition to anticipated FTE shortfalls, the report also identified existing and projected deficits of FHA staff with certain important competencies such as technical credibility and knowledge of single-family programs, policies, and regulations.²⁹ For example, the consultant projected a difference of 28 percentage points between the percentage of staff requiring technical credibility and the percentage that would meet this requirement in fiscal year 2008. FHA officials have acknowledged the agency's staffing challenges and have developed plans to address the projected gaps. In fiscal years 2005 and 2006, FHA gained 228 staff through hiring or transfers. However, the contractor had assumed

²⁸LMI Government Consulting for the U.S. Department of Housing and Urban Development, *Strategic Workforce Plan* (McLean, Va.: November 2004).

²⁹The analysis defined technical credibility as demonstrating programmatic, financial, and technical knowledge and expertise that is commensurate with the demands of the position and understanding requirements for the administration of federal grants and loan guarantees.

gains of 362 staff during those years, which means that the projected fiscal year 2008 shortfall will be worse than originally estimated without substantial staff accessions in fiscal years 2007 and 2008.

FHA also faces hiring and salary constraints that other mortgage institutions do not. FHA's hiring authority is limited by statute and congressional appropriations. Federal statute (Title 5 of the U.S. Code) restricts the amounts that FHA can pay staff, and each year's appropriation determines how many staff it can hire. Further, FHA must compete with other divisions within HUD for staffing resources and may not always receive its full request. Other mortgage institutions have greater flexibility in their ability to hire and compensate staff. For example, Fannie Mae and Freddie Mac are not subject to federal pay and hiring restrictions. These restrictions create challenges for FHA as it competes for qualified staff in the competitive mortgage labor market.

FHA's Prior Risk Management Did Not Always Utilize Common Industry Practices Such as Piloting, but Some Planned Actions Could Help Address New Risks and Challenges

Although FHA has not always utilized risk-management practices that other mortgage institutions use, it plans to take some steps to help address the new risks and challenges associated with the legislative proposals. In November 2005, we reported that HUD needed to take additional actions to manage risks related to the approximately one-third of its loans with down-payment assistance from seller-funded nonprofits.³⁰ Unlike other mortgage industry participants, FHA does not restrict homebuyers' use of such assistance. Our 2005 analysis found that the probability that these loans would result in an insurance claim was 76 percent higher than for comparable loans without such assistance, and we recommended that FHA revise its underwriting standards to consider such assistance as a seller contribution (which cannot be used to meet the borrower contribution requirement).³¹ Despite the detrimental impact of these loans on the Fund, FHA did not act promptly to mitigate the problem by adjusting underwriting standards or using its existing authority to raise

³⁰GAO, *Mortgage Financing: Additional Action Needed to Manage Risks of FHA-Insured Loans with Down Payment Assistance*, [GAO-06-24](#) (Washington, D.C.: Nov. 9, 2005).

³¹We reviewed a national sample of FHA-insured home purchase loans from 2000, 2001, and 2002.

premiums. However, in May 2007, FHA published a proposed rule that would prohibit seller-funded down-payment assistance.³²

In addition, as we reported in February 2005, other mortgage institutions limit the availability of or pilot new products to manage risks associated with changing or expanding product lines.³³ We have previously indicated that, if Congress authorizes FHA to insure new products, it should consider a number of means, including limiting their initial availability, to mitigate the additional risks these loans may pose. We also recommended that FHA consider similar steps for any new or revised products. However, in response, FHA officials told us that they lacked the resources to effectively manage a program with limited volumes. We noted that if FHA did not limit the availability of new or changed products, the potential costs of making widely available a product with risks that may not be well understood could exceed the cost of a pilot program. With respect to its legislative proposal, FHA officials told us that they do not plan to pilot or limit the initial availability of any zero-down-payment product the agency was authorized to offer. They also indicated that they expected that a zero-down-payment product would perform similarly to loans with seller-funded down-payment assistance. While the experience of loans with this type of assistance is informative, a zero-down-payment product could be utilized by a different population of borrowers and may not perform the same as these loans.

Nevertheless, if the legislative proposals were to be enacted, FHA plans to take some steps to help address risks and challenges associated with (1) managing the risks of no-down-payment loans, (2) setting premiums to achieve a modestly negative subsidy rate, and (3) modifying oversight of lenders. First, loans with low or no down payments carry greater risk because of the direct relationship that exists between the amount of equity borrowers have in their homes and the risk of default. The higher the LTV ratio, the less cash borrowers will have invested in their homes and the

³²See 72 Fed. Reg. 27048 (May 11, 2007). FHA also has been anticipating a reduction in the number of loans with down-payment assistance from seller-funded nonprofit organizations as a result of actions taken by the Internal Revenue Service (IRS). IRS issued a ruling in May 2006 stating that these organizations do not qualify as tax-exempt charities, effectively making loans with such assistance ineligible for FHA insurance. According to FHA, as of June 2007, IRS had rescinded the charitable status of three of the 185 organizations that IRS is examining.

³³GAO, *Mortgage Financing: Actions Needed to Help FHA Manage Risks from New Mortgage Loan Products*, [GAO-05-194](#) (Washington, D.C.: Feb. 11, 2005).

more likely it is that they may default on mortgage obligations, especially during times of economic hardship or price depreciation in the housing market. No-down-payment loans became common in the conventional market when rapid appreciation in home prices helped mitigate the risk of these loans. However, if authorized to offer a zero-down-payment mortgage in the near future, FHA would be introducing this product at a time when home prices have stagnated or are declining in some parts of the country. And because FHA would continue to allow borrowers to finance some portion of closing costs and up-front insurance premiums, the effective LTV ratio for loans with very low or no down payments could be greater than 100 percent, further increasing FHA's insurance risk. To mitigate the risks associated with loans with no down payments, FHA plans to impose stricter underwriting criteria for such loans:

- FHA would limit the amount of up-front premium and closing costs that could be financed; therefore, all borrowers would be making some minimum cash contribution.
- FHA plans to require a minimum credit score of 640 to obtain FHA insurance on loans with no down payments.³⁴
- FHA would limit its zero-down-payment product to loans for owner-occupied, one-unit properties.

Second, FHA's legislative proposal would fundamentally change the way the agency manages the Fund in that FHA would set premiums to achieve a modestly negative overall subsidy rate, representing the weighted average of the subsidy rates for the different risk-based pricing categories. The President's budget for fiscal year 2008 estimates that the weighted average subsidy rate would be -0.6 percent (meaning that the Fund would generate negative subsidies amounting to 0.6 percent of the total dollars insured for loans originated that year).³⁵ Achieving a modestly negative credit subsidy rate would depend on FHA's ability to price new products whose risks may not be well understood, although risk-based pricing could help FHA be more precise in setting and adjusting premiums for different segments of its portfolio. FHA officials told us that they would monitor the proportion of loans in its two highest-risk categories and consider raising

³⁴Private mortgage insurers also set credit score thresholds for zero-down-payment loans.

³⁵If the HECM program were moved to the Fund, as FHA has proposed, the weighted average subsidy rate would be -0.82 percent.

premiums or tightening underwriting standards if unexpectedly high demand exposed FHA to excessive financial risk. Fannie Mae, Freddie Mac, and the four private mortgage insurers we interviewed noted that they carefully monitor their portfolios to make sure that they do not have too many loans in any given risk category and take similar steps when they determine that this is the case.

Third, FHA may need to modify the way that it oversees lenders if the legislative proposals were enacted. FHA has indicated that its legislative proposals would help the agency to expand service to higher-risk borrowers in a financially sound manner. However, FHA may need to revise its Credit Watch program if it is to achieve this end. Under Credit Watch, FHA terminates the loan origination authority of any lender branch office that has a default and claim rate on mortgages insured by FHA in the prior 24 months that exceeded both the national average and 200 percent of the average rate for lenders in its geographic area. Because termination currently is based on how a lender's loans perform relative to other lenders in its geographic area, lenders that chose to make loans to higher-risk borrowers could suffer in comparison with lenders that served only lower-risk borrowers. To encourage lenders to serve borrowers in the higher-risk categories, FHA officials told us that they would consider taking into account the mix of borrowers in the various risk categories when evaluating a lender's performance. Because higher-risk loans can be expected to incur higher default and claim rates, they stated that FHA would not want to penalize lenders with larger shares of these loans as long as the loans were performing within expected risk parameters. FHA also has improved the accuracy and timeliness of the loan performance data it uses to evaluate lenders by requiring lenders to update the delinquency status of their loans more frequently.

Congress and FHA Could Consider Other Administrative and Legislative Changes to Help FHA Adapt to Changes in the Mortgage Market

Mortgage industry participants and researchers have suggested additional options that Congress and FHA could consider to help FHA adapt to changes in the mortgage market, but some changes could have budget and oversight implications. FHA already has authority to undertake some of these options. Other options would require additional authorities from Congress to increase the agency's operational flexibility. Congress also could consider alternative approaches to the provision of federal mortgage insurance such as converting FHA to a government corporation or implementing risk-sharing arrangements with private partners.

FHA Has Existing Authority to Make More Administrative Changes

Although FHA already has made several administrative changes to streamline the agency's insurance processes, additional administrative changes within FHA's existing authority could alleviate, to some extent, the need for a positive subsidy in fiscal year 2008. More specifically, FHA could exercise its existing authority to raise up-front premiums up to 2.25 percent and, for borrowers with down payments of less than 5 percent, annual premiums to 0.55 percent.

To moderate the need for a positive subsidy in fiscal year 2008, FHA could use its existing authority to increase premiums in one of three ways: (1) FHA could raise premiums for all borrowers, as the President's fiscal year 2008 budget suggests will be necessary; (2) FHA could charge the higher 0.55 percent annual premium to borrowers with lower down payments; or (3) FHA could implement a more limited form of risk-based pricing than it has proposed by adjusting premiums within the current statutory limits. HUD's Office of General Counsel determined in March 2006 that FHA has the authority to structure premiums for programs under the Fund on the basis of risk. FHA could implement premium adjustments, either for all or some borrowers, through the regulation process. However, according to FHA officials, the current statutory limits on premiums are too low to allow FHA to implement a risk-based pricing plan that would allow the agency to set prices high enough to compensate for the expected losses from the highest-risk borrowers or a new zero-down-payment product. And while raising premiums for some higher-risk borrowers could improve the Fund's credit subsidy rate, raising premiums for all borrowers might exacerbate FHA's adverse selection problem. That is, FHA could lose higher credit quality borrowers, resulting in fewer borrowers to subsidize lower credit quality borrowers. This, in turn, could require FHA to raise premiums again.

Additional Authorities for Investment in Technology, Pay and Hiring, and Introduction of Products Could Increase FHA's Operational Flexibility

According to mortgage industry participants and researchers, Congress also could consider granting FHA additional authorities to increase the agency's ability to invest in technology and staff or offer new insurance products. First, Congress could grant FHA specific authority to invest a portion of the Fund's current resources—that is, negative subsidies that accrue in the Fund's reserves—in technology enhancement. The congressionally-appointed Millennial Housing Commission (MHC) found that FHA's dependence on the appropriations process for budgetary resources and competition for funds within HUD had led to under-

investment in technology, increasing the agency's operational risk and making it difficult for FHA to work efficiently with lenders and other industry partners.³⁶ Because FHA's single-family insurance program historically has generated estimated negative subsidies, FHA and some mortgage industry officials have suggested that the agency be given the authority to use a portion of the Fund's current resources to upgrade and maintain its technology.

One benefit of this option is that the technology enhancements could improve FHA's operations. As previously noted, FHA has more than 40 single-family information systems that are poorly integrated, expensive to maintain, and do not fully support the agency's business requirements. However, according to FHA, the option would require a statutory change to allow FHA to use the Fund's current resources to pay for technology improvements. Also, the Fund is required by law to operate on an actuarially sound basis. Because the soundness of the Fund is measured by an estimate of its economic value—an estimate that is subject to inherent uncertainty and professional judgment—the Fund's current resources should be used with caution. Spending the Fund's current resources would lower the Fund's reserves, which in turn would lower the economic value of the Fund. As a result, the Fund's ability to withstand severe economic conditions could be diminished. Also, using the Fund's current resources would increase the federal budget deficit unless accompanied by corresponding reductions in other government spending or an increase in receipts.

Second, Congress could consider allowing FHA to manage its employees outside of federal pay scales. Some federal agencies, such as the Securities and Exchange Commission, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation, are permitted to pay salaries above normal federal pay scales in recognition of the special skills

³⁶The MHC, established by Congress in 2000, studied the federal role in meeting the nation's housing challenges and issued a report in 2002, which included recommendations for a variety of reforms to federal housing programs. See *Meeting Our Nation's Housing Challenges: Report of the Bipartisan Millennial Housing Commission* (Washington, D.C.: May 30, 2002).

demanded by sophisticated financial market operations.³⁷ The MHC and mortgage industry officials have suggested that FHA be given similar authority. This option could help FHA to recruit experienced staff to help the agency adapt to market changes. Like the authority to invest in technological enhancement, this option could be funded with the Fund's current resources but would have similar implications for the financial health of the Fund and the federal budget deficit.

Third, Congress could authorize FHA to offer and pilot new insurance products without prior congressional approval. A variety of new mortgage products have appeared in the mortgage market in recent years, but FHA's ability to keep pace with market innovations is limited. For example, the MHC found that the statutes and regulations to which FHA is subject dramatically increase the time necessary to develop and implement new products. The MHC and mortgage industry officials have recommended that Congress expressly authorize FHA to introduce new products without requiring a new statute for each. Such authority would offer FHA greater flexibility to keep pace with a rapidly changing mortgage market. However, Congress would have less control over FHA's product offerings and, in some cases, it might take years before a new product's risks were well understood.

To manage the risks of new products, mortgage institutions may impose limits on the volume of the new products they will permit and on who can sell and service those products. Limits on the availability of new or revised FHA mortgage insurance products are sometimes set through legislation and focus on the volume of loans that FHA may insure. In a prior report, we recommended that FHA consider using pilots for new products and making significant changes to its existing products.³⁸ Since FHA officials questioned the circumstances in which they could use pilots or limit volumes when not required by Congress, we also recommended that FHA seek the authority to offer new products on a limited basis, such as through pilots, if the agency determines it currently lacks sufficient authority. However, FHA has not sought this authority. Furthermore, while

³⁷In 1989, the Financial Institutions Reform, Recovery and Enforcement Act (P. L. 101-73) authorized certain financial regulators to determine their own compensation and benefits so that they could more effectively compete in the marketplace for qualified applicants. In 2002, the Investor and Capital Markets Fee Relief Act (P. L. 107-123) gave SEC similar authority as those federal banking regulatory agencies. These agencies are permitted by statute to pay salaries in excess of the Title 5 ceilings.

³⁸[GAO-05-194](#).

piloting could help FHA manage the risks associated with implementing new products, FHA officials told us that they lack the resources to manage a program with limited volumes effectively.³⁹

Finally, Congress could authorize FHA to insure less than 100 percent of the value of the loans it guarantees. Unlike private mortgage insurers, which offer several levels of insurance coverage up to a maximum of 40 or 42 percent (depending on the company) of the value of the loan, FHA insures 100 percent of the value of the loan. But since most FHA insurance claims are offset by some degree of loss recovery, some mortgage industry observers have suggested that covering 100 percent of the value of the loan may not be necessary. In prior work, we examined the potential effects of reducing FHA's insurance coverage and found that while lower coverage would cause a reduction in the volume of FHA-insured loans and a corresponding decline in income from premiums, it would also result in reduced losses and ultimately have a beneficial effect on the Fund.⁴⁰ However, we also noted that partial FHA coverage could lessen FHA's ability to stabilize local housing markets when regional economies decline and may increase the cost of FHA-insured loans as lenders set higher prices to cover their risk.

Alternative Approaches for Providing Federal Mortgage Insurance Include Converting FHA to a Government Corporation

The MHC, HUD officials, and other mortgage industry participants have suggested alternative approaches to provide federal mortgage insurance in a changing mortgage market. First, since the mid-1990s, several groups including HUD and the MHC have proposed converting FHA into either an independent or a HUD-owned government corporation—that is, an agency of government, established by Congress to perform a public purpose, which provides a market-oriented service and produces revenue that meets or approximates its expenditures. Government corporations operate more independently than other agencies of government and can be exempted from executive branch budgetary regulations and personnel and compensation ceilings. Therefore, converting FHA to a corporation could provide the corporation's managers with the flexibility to determine the best ways to meet policy goals set by Congress or HUD.

³⁹FHA officials reported difficulties administering the HECM program initially as a demonstration for only 2,500 loans because of the challenges of selecting a limited number of lenders and borrowers.

⁴⁰GAO, *Homeownership: Potential Effects of Reducing FHA's Insurance Coverage for Home Mortgages*, [GAO/RCED-97-93](#) (Washington, D.C.: May 1, 1997).

This option could have budgetary and oversight implications that would need to be considered when setting up the new corporation. For example, Congress would have to determine the extent to which (1) the corporation's earnings in excess of those needed for operations and reserves would be available for other government activities and (2) the corporation would be subject to federal budget requirements. Also, if the corporation were created outside of HUD, Congress would have to consider whether oversight of the corporation would require a new oversight institution or could be performed by an existing organization.

Alternatively, rather than maintaining all the functions of a mortgage insurer within a government entity, the MHC and private mortgage insurers have suggested that the federal government could provide mortgage insurance through risk-sharing agreements with private partners.⁴¹ FHA already works with partners to conduct various activities related to its operations. For example, FHA has delegated underwriting authority to approved lenders, and contractors perform many day-to-day activities (such as marketing foreclosed properties) that once were performed by FHA employees. A public-private risk-sharing arrangement would recognize that government has a better ability to spread risk, while private mortgage industry participants generally are more flexible and responsive to market pressures and better able to innovate and adopt new technologies quickly. There are many different possible ways to structure a risk-sharing approach, with variables such as the amount of insurance coverage provided, the number and type of risk-sharing partners, the degree of risk accepted by each partner, and the roles and responsibilities of the partners.

Whatever the structure, a risk-sharing approach could result in greater efficiency and allow FHA to reach new borrowers through new partner channels. However, risk sharing also could diminish the federal government's ability to stabilize markets if private partners lacked incentive to serve markets where economic conditions were deteriorating. Additionally, implementing risk-sharing arrangements might require more specialized expertise than FHA currently has among its staff. For example, careful analysis in both program design and monitoring would be needed to ensure that FHA's financial interests were adequately protected.

⁴¹FHA has implemented risk-sharing arrangements in its multifamily insurance program.

Finally, Congress and FHA could elect to make no changes at this time and allow the private market to play the definitive role in determining the future need for federal mortgage insurance. The recent decline in FHA's market share occurred at a time when interest rates were low, house price appreciation was high, and mortgage credit was widely available. However, changes in the mortgage market, such as higher interest rates and stricter underwriting standards for subprime loans, may lead to an increasing role for FHA in the future or at least a continued role for the federal government in guaranteeing mortgage credit for some borrowers. Therefore, even if Congress and FHA were to make no changes at this time, FHA's market share might increase due to the recent change in market conditions. Or it might eventually become so small as to indicate that there is no longer a need for a federal role in providing mortgage insurance. If FHA's market share continues to decline to such a level, FHA might be eliminated or critical functions reassigned to maintain a minimal federal role in guaranteeing mortgage credit.

Making no changes to FHA at this time would acknowledge the substantial role the private market now plays in meeting the mortgage credit needs of borrowers. However, some home buyers might find it more difficult and more costly to obtain mortgages if FHA were eliminated or its functions reduced and reassigned to another federal agency.⁴² And allowing FHA to become too small could impact the federal government's ability to play a role in stabilizing mortgage markets during an economic downturn. Also, any option that might lead to the eventual elimination of FHA's single-family mortgage insurance program would have broader implications for FHA and its other programs, such as the multifamily mortgage insurance and regulatory programs, which this report does not address. Such implications would, therefore, require further study.

Observations

Recent trends in the mortgage market, including the prevalence of low- and no-down-payment mortgages and increased competition from conventional mortgage and insurance providers, have posed challenges for FHA. FHA's market share has declined substantially over the years, and

⁴²In 1995, legislation was introduced in the House and Senate (but never enacted) that proposed to abolish FHA and replace FHA's single-family mortgage insurance program with a program in which risk would be shared between qualified mortgage insurers and a Federal Home Mortgage Insurance Fund within the Department of the Treasury. The federal government would have provided partial mortgage insurance on some single-family homes (and would no longer have insured multifamily mortgages).

what was a negative subsidy rate for the single-family insurance program has crept toward zero. To adapt to market changes, FHA has implemented new administrative procedures and proposed legislation designed to modernize its mortgage insurance processes, introduce product changes, and provide additional risk-management tools. To its credit, FHA has performed considerable analysis to support its legislative proposal and has made or planned enhancements to many of the specific tools and resources that would be important to its implementation.

However, the proposals present risks and challenges and should be viewed with caution for several reasons. First, FHA has not always effectively managed risks associated with product changes, most notably the growth in the proportion of FHA-insured loans with seller-funded down-payment assistance. In that case, FHA did not use the risk-management tools already at its disposal to mitigate adverse loan performance that has had a detrimental impact on the Fund. Second, the proposal to lower down-payment requirements potentially to zero raises concerns given the greater default risk of loans with high LTVs, policies that could result in effective LTV ratios of over 100 percent, and housing market conditions that could put borrowers with such loans in a negative equity position. Sound management of very low or no-down-payment products would be necessary to help ensure that FHA and borrowers do not experience financial losses. Piloting or otherwise limiting the availability of new products would allow FHA the time to learn more about the performance of these loans and could help avoid unanticipated insurance claims. Despite the potential benefits of this practice, FHA generally has not implemented pilots, unless directed to do so by Congress. We have previously indicated that, if Congress authorizes FHA to insure new products, Congress and FHA should consider a number of means, including limiting their initial availability, to mitigate the additional risks these loans may pose. We continue to believe that piloting would be a prudent approach to introducing the products authorized by FHA's legislative proposal. Finally, FHA would face the challenge of setting risk-based premiums—potentially for products whose risks may not be well understood—to achieve a specific financial outcome, a relatively small negative subsidy. Because the estimated subsidy rate is close to zero and FHA has consistently underestimated its subsidy costs, FHA runs some risk of missing its target and requiring a positive subsidy. Additionally, limitations we have identified in FHA's TOTAL scorecard, which would be a key tool used in risk-based pricing, could reduce the agency's ability to set prices commensurate with the risk of the loans. Accordingly, it will be important for FHA to continue making progress in addressing these limitations.

Our recent report on trends in FHA's market share underscores the challenges that FHA has faced in adapting to the changing mortgage market. For example, we noted that FHA's share of the market for home purchase mortgages has declined precipitously since 2001 due in part to FHA product restrictions and a lack of process improvements relative to the conventional market. While FHA has taken some steps to improve its processes and enhance the tools and resources that it would use to implement the modernization proposals, additional changes may be necessary for FHA to operate successfully in the long run in a competitive and dynamic mortgage market. Other mortgage industry participants have greater flexibility to hire and compensate staff, invest in information technology, and introduce new products, enhancing their ability to adapt to market changes and manage risk. A number of policy options that go beyond FHA's modernization proposals would give FHA similar flexibility but would have other implications that would require careful deliberation.

Agency Comments and Our Evaluation

We provided HUD with a draft of this report for review and comment. HUD provided comments in a letter from the Assistant Secretary for Housing-Federal Housing Commissioner (see app. II). HUD said that the draft report provided a balanced assessment but also that the report's concerns about FHA's risk management and emphasis on the need for piloting lower-down-payment products were unwarranted.

HUD said that it welcomed the draft report's acknowledgement of FHA's improvements in program administration and risk management but questioned the report's concerns about FHA's ability to understand and manage risk. HUD indicated that its proposal to diversify FHA's product offerings and pricing structure grew out of recognition that FHA was subject to adverse selection, as evidenced by the loss of borrowers with better credit profiles and growth in seller-funded down-payment assistance loans. In addition, HUD listed steps it had taken to curtail seller-funded down-payment assistance, including publishing a proposed rule in May 2007 that would effectively eliminate seller-funded down-payment assistance in conjunction with FHA-insured loans. Our draft report cited a number of improvements in FHA's risk management, such as enhancements to its loan performance models. However, we continue to believe that our concerns about FHA's ability to manage risk are warranted. As our draft report noted, FHA did not take prompt action to mitigate the adverse financial impact of loans with seller-funded down-payment assistance. Furthermore, our draft report identified additional steps, such as improvements to TOTAL scorecard, that would help address the risks and challenges associated with the legislative proposals.

With regard to piloting, HUD said that pilot programs are appropriate where a concept is untested but that the concept of zero- or lower-down-payments was well understood. HUD indicated that it had a firm basis for anticipating the performance of zero- and lower-down-payment loans as a result of its experience with mortgages with seller-funded down-payment assistance. HUD said it used this experience to establish risk-based insurance premiums and minimum credit scores for zero- and lower-down-payment borrowers. Additionally, HUD said that it had recently started to collect 30-day and 60-day delinquency data, giving the agency the capability to track performance trends for different segments of its loan portfolio on a monthly basis. HUD stated that, for these reasons, the risks of zero- or lower-down-payment loans were sufficiently well known or knowable to not warrant a pilot program.

As our draft report noted, we previously have reported that other mortgage institutions limit the availability of, or pilot, new products to manage the risks associated with changing or expanding their product lines and have recommended that FHA consider adopting this practice. Our draft report also acknowledged that FHA's experience with seller-funded down-payment assistance could inform assessment of how a zero-down-payment product would perform. However, we continue to believe that FHA should consider limiting the availability of a loan product with no down payment. In particular, our draft report discussed two factors that indicate the need for caution in introducing such a product. First, a zero-down-payment product could be utilized by a different population of borrowers than seller-funded down-payment assistance loans and may not perform similarly to these loans. Second, zero-down-payment loans became common in the conventional mortgage market when rapid appreciation in home prices helped mitigate the risks of these loans. If authorized to offer a zero-down-payment product in the near future, FHA would be introducing it at a time when home prices have stagnated or are declining in some parts of the country. Because of these risks and uncertainties, we continue to believe that a prudent way to introduce a zero-down-payment product would be to limit its initial availability such as through a pilot program.

We are sending copies of this report to the Chairman, Senate Committee on Banking, Housing, and Urban Affairs; Chairman and Ranking Member, Subcommittee on Housing and Transportation, Senate Committee on Banking, Housing, and Urban Affairs; Chairman and Ranking Member, House Committee on Financial Services; and Chairman and Ranking Member, Subcommittee on Housing and Community Opportunity, House

Committee on Financial Services. We will also send copies to the Secretary of Housing and Urban Development and to other interested parties and make copies available to others upon request. In addition, the report will be made available at no charge on the GAO Web site at <http://www.gao.gov>.

Please contact me at (202) 512-8678 or shearw@gao.gov if you or your staff have any questions about this report. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix III.



William B. Shear
Director, Financial Markets and
Community Investment

Appendix I: Objectives, Scope, and Methodology

The Ranking Member of the Senate Committee on Banking, Housing, and Urban Affairs and Senator Wayne Allard requested that we evaluate FHA's modernization efforts, which include administrative and proposed legislative changes. Specifically, we examined (1) the likely program and budgetary impacts of FHA's modernization efforts, (2) the tools, resources, and risk-management practices important to FHA's implementation of the legislative proposals, if passed, and (3) other options that FHA and Congress could consider to help FHA adapt to changes in the mortgage market and the pros and cons of these options.

To determine the likely program and budgetary impacts of FHA's modernization efforts, we reviewed FHA guidance on three administrative changes implemented in 2006: the Lender Insurance Program and revisions to the agency's appraisal protocols and closing cost guidelines. To determine the extent to which these administrative changes have affected the processing of FHA-insured loans, we interviewed representatives of Countrywide Financial, Wells Fargo, Bank of America, and Lenders One (a mortgage co-operative representing about 90 independent mortgage bankers). We selected Countrywide Financial and Wells Fargo because they are large FHA lenders, Bank of America because it had recently decided to grow its FHA business, and Lenders One because some of its members make FHA loans. We also interviewed representatives of three mortgage and real estate industry groups—Mortgage Bankers Association, National Association of Realtors, and National Association of Home Builders. To determine how the Lender Insurance Program has affected the processing of FHA insurance, we interviewed FHA officials and obtained documentation from them on the extent of lender participation in the program and its effect on insurance processing time and costs.

In evaluating the likely program impacts of FHA's proposed legislative changes, we focused on the proposals to raise FHA loan limits, institute risk-based pricing of mortgage insurance premiums, and lower down-payment requirements. To examine the effect of raising loan limits on demand for FHA-insured loans, we analyzed 2005 HMDA data (the most current available). Specifically, we analyzed the home purchase loans recorded in 2005 to determine the number of loans in each of 380 core based statistical areas (CBSA) and used that data to calculate FHA's

market share in each CBSA.¹ (These 380 CBSAs were those for which we had data and included one aggregate “nonmetro” category.) We then determined the number of additional loans that, based on their loan amounts, would have been eligible for FHA insurance in 2005 had the higher proposed loan limits been in effect. Finally, we estimated the percentage of the newly-eligible loans in each CBSA that FHA would have insured using the following range of assumptions: (1) that FHA’s market share would have been approximately the same as it was among all loans in that CBSA under the actual 2005 loans limits, (2) that FHA’s market share would have been approximately the same as its share of loans with loan amounts ranging from 70 to 100 percent of the actual 2005 loan limits in that CBSA, (3) that FHA’s market share would have been approximately the same as its share of loans with loan amounts ranging from 75 to 100 percent of the actual 2005 loan limits in that CBSA, and (4) that FHA’s market share would be approximately the same as its share of loans with loan amounts ranging from 80 to 100 percent of the actual 2005 loan limits in that CBSA.²

For each of these four scenarios, we calculated the total number and dollar amount of new loans across all 380 CBSAs that could have been insured by FHA had the higher loan limits been in effect. All four assumptions yielded similar results. After arriving at an estimate of an overall increase in the number of FHA-insured loans, we then determined the proportions of the increase that would have resulted from raising the loan limit floor in low-cost areas, raising the loan limit ceiling in high-cost areas, or raising the limits in areas that fell between the floor and the ceiling. Finally, we calculated the average FHA-insured loan amount in 2005, as well as the average loan amount that FHA might have insured had the loan limits been increased. We assessed the reliability of the HMDA data we used by reviewing information about the data, performing electronic data testing to detect errors in completeness and

¹We excluded second liens and non-owner-occupied properties from our analysis because they are not a substantial part of FHA’s business. As defined by the Office of Management and Budget, CBSAs are statistical geographic entities consisting of the county or counties associated with at least one core (urbanized area or urban cluster) of at least 10,000 population, plus adjacent counties having a high degree of social and economic integration with the core.

²Our analysis was based on an earlier FHA analysis. This analysis assumed that FHA would achieve a market share for newly eligible loans of (1) at least 50 percent of FHA’s national market share for loans in areas with median home prices exceeding the 87 percent conforming limit and (2) 75 percent of FHA’s current market share in an area that was not constrained by the 87 percent conforming loan limit.

reasonableness, and interviewing a knowledgeable official regarding the quality of the data. We determined that the data were sufficiently reliable for the purposes of this report.

To estimate the effects of risk-based pricing on borrowers' eligibility for FHA insurance and the premiums they would pay, we reviewed FHA's risk-based pricing proposal and interviewed FHA officials regarding their plans to implement risk-based pricing, if authorized. We then analyzed SFDW data on FHA's 2005 home purchase borrowers to determine how they would have been affected by FHA's risk-based pricing proposal. (We focused on 2005 borrowers because that was the most recent year for which we had complete data, and we restricted our analysis to purchase loans because they comprise the bulk of FHA's business.) First, we assigned borrowers to one of seven categories (FHA's six proposed risk-based pricing categories and one category for those who would not have been eligible for FHA insurance) based upon their LTV ratio and credit score. Since FHA does not currently insure loans without a down payment, we identified borrowers with down-payment assistance and determined the source and amount of assistance to approximate borrowers with LTV ratios of 100 percent. We recalculated the LTV ratio of their loans by adding the amount of their assistance to the principal balance of their loan. We then examined the demographic characteristics (race, income, and first-time home buyer status) of borrowers in each of the six pricing categories, as well as those borrowers who would no longer qualify for FHA insurance. We assessed the reliability of the SFDW data we used by reviewing information about the system and performing electronic data testing to detect errors in completeness and reasonableness. We determined that the data were sufficiently reliable for the purposes of this report.

We also interviewed representatives of the following consumer advocacy groups to obtain their views on FHA's proposed legislative changes: Center for Responsible Lending, Consumer Action, Consumer Federation of America, National Association of Consumer Advocates, National Community Reinvestment Coalition, National Consumer Law Center, and National Council of La Raza. We examined the potential budgetary impacts of the legislative proposals by reviewing the President's fiscal year 2008 budget and FHA cost estimates as shown in the 2008 *Federal Credit Supplement*. (The *Federal Credit Supplement* provides summary information about federal direct loan and loan guarantee programs, including current subsidy rates and reestimated subsidy rates.)

To determine the tools, resources, and risk-management practices important to FHA's implementation of the legislative proposals, we interviewed and reviewed documentation from FHA officials regarding the agency's plans for implementing the legislative proposals, if passed. We focused on completed and planned enhancements to FHA's SFDW data, loan performance models, TOTAL mortgage scorecard, information technology, human capital, and risk-management practices. To help us evaluate the need for enhancements to FHA's tools, resources, and practices, we followed up on our past work on (1) FHA's development and use of TOTAL, (2) FHA's estimation of subsidy costs for its single-family insurance program, (3) practices that could be instructive for FHA in managing the risks of new mortgage products, and (4) FHA's management of loans with down-payment assistance.³ To obtain information on the tools and resources that other mortgage institutions use to set prices and manage risk, we interviewed Fannie Mae, Freddie Mac, the Mortgage Insurance Companies of America (the industry group that represents the private mortgage insurance industry), and four private mortgage insurance companies—AIG United Guaranty, Genworth Mortgage Insurance Company, Mortgage Guaranty Insurance Corporation, and PMI Mortgage Insurance Company.

To determine other options that FHA and Congress could consider and the pros and cons of these options, we reviewed relevant literature, including the report of the Millennial Housing Commission,⁴ articles discussing past FHA restructuring proposals,⁵ and our past work on various options for FHA.⁶ We also interviewed FHA officials, academic experts, FHA lenders, and private mortgage insurance companies.

We conducted this work in Washington, D.C., from September 2006 to June 2007 in accordance with generally accepted government auditing standards.

³See [GAO-06-435](#), [GAO-05-875](#), [GAO-05-194](#), and [GAO-06-24](#).

⁴*Meeting Our Nation's Housing Challenges: Report of the Bipartisan Millennial Housing Commission* (Washington, D.C.: May 30, 2002).

⁵See, for example, Kerry D. Vandell, "FHA Restructuring Proposals: Alternatives and Implications," *Housing Policy Debate*, volume 6, issue 2 (1995).

⁶See, for example, [GAO/RCED-97-93](#).

Appendix II: Comments from the Department of Housing and Urban Development



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING
FEDERAL HOUSING COMMISSIONER

JUN - 8 2007

Mr. William B. Shear
Director
Financial Markets and Community Investments
United States Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Shear:

Thank you for the opportunity to comment on the Government Accountability Office (GAO) report, "Federal Housing Administration: Modernization Proposals Would Have Program and Budget Implications and Require Continued Improvements in Risk Management," (GAO-07-708). I welcome GAO's acknowledgement that FHA has made substantial improvements in both program administration and risk management, but feel that GAO's remaining reservations about FHA's ability to manage risk are unwarranted, and I believe that its recommendation that FHA implement lower downpayment programs by pilot is not appropriate considering the large volume of data now available for this type of program. Let me elaborate.

FHA's modernization proposals grow out of internal analyses showing that FHA was being adversely selected. As a result of profound changes in primary and secondary mortgage markets, borrowers traditionally served by FHA—lower-income and minority first-time homebuyers increasingly had access to mortgage financing, but frequently at excessive cost. As a government agency closely bound by statutes and regulations, FHA was unable to respond to these changes in a flexible manner. Under its one-size fits all pricing structure, FHA witnessed the loss of borrowers with better credit profiles and the rapid growth of seller-funded downpayment assistance loans.

FHA recognized the need to diversify its product offerings and its pricing structure. It further recognized that borrowers using seller-funded downpayment assistance loans would be served at lower risk to themselves and to FHA's insurance fund by zero- or lower-downpayment loans that would remove the incentive of parties to the purchase transaction to inflate house prices and, consequently, mortgage amounts, monthly payments, and borrower risk. FHA has taken steps to curtail seller-funded downpayment assistance. It supported the Internal Revenue Service when it issued a ruling withdrawing nonprofit status from entities funneling seller-funded downpayment assistance to borrowers, and, on May 11, 2007, it published a proposed rule that would effectively eliminate seller-funded downpayment assistance from use with FHA-insured loans. FHA believes that other alternatives, including risk-based pricing and a variable downpayment program, would better serve the same types of borrowers who currently need such assistance.

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In FY 2005, FHA included Zero Downpayment and Payment Incentives products in its budget proposal, but these initiatives were not enacted into law. In FY 2006, FHA submitted a comprehensive reform proposal to Congress that passed the House of Representatives with a 415-to-7 vote, but the legislation stalled in the Senate. In FY 2007, FHA is again promoting a reform proposal that would increase its flexibility in offering mortgage insurance products and would permit a wider range of mortgage insurance premiums based on objective indicators of risk. With this new authority, FHA seeks to increase the options available to its traditional borrowers—lower-income and minority first-time homebuyers—so that they can attain their goal of homeownership at reasonable cost. Pricing risk in a mortgage insurance premium instead of the mortgage interest rate gives borrowers access to prime interest rates, lowers their current and overall borrowing costs, and facilitates more transparent mortgage transactions.

While the GAO report shows commendable understanding of FHA, it continues to express concern about FHA's ability to understand and manage risk, and recommends that FHA pursue reform through the use of pilot programs. FHA recognizes that pilot programs are appropriate where a concept is untested. For example, in 1989, FHA piloted Home Equity Conversion Mortgages that today have become FHA's fastest growing program. But the concept of zero- or lower-downpayments is well understood. In fact, the National Association of Realtors polled 7,548 consumers who bought homes between mid-2005 and mid-2006 and found that 45 percent of first-time buyers financed 100 percent of the transaction; they made no downpayments whatsoever.

FHA already has a firm basis for anticipating the performance of zero- and lower-downpayment loans by virtue of its experience with seller-funded downpayment assistance. In its FY 2008 budget proposal, FHA used this experience to posit minimum FICO scores for zero- and lower-downpayment borrowers and premiums graded by potential risk based on historical experience. As GAO is aware, FHA uses conditional claim and prepayments rates produced by an independent annual actuarial review in state-of-the-art cash flow models to re-examine loan performance and reset premiums on an annual basis. Having recently started to collect 30- and 60-day as well as 90-day delinquency data, FHA now has the capability of tracking trends by book of business or other segment of the portfolio on a monthly basis. For these reasons, FHA believes that the risks of zero- or lower-downpayment loans are sufficiently known or knowable to that a pilot program is unwarranted.

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In conclusion, FHA is grateful for GAO's balanced assessment, but respectfully suggests that FHA is ready now to manage the risks of zero- and lower-downpayment loans and so, to offer an alternative to borrowers who would otherwise be turned away or turn to higher cost alternatives.

Sincerely,



Brian D. Montgomery
Assistant Secretary for Housing-
Federal Housing Commissioner

Appendix III: GAO Contact and Staff Acknowledgments

GAO Contact

William Shear (202) 512-8678 or shearw@gao.gov

Staff Acknowledgments

In addition, Steve Westley (Assistant Director), Steve Brown, Laurie Latuda, John McGrail, Barbara Roesmann, Paige Smith, and Richard Vagnoni made key contributions to this report.

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