



September 2013

FHA MORTGAGE INSURANCE

Applicability of Industry Requirements Is Limited, but Certain Features Could Enhance Oversight

GAO Highlights

Highlights of [GAO-13-722](#), a report to congressional requesters

Why GAO Did This Study

FHA insures private lenders against losses from defaults on single-family mortgages that meet FHA criteria. FHA's insured portfolio was more than \$1 trillion at the end of fiscal year 2012. The mortgage insurance market also includes PMIs regulated by the states. Since 2009, FHA's Fund (under which FHA insures almost all its single-family mortgages) has not met its statutory 2 percent capital requirement. GAO was asked to examine the financial condition requirements that apply to FHA and PMIs. This report examines (1) how reserving practices and capital requirements for FHA's Fund compare with those for PMIs, and (2) how applicable PMI practices and requirements could enhance Fund oversight.

To address these objectives, GAO reviewed accounting standards, federal and state laws, regulations, and policies; analyzed FHA data; and interviewed federal officials and PMI industry officials and analysts.

What GAO Recommends

Congress should consider requiring FHA to submit a capital restoration plan and regular updates on implementation whenever the Fund's capital ratio does not meet required levels. Also, FHA should disclose estimates of specific cash flows (premiums, claims, and recoveries) over time to provide additional perspective on the Fund's financial status. FHA generally agreed with GAO's recommendation.

View [GAO-13-722](#). For more information, contact Mathew Scire at 202-512-8678 or sciremj@gao.gov

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What GAO Found

Reserving practices and capital requirements for the Mutual Mortgage Insurance Fund (Fund) of the Federal Housing Administration (FHA) differ in key respects from those for private mortgage insurers (PMI). These differences stem from the distinct environments in which FHA and PMIs operate, including the particular accounting principles and statutory provisions that they must follow. For example, statutory accounting principles (developed to meet the needs of insurance regulators in assessing financial condition) require PMIs to establish several reserve components, including a reserve for estimated losses expected in the near term on loans that are delinquent (loss reserve). In contrast, generally accepted accounting principles for federal entities (developed to align financial statement reporting with federal budget requirements) require FHA to reserve for the present value of estimated losses for all outstanding loans net of anticipated revenues (liability for loan guarantees). For both FHA and PMIs, capital requirements are expressed as comparisons of risk to capital, but the calculations measure risk and capital differently. Like FHA, PMIs have struggled to meet their capital requirements in recent years.

The PMI regulatory framework has limited applicability to FHA's Fund, but it has certain features that could enhance Fund oversight. Some of the purposes and concepts underlying PMI reserving practices and capital requirements are not pertinent to FHA. For example, two of the PMI reserve components (the unearned premium reserve and the contingency reserve) are intended, in part, to prevent PMIs from reducing capital through payment of excessive dividends to stockholders. However, the concept of separately disclosing reserve components as PMIs do could be applied to the Fund. The PMI loss reserve and unearned premium reserve focus on the timing of specific cash flows—the loss reserve on near-term insurance claims for delinquent loans and the unearned premium reserve on insurance premiums as they are earned over time. In contrast, FHA's liability for loan guarantees combines 30-year estimates of future claims, premiums, and recoveries into a single number, as required, and does not disclose the timing of each type of cash flow. Disclosing the timing of specific cash flows would help illustrate the extent to which estimates of claims payments, premiums, and recoveries in the liability for loan guarantees are concentrated in the near term or longer term and therefore more or less certain. Such disclosure could enhance congressional oversight of FHA and would be consistent with reporting practices of other federal programs and federal internal control guidance for communicating externally about an agency's risks. Accountability features of the PMI regulatory framework also could be applied to FHA. Unlike FHA, PMIs must take certain actions for noncompliance with their capital requirements. These actions may include remediation plans to restore capital to required levels and additional reporting. In 2012, FHA provided Congress with a set of planned actions to address its capital shortfall, but had not done so in prior years. Producing a capital restoration plan when the capital ratio fell below the required level could help ensure prompt action by FHA. This type of requirement is contained in legislative proposals currently before Congress and would be consistent with requirements Congress has enacted for the Federal Deposit Insurance Corporation and certain financial institutions.

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Abbreviations

FASAB	Federal Accounting Standards Advisory Board
FCRA	Federal Credit Reform Act of 1990
FHA	Federal Housing Administration
GAAP	generally accepted accounting principles
HERA	Housing and Economic Recovery Act of 2008
HUD	Department of Housing and Urban Development
MPP	minimum policyholders position
PMI	private mortgage insurers
PV	present value
RHS	Rural Housing Service
VA	Department of Veterans Affairs

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September 9, 2013

The Honorable Jeb Hensarling
Chairman
Committee on Financial Services
House of Representatives

The Honorable Randy Neugebauer
Chairman
Subcommittee on Housing and Insurance
Committee on Financial Services
House of Representatives

The Federal Housing Administration (FHA), within the Department of Housing and Urban Development (HUD), administers single-family mortgage insurance programs, which insure private lenders against losses on mortgages that finance purchases of properties or that refinance existing mortgages. FHA's insured portfolio was more than \$1 trillion at the end of fiscal year 2012. The insured mortgage market also includes private mortgage insurers (PMI), which typically insure loans that are sold to either of two housing-related enterprises, Fannie Mae and Freddie Mac (the enterprises).¹ In recent years, FHA has faced fiscal challenges, as has the rest of the mortgage insurance industry. Since 2009, the Mutual Mortgage Insurance Fund (Fund)—under which FHA insures almost all of its single-family mortgages—has not met minimum statutory capital requirements. Also, declining balances in the Fund's capital reserve account and higher-than-expected claims on loans insured before 2010 have increased the possibility that FHA will require additional

¹The enterprises bundle the mortgages into securities and guarantee the timely payment of principal and interest to investors in the securities. On September 6, 2008, the enterprises were placed under federal conservatorship because of concern that their deteriorating financial condition threatened the stability of financial markets.

funds to have sufficient resources for all future insurance claims on its existing portfolio.²

You asked us to examine the financial condition requirements that apply to FHA and PMIs. This report discusses (1) how the reserving practices and capital requirements of FHA's Fund compare with those for the PMI industry and (2) how, if at all, applicable PMI reserving practices and capital requirements could enhance oversight of FHA's Fund. In a companion report, we discuss options for improving FHA's long-term viability and their implications.³

To compare FHA's reserving practices and capital requirements with those of the PMI industry, we identified and reviewed accounting standards and federal statutes that apply to FHA's Fund, limiting our scope to forward mortgages.⁴ We identified and reviewed accounting standards, Fannie Mae and Freddie Mac policies, and state statutes and regulations that apply to PMIs. We also reviewed information on the capital positions of FHA and PMIs from 2001 through 2012, as well as PMI financial statements and regulatory reports. In addition, we interviewed mortgage market participants and stakeholders, including federal officials, state regulators, and major PMIs, to confirm our understanding of the practices and requirements. To assess how applicable industry practices and requirements could enhance oversight

²Considering FHA's financial difficulties, as well as continuing uncertainty over the resolution of Fannie Mae and Freddie Mac and the potential impact of their resolution on FHA, in February 2013 we included FHA in a high-risk area called "modernizing the U.S. financial regulatory system and the federal role in housing finance." Every 2 years, we provide Congress with an update on our High-Risk Program, which highlights major areas that are at high risk for fraud, waste, abuse, or mismanagement, or need broad reform. We previously had identified "modernizing the U.S. financial regulatory system" as a high-risk area and included a discussion of concerns about the resolution of Fannie Mae and Freddie Mac. See GAO, *High-Risk Series: An Update*, [GAO-13-283](#) (Washington, D.C.: Feb. 14, 2013).

³GAO, *Federal Housing Administration: Analysis of Options for Modifying Its Products, Market Presence, and Powers*, [GAO-13-682](#) (Washington, D.C.: Sept. 9, 2013).

⁴With forward mortgages, the borrower's monthly loan payments to the lender add to the borrower's home equity and decrease the loan balance. FHA also insures reverse mortgages that permit persons 62 years and older to convert their home equity into cash advances. With reverse mortgages, the borrower receives payments from the lender. The lender adds the principal and interest to the loan balance, reducing the homeowner's equity. This report focuses on forward mortgages because PMIs do not insure reverse mortgages.

of FHA's Fund, we determined the extent to which they would provide information to enhance Fund oversight, considering factors such as the compatibility of concepts and calculations with FHA operations. We interviewed insurance regulators in three states—North Carolina, Pennsylvania, and Wisconsin—to identify the information PMIs report that regulators use in assessing financial condition. We selected these states based on criteria including market share of PMIs domiciled in the states and diversity of regulatory requirements.⁵ We also interviewed FHA officials, regulators, major PMIs, and other industry analysts to obtain perspectives on applying PMI practices and requirements to FHA's Fund and the implications for increased transparency and understanding of the Fund's financial condition. Furthermore, we reviewed annual actuarial reviews of the Fund, HUD appendixes to the President's budget, and FHA's audited financial statements to provide additional perspectives on the Fund's financial condition. To assess the reliability of unaudited data we obtained from FHA, we conducted reasonableness checks on data elements and discussed the sources and interpretation of the data with FHA officials. We determined that this information was sufficiently reliable for purposes of characterizing the financial condition of the Fund. See appendix I for additional information on our scope and methodology.

We conducted this performance audit from February 2013 to September 2013 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

⁵These states were the domiciliary states and primary regulators for PMIs that, according to industry data, accounted for 90 percent of the mortgages insured by PMIs in 2012.

Background

Federal Housing Administration

Established in 1934 under the National Housing Act, FHA operates the largest federal mortgage insurance program, which is backed by the full faith and credit of the federal government.⁶ FHA primarily insures forward mortgages for initial home purchases and refinancing. Generally, lenders require borrowers to purchase mortgage insurance when the initial loan-to-value ratio (the amount of the mortgage loan divided by the value of the home) exceeds 80 percent. In fiscal year 2012, FHA reported that it insured almost 1.2 million forward mortgages representing approximately \$213 billion in mortgage insurance-in-force. Its reported total amortized insurance-in-force on forward loans at the end of fiscal year 2012 was \$1.07 trillion.⁷

Three different reviews of the financial condition of the Fund are conducted annually. First, the Omnibus Budget Reconciliation Act of 1990 required an annual independent actuarial study of the economic net worth and soundness of FHA's Fund.⁸ As part of this review, an independent actuary estimates the economic value of the Fund, which FHA uses to calculate the Fund's capital ratio.⁹ The actuary's analysis considers the net current resources available to the Fund; historical performance of existing loans; projected claim, loss, and prepayment rates; and projected future economic conditions. The actuarial study is now a requirement in the Housing and Economic Recovery Act of 2008 (HERA), which also requires that the Secretary of HUD submit an annual report to Congress

⁶The Department of Veterans Affairs (VA) and the Department of Agriculture's Rural Housing Service (RHS) administer the other two federal programs that guarantee single-family mortgages. RHS operates the government's smallest mortgage guarantee program.

⁷Amortized insurance-in-force is the remaining principal balance on all insured loans outstanding. This represents FHA's potential risk because FHA's insurance covers 100 percent of the loan balance.

⁸Pub. L. No. 101-508, § 2105.

⁹As we will discuss later in this report, the Fund's economic value is defined as its existing net capital resources plus the estimated present value of future net cash flows of existing insured loans. The Fund's capital ratio is the economic value of the Fund divided by the amortized insurance-in-force.

on the results of the actuarial study, as well as quarterly status reports on the Fund.¹⁰

Second, estimates that FHA prepares for the federal budget provide another review of the financial condition of the Fund. Specifically, under the Federal Credit Reform Act of 1990 (FCRA), FHA and other federal agencies must estimate the net lifetime costs (known as credit subsidy costs) of their loan insurance or guarantee programs and include the costs to the government in their annual budgets.¹¹ Agencies annually estimate credit subsidy costs by cohort—the loans agencies commit to insure or guarantee in a given fiscal year. The initial credit subsidy cost in the year the loans are insured is equal to the net present value of estimated lifetime cash flows, excluding administrative costs.¹² For a mortgage insurance program, cash inflows consist primarily of premiums charged to insured borrowers and recoveries from sales of foreclosed properties, and cash outflows consist mostly of claim payments to lenders. A balance equal to the amount needed to cover estimated net future costs is held in the Fund’s financing account. Estimated lifetime revenues in excess of this amount are recorded in the Fund’s capital reserve account. Historically, FHA has estimated that its loan insurance program is a negative subsidy program—that is, the present value of estimated cash inflows exceeds the present value of estimated cash outflows. On the basis of these negative subsidy estimates, FHA built up substantial balances over the years in the capital reserve account. Generally, agencies must produce annual updates of their subsidy estimates—known as reestimates—for each cohort on the basis of updated information on actual performance and new estimates of future loan performance. Upward reestimates reflect increases in credit subsidy costs (or lower lifetime net revenues) and downward reestimates represent decreases in credit subsidy costs (or higher lifetime net revenues). Balances in the capital reserve account are transferred to the

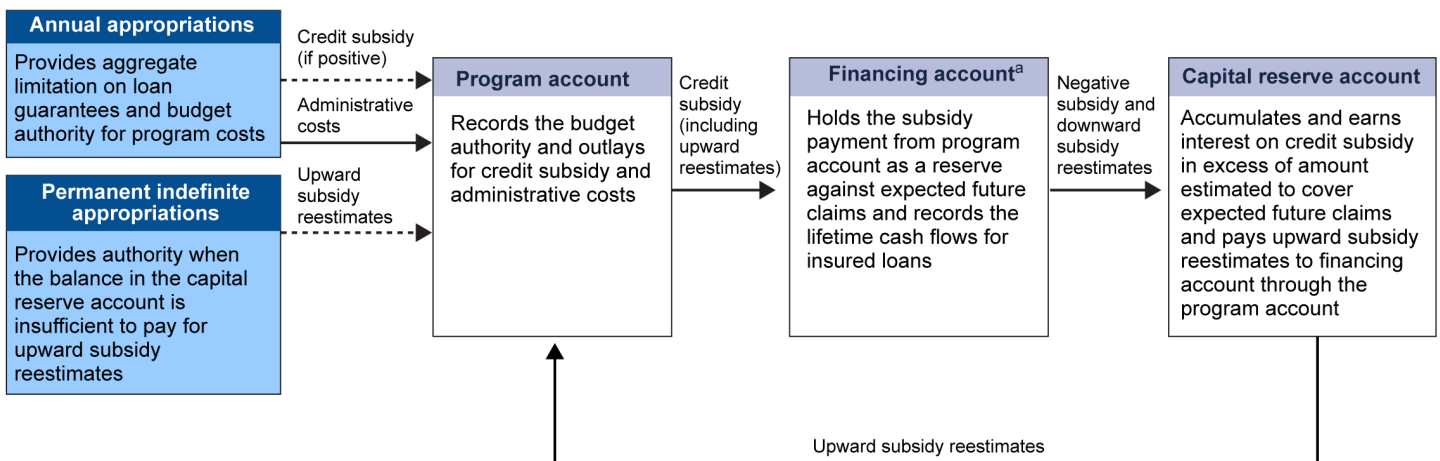
¹⁰Pub. L. No. 110-289, § 2118.

¹¹Pub. L. No. 101-508.

¹²Present value expresses the worth of a future stream of cash inflows and outflows in terms of an equivalent lump sum received (or paid) today. Net present value is the present value of estimated future cash inflows minus the present value of estimated future cash outflows. Because the cash flows occur in the future, they must be discounted to determine their net present values. To do this, Office of Management and Budget guidance requires FHA to use discount rates that are based on interest rates for U.S. Treasury securities.

financing account to cover upward reestimates (see fig. 1).¹³ However, since 2009 higher-than-expected claims have depleted funds in FHA's capital reserve account to just over \$3 billion at the end of fiscal year 2012. If the capital reserve account were to be depleted and FHA required additional funds in the financing account to meet budget reestimate requirements, HUD would need to draw on permanent and indefinite budget authority, as authorized by FCRA. The President's fiscal year 2014 budget contained a \$22 billion upward credit subsidy reestimate for the Fund and indicated that the reestimate would deplete FHA's capital reserve account in 2013, potentially causing FHA to draw on \$943 million in permanent and indefinite budget authority.

Figure 1: Budget Accounting for FHA's Mutual Mortgage Insurance Fund



Source: GAO.

^aThe financing account appears in the budget for informational and analytical purposes, but is not included in the budget totals for budget authority or outlays. It is required to record lifetime cash flows for loans insured in 1992 and thereafter.

Third, FHA's audited financial statements also include a review of the Fund. FHA's financial statements are prepared according to generally accepted accounting principles in the United States applicable to federal agencies (federal GAAP) as promulgated by the Federal Accounting

¹³The Fund also has a program account, which receives appropriations for the administrative and subsidy costs of a credit program and records the budget authority and outlays for these costs. The program account is used to pay the associated subsidy cost to the financing account when a guaranteed loan is disbursed.

Standards Advisory Board (FASAB).¹⁴ Federal GAAP requires that FHA calculate its liability for loan guarantees for its loan insurance commitments on a present value basis.¹⁵ The liability for loan guarantees represents net losses FHA expects on its outstanding insurance portfolio.¹⁶ The use of the present value accounting method is consistent with budgeting requirements under FCRA. Under federal GAAP, FHA recognizes potential lifetime losses and revenues at the point it insures a loan.

Private Mortgage Insurance Industry

The private mortgage insurance industry dates to the 1880s. According to an industry consultant report, the industry went bankrupt during the housing collapse of the early 1930s but reemerged in the mid-1950s after drawing on lessons learned from its prior failure.¹⁷ These lessons included the need for laws and regulations to help ensure that PMIs were prepared for economic shocks. Most residential mortgages insured by PMIs are sold to the enterprises. The enterprises have a statutory requirement to obtain credit enhancement on single-family residential mortgages purchased with loan-to-value ratios of over 80 percent, and private mortgage insurance is the major credit enhancement they use. In 2012, the PMI industry, which consisted of six active PMIs and their affiliates, reported that PMIs insured about 416,000 mortgages representing approximately \$175 billion in mortgage insurance.

PMIs are regulated by the states in which they do business, with the state of domicile (that is, the state in which a PMI is chartered) providing primary regulatory oversight. Each state conducts financial oversight of the companies operating in its jurisdiction to help ensure that policyholders receive the insurance benefits they are entitled to receive.

¹⁴The term “generally accepted accounting principles” has a specific meaning for accountants and auditors. The American Institute of Certified Public Accountants Council has designated FASAB as the independent body that establishes generally accepted accounting principles for federal entities.

¹⁵The VA and RHS single-family mortgage guarantee programs also follow federal GAAP.

¹⁶The liability for loan guarantees applies to insurance commitments made on or after October 1, 1991.

¹⁷Promontory Financial Group, LLC, *The Role of Private Mortgage Insurance in the U.S. Housing Finance System*, a report prepared at the request of Genworth Financial, Inc., January 2011.

State laws and regulations limit the risk PMIs can assume through means such as reserve and capital requirements, investment and risk concentration restrictions, and restrictions on activities other than mortgage-related insurance. The PMIs also must comply with the enterprises' requirements in order for the mortgages they insure to be eligible for sale to the enterprises.

PMIs file audited financial statements, which are prepared in accordance with statutory accounting principles, with insurance regulators. Statutory accounting principles historically have been those practices or procedures prescribed or permitted by an insurer's domiciliary state through statutes, regulations, and practices. The National Association of Insurance Commissioners has standardized and incorporated these principles in its Accounting Practices and Procedures manuals (which provide a comprehensive guide of statutory principles) and other publications.¹⁸ Statutory accounting principles were developed to meet the needs of insurance regulators, who are focused on insurers' solvency and ability to satisfy their obligations to policyholders and creditors—in particular, to pay future claims. Under statutory accounting principles, PMIs recognize potential losses once loans become delinquent and recognize premium revenues over the period the insurance is outstanding.

In addition to reporting based on statutory accounting principles, many of the parent companies of PMIs also publicly report their financial results using private-sector GAAP in quarterly and annual filings with the Securities and Exchange Commission. The objectives of GAAP reporting differ from the objectives of statutory accounting principles reporting. GAAP is designed to meet the varying needs of different users of financial statements, while statutory accounting principles are designed to address concerns of regulators, as previously noted. Although statutory accounting principles incorporate private-sector GAAP guidance for certain principles, the two sets of accounting principles have differences. Statutory accounting principles are more conservative than private-sector

¹⁸The National Association of Insurance Commissioners is the voluntary association of the heads of insurance departments from the 50 states, the District of Columbia, and five U.S. territories. While it does not regulate insurers, according to association officials, it does provide services designed to make certain interactions between insurers and regulators more efficient. According to the association, these services include providing detailed insurance data to help regulators analyze insurance sales and practices; maintaining a range of databases useful to regulators; and coordinating regulatory efforts by providing guidance, model laws and regulations, and information-sharing tools.

GAAP—for example, they do not recognize certain assets recognized under private-sector GAAP.¹⁹

Differences between FHA and Private Insurer Programs and Market Roles

Although FHA and PMIs both provide mortgage insurance to first-time home buyers and others seeking low down-payment mortgages, their mortgage insurance programs differ in several respects. Some of these differences include:

- *Coverage.* FHA insurance covers 100 percent of the principal balance of each loan, whereas PMIs generally cover from 20 to 30 percent of the loan balance, usually based on what the enterprises require.²⁰
- *Premiums.* FHA collects both an up-front premium (paid at loan origination) and annual premiums (paid in monthly installments) from all borrowers. PMIs generally charge either premiums paid in monthly installments or a single premium (one payment at loan origination that fully pays for the insurance policy).²¹
- *Minimum down payment.* To meet the requirements of the enterprises, PMI-insured loans generally have higher down payments than those insured by FHA. One PMI representative told us that a small portion of PMIs' insured loans have a down payment of less than 5 percent. In contrast, more than 70 percent of the loans FHA insured in 2012 had a down payment of less than 5 percent.²²

¹⁹We previously described some of the differences between private GAAP and statutory accounting principles in the context of risk retention groups. See appendix III in GAO, *Risk Retention Groups: Common Regulatory Standards and Greater Member Protections Are Needed*, [GAO-05-536](#) (Washington, D.C.: Aug. 15, 2005).

²⁰FHA may recover a portion of each claim amount through disposition methods including sales of foreclosed properties. FHA estimates that its claim payout net of recoveries is generally between 50 and 75 percent of the balance of a guaranteed loan. PMI coverage limits are generally imposed by state law.

²¹According to a representative of the Mortgage Insurance Companies of America, a PMI trade association, about 25 percent of insured borrowers pay for mortgage insurance with a single premium.

²²Borrowers purchasing a home with an FHA-insured mortgage are required by statute to make a cash investment of at least 3.5 percent of the current purchase price. This investment may come from the borrowers' own funds or from certain third-party sources.

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- *Borrower qualifications.* PMIs generally require their borrowers to have higher credit scores and lower debt service-to-income ratios than does FHA.²³
 - *Recoveries.* FHA generally receives significant recoveries on the sale of foreclosed properties. According to officials from one PMI, it is generally not in a PMI's best interest to take possession of foreclosed properties. Instead, PMIs usually pay their coverage percentage multiplied by the sum of the unpaid loan balance and allowable foreclosure related expenses.

FHA and PMIs also have different operational goals and market roles. Most PMIs are publicly traded companies or subsidiaries of such companies, which have a responsibility to provide a return on investment to their shareholders. FHA's statutory operational goals are to minimize the default risk to the Fund and homeowners and provide mortgage insurance to traditionally underserved borrowers, which FHA defines as including first-time homebuyers, minorities, low-income families, and residents of underserved communities.²⁴ FHA traditionally has played a particularly large role among such borrowers. FHA 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 experiencing economic downturns. By expanding its presence when the private market contracts, FHA plays a countercyclical role in the mortgage market. FHA typically does not restrict its business or change the terms under which it provides mortgage insurance in economically distressed geographic locations. FHA must ensure that any changes to the terms and conditions for mortgage insurance comply with fair lending laws and its obligation to affirmatively further fair housing. However, PMIs may change the conditions under which they will provide new insurance in a geographic area to reflect the increased risk of losses in an area experiencing economic hardship. For example, in previous work we found that by tightening the terms of the insurance they would provide, PMIs may have decreased their share of the market in economically stressed

²³The debt service-to-income ratio represents the percentage of a borrower's income that goes toward all recurring debt payments, including mortgage payments.

²⁴12 U.S.C. § 1708(a)(7).

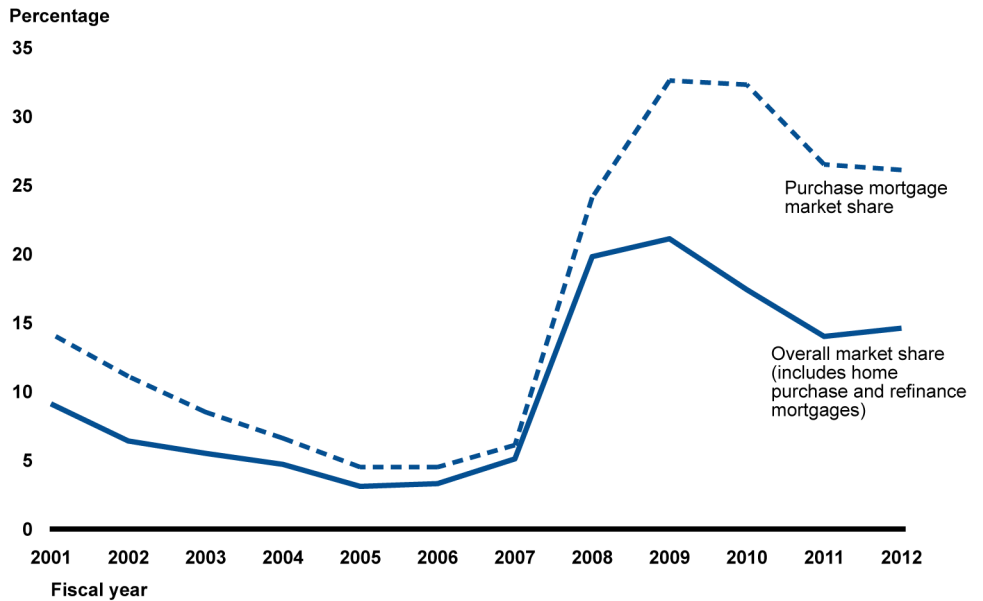
regions of the country during regional economic downturns in the late 1980s.²⁵

Consistent with its countercyclical role, FHA's market share expanded during the recent mortgage crisis. According to HUD's *U.S. Housing Market Conditions*, FHA's share of the market for home purchase mortgages (in terms of loan originations) grew sharply, rising from approximately 4.5 percent in 2006 to approximately 26.1 percent in 2012. In addition, FHA's share of the entire mortgage market (including refinance activity) rose dramatically after 2007, and stood at 14.6 percent in 2012 (see fig. 2). According to data from *Inside Mortgage Finance*, FHA's share of the insured mortgage market as of the end of 2012 was 45 percent as measured by annual dollar volume, down from 71 percent in 2009.²⁶

²⁵GAO, *Homeownership: FHA's Role in Helping People Obtain Mortgages*, [GAO/RCED-96-123](#) (Washington, D.C.: Aug. 13, 1996).

²⁶These data may somewhat overstate FHA's share of the insured market because they do not include loans guaranteed by RHS. Data from HUD's *U.S. Housing Market Conditions*, which capture the number of loans insured annually, also show a sharp decline in FHA's market share over that period (from 72 percent in 2009 to 57 percent in 2012) but also may overstate FHA's market share because they do not include loans guaranteed by RHS or mortgages insured by all PMIs.

Figure 2: FHA's Share of Loan Originations, 2001-2012



Source: GAO analysis of HUD data.

FHA and Private Insurers Follow Distinct Reserving Practices and Capital Requirements

Reserving practices and capital requirements for FHA's Fund differ in key respects from those for PMIs. These differences stem from the distinct environments in which FHA and PMIs operate, including the particular accounting principles and statutory provisions that they must follow. For both FHA and PMIs, capital requirements are expressed as ratios that compare risk and capital, but these terms have different meanings in the PMI and FHA contexts.

FHA and Private Mortgage Insurers Establish Different Types of Reserves under Their Respective Accounting Principles

From an accounting perspective, certain reserves are recorded as liabilities on an entity's balance sheet to account for net future obligations and unearned revenue. Under their respective accounting principles, FHA and PMIs follow different reserving practices to prepare their audited financial statements. Under federal GAAP, FHA effectively has one reserve, the liability for loan guarantees. It is calculated by estimating the net present value of expected future cash flows for all outstanding loans (anticipated losses less anticipated future revenue).

In contrast, under statutory accounting principles, PMIs establish up to four separate reserve components, as follows:²⁷

- *Unearned premium reserve.* This reserve represents the amount of insurance premiums that have been collected but not yet earned. Premiums paid in advance (single premiums) generally would be earned over time based on a schedule specified by a PMI's domiciliary state.
- *Contingency reserve.* This reserve represents half of the insurance premiums earned each year for the previous 10 years in order to build up a countercyclical capital buffer.²⁸ This reserve also prevents a PMI from paying out excessive dividends to shareholders during profitable times to preserve its ability to pay claims during economic downturns. A PMI may release funds, with regulatory approval, if necessary, from this reserve to increase its statutory surplus when losses incurred in a year exceed 35 percent of premiums earned that year.²⁹
- *Loss reserve.* This reserve represents expected losses on loans that become delinquent. Because the reserve is for loans that are already delinquent, it represents an estimate of losses that are likely to occur in the near term.
- *Premium deficiency reserve.* This reserve is intended to cover the difference between future losses and existing reserves plus future premiums, if future losses are greater. More specifically, it represents the amount by which the present value of estimated future losses (less future uncollected premium revenues on all loans outstanding)

²⁷We focus on PMI requirements under statutory accounting principles rather than private-sector GAAP because they are the requirements used by regulators to assess solvency.

²⁸According to PMI representatives and state insurance regulators, the countercyclical purpose of the contingency reserve is to build up capital during periods when losses are minimal to protect policyholders against losses during periods of extreme economic contraction.

²⁹Statutory surplus consists of capital stock, gross paid-in and contributed surplus, and unassigned funds (surplus), among other items. Components of unassigned funds (surplus) include net income or retained earnings (which increase it) and dividends to stockholders (which reduce it). Changes to the contingency reserve are recorded against unassigned funds (surplus)—for example, funds released from the contingency reserve increase it. However, the contingency reserve is considered capital in determining a PMI's risk-to-capital ratio, as discussed later in this report.

exceeds the sum of the contingency reserve, loss reserve, and unearned premium reserve.

The differences between FHA and PMI reserving practices stem from the different accounting principles these entities are required to follow and the different purposes these principles serve. Table 1 shows how FHA and PMI reserves are calculated. FHA's practice of reserving for anticipated net losses follows federal GAAP, which emphasizes the consistent calculation of long-term costs to the government of the subsidies associated with insurance, direct loans, and loan guarantees and supports budgeting under FCRA. As previously noted, federal GAAP accounts for estimated lifetime losses and revenues on insurance, direct loans, and guarantee activities on a present value basis in the fiscal year in which the commitment to insure, originate, or guarantee a loan occurs. In contrast, PMIs follow statutory accounting principles under which potential losses are recognized in the loss reserve component when loans become delinquent and revenues are recognized as they are earned over the coverage period.

Table 1: Calculations for FHA and PMI Reserves for Financial Accounting Purposes

Entity	Reserve	Calculation
FHA	Liability for loan guarantees	(Present value (PV) of future losses) minus (PV of future revenues) on all outstanding loans.
	Unearned premium reserve	(Premiums paid in advance) minus (portion of premiums earned).
	Contingency reserve	One-half of premiums earned during the previous 10 years, unless incurred losses exceed 35 percent of earned premiums.
PMI	Loss reserve	(Insured portion of the loan balance for delinquent loans) multiplied by (estimated percentage that will result in claims) multiplied by (estimated loss severity). This is calculated on a nominal basis (not discounted).
	Premium deficiency reserve	(PV of future losses) minus (PV of future revenues) on all outstanding loans minus (contingency reserve) minus (loss reserve) minus (unearned premium reserve), if result is positive. If revenues are greater than losses, no amount is recorded.

Source: GAO.

Despite these differences, a present value calculation of future cash flows is used in both the PMI premium deficiency reserve and the FHA liability for loan guarantees.³⁰ Specifically, FHA's liability for loan guarantees is

³⁰Although the type of calculation is similar, FHA and PMIs may use different economic assumptions to perform the calculations.

equal to the net present value of expected future cash flows for all outstanding loans (anticipated losses less anticipated future revenue). PMIs also calculate the net present value of expected future cash flows, but rather than establishing reserves equal to this amount, PMIs compare it with the sum of their existing loss reserves, contingency reserves, and unearned premium reserves. If the net present value of expected future losses exceed the combination of these three reserve components, PMIs establish a premium deficiency reserve to make their total reserves equal to their anticipated net losses (if not, there is no liability for a premium deficiency).³¹ PMIs generally have not had to establish premium deficiency reserves because the sum of their existing reserves has been greater than the net present value of expected future losses. This reflects the conservative nature of reserving practices under statutory accounting principles.

FHA's Statutory Capital Requirement Differs from Private Insurers' Requirements

FHA and PMIs both calculate ratios for capital relative to risk outstanding, but the calculations measure capital and risk differently (see table 2). As noted earlier, the capital position of FHA's Fund is assessed annually by an independent actuary. By statute, the Fund's economic value—existing net capital resources plus the present value of future net cash flows of all currently insured loans—must be at least 2 percent of the remaining principal balance on all insured loans in the Fund (amortized insurance-in-force).³² In contrast, PMIs are subject to two capital requirements—a risk-to-capital ratio not to exceed 25 to 1 and a minimum policyholders position (MPP) that varies based on the loan-to-value ratio and coverage percentage of the mortgages insured.³³ The risk-to-capital ratio, which is required by 12 states, compares statutory surplus and contingency

³¹In circumstances when a premium deficiency reserve is necessary, a PMI's total reserves would be conceptually equivalent to a liability for loan guarantees. In circumstances when a premium deficiency reserve is not necessary, a PMI's total reserves conceptually would exceed a liability for loan guarantees. However, as noted earlier, FHA and PMIs may use different economic assumptions to perform the calculations.

³²As noted earlier, the remaining principal balance on all insured loans in the Fund represents FHA's potential risk because FHA's insurance covers 100 percent of the loan balance.

³³Thirty-four states do not have specific capital requirements for PMIs. Because PMIs operate nationally, they are all effectively subject to both the risk-to-capital ratio and MPP requirements.

reserves with the insured portion of the remaining balance on performing loans (risk-in-force).³⁴ The MPP, which is required by four states, establishes the amount of funds a PMI must have currently available to pay claims using a percentage of the initial balances of insured loans. PMIs may use a combination of statutory surplus, contingency reserves, and unearned premium reserves to meet the MPP requirement. PMIs' statutory surplus includes premium revenues earned to date. Consistent with how revenues are recognized under their respective accounting principles, capital in the PMI context does not include estimated future revenues for existing insurance, while capital in the FHA context does. In addition, for the PMI risk-to-capital ratio, risk is assessed based on performing loans (because the risk for nonperforming loans has been reserved for), while for the FHA capital ratio, risk is assessed based on all loans.

Table 2: Capital Requirements for FHA and PMIs

	FHA		PMIs
Measure	Capital ratio	Risk-to-capital ratio	Minimum policyholders position
Source of requirement	Federal statute	Statutes or regulations of 12 states	Statutes or regulations of 4 states
Basic calculation	$= \frac{\text{Capital}}{\text{Risk}}$	$= \frac{\text{Risk}}{\text{Capital}}$	= Risk × specified percentage ^a
Elements of capital	Total assets minus total liabilities plus PV of future cash flows on insured loans ^b	Statutory surplus plus contingency reserves	Statutory surplus plus contingency reserves plus unearned premium reserves
Elements of risk	Remaining balance on all insured loans in the Fund	Insured portion of the remaining balance on performing loans	Initial balances of insured loans
Required level	Greater than or equal to 2 percent	Less than or equal to 25:1 ^c	Varies by loan-to-value ratio and coverage amount
Who calculates	Independent actuary		PMI
Frequency of calculation	Annually		Quarterly

Source: GAO.

^aThese percentages are specified in various states' statutes or regulations.

^bPV equals present value.

^cA risk-to-capital ratio that is less than or equal to 25:1 is mathematically equivalent to a capital to risk ratio that is greater than or equal to 4 percent.

³⁴Risk-in-force on performing loans is equal to total risk-in-force minus risk-in-force on delinquent loans minus risk-in-force on ceded reinsurance contracts. Reinsurance is the practice of ceding a portion of a PMI's risk (with corresponding premiums) to another insurance company as a means of risk management.

FHA has not met its capital requirement for the last 4 years (see fig. 3).³⁵ FHA met the 2 percent capital ratio from fiscal years 2001 through 2008, with a high of 6.82 percent for forward mortgages in the Fund. However, the ratio fell below the statutory minimum in 2009 when economic and market developments created conditions that simultaneously reduced the insurance fund's economic value (the numerator of the capital ratio) and increased the amortized insurance-in-force (the denominator of the capital ratio). By the end of fiscal year 2012, the ratio had fallen to a negative 1.28 percent for single family forward loans (and a negative 1.44 percent for forward and reverse loans combined). The 2012 actuarial report shows that the negative economic value for forward loans is composed of capital assets of \$25.6 billion and estimated future cash flows of negative \$39.1 billion. Forward loans guaranteed prior to fiscal year 2011 have estimated negative future cash flows and loans guaranteed in fiscal years 2011 and later have estimated positive future cash flows. According to the baseline estimate in the 2012 actuarial report, the Fund's capital ratio is not estimated to rise above the statutory 2 percent level until fiscal year 2017.³⁶ In 2001, we found that setting a minimum or target capital ratio may not be appropriate for all of the circumstances the Fund may face. We therefore recommended that Congress or HUD determine the economic conditions the Fund would be expected to withstand without drawing on permanent and indefinite budget authority.³⁷ Congress has considered but not enacted legislation consistent with this recommendation.³⁸ In addition, HUD disagreed with this recommendation at the time of the report and has not acted upon it.

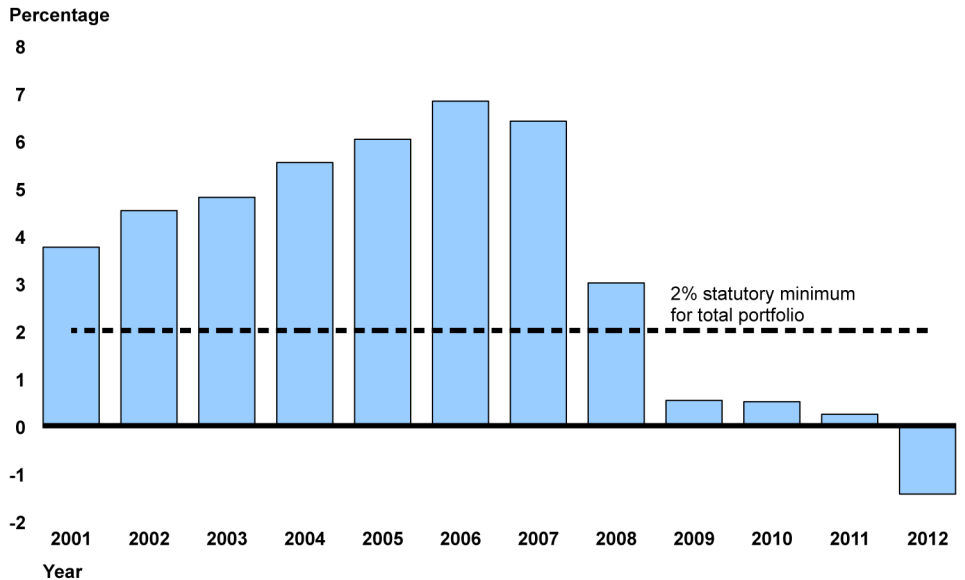
³⁵In fiscal year 2009, the reverse mortgage program was added to the Fund. Since then, the 2 percent statutory requirement has applied to forward and reverse mortgages combined.

³⁶The baseline estimate is an average of 100 separate estimates based on 100 stochastically-generated scenarios of future economic conditions. Some of these scenarios generate significantly better or significantly worse outcomes than this baseline average.

³⁷GAO, *Mortgage Financing: FHA's Fund Has Grown, but Options for Drawing on the Fund Have Uncertain Outcomes*, [GAO-01-460](#) (Washington, D.C.: Feb. 28, 2001).

³⁸For example, see H.R. 3995, 107th Cong. (2002).

Figure 3: FHA Capital Ratio, Fiscal Years 2001-2012



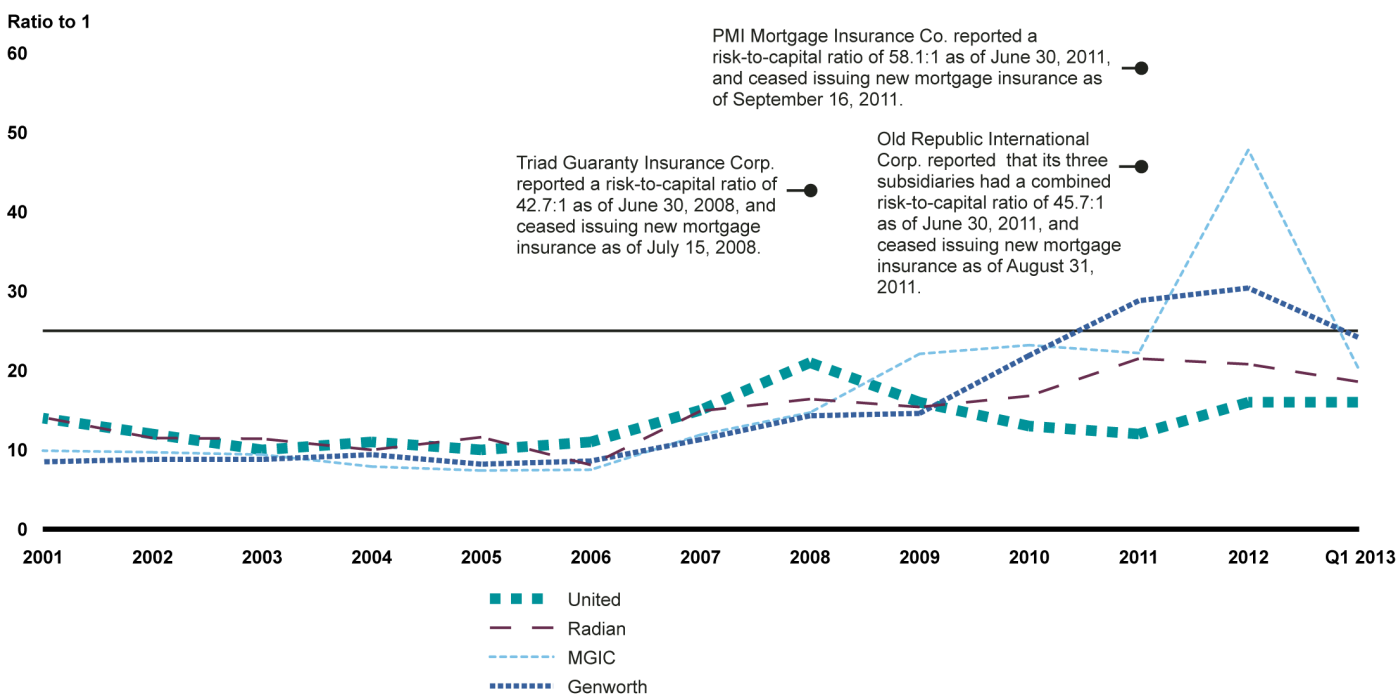
Source: GAO analysis of FHA data.

Note: In fiscal year 2009, the reverse mortgage program was added to the Fund. Since then, the 2 percent statutory requirement has applied to forward and reverse mortgages combined.

As shown in figure 4, PMIs also have struggled to meet their capital requirements in recent years, and regulators forced three large PMIs to cease writing new business for failing to meet these requirements. PMIs have relied heavily on capital and surplus contributions from outside investors and their parent companies to meet their capital requirements. To illustrate, from 2008 through 2012, three of the four largest PMIs received capital and surplus contributions that were greater than their total capital as of the end of 2012. In addition, these PMIs completely exhausted their contingency reserves. Ceding risk to reinsurance companies and higher-quality books of business in recent years also have helped PMIs to lower their risk-to-capital ratios. In contrast, FHA (which has not met its capital requirement) has continued to write new business, as authorized through annual appropriations acts, and would not receive additional funding through permanent and indefinite budget

authority until it is needed to help cover an upward credit subsidy reestimate.³⁹

Figure 4: Risk-to-Capital Ratios of Selected PMIs, 2001-2012



Source: GAO analysis of PMI data.

Note: The risk-to-capital ratios in the figure include capital and surplus contributions from outside investors and parent companies. Radian Guaranty was granted waivers that were in effect in 2012 by 10 states. Genworth Mortgage Insurance Company was granted waivers that were in effect in 2012 by 11 states. Mortgage Guaranty Insurance Corporation was granted waivers that were in effect in 2012 by 8 states.

PMIs face several potential consequences when their risk-to-capital ratios rise above the statutory ceiling of 25:1. When a PMI fails to meet state regulatory requirements, it must stop writing new business or receive a

³⁹As noted earlier, upward reestimates reflect increases in credit subsidy costs (or lower lifetime net revenues).

waiver from the state to continue operating.⁴⁰ If a PMI is forced to stop writing new business, the PMI continues to insure existing business (collecting premiums and paying claims) until all current business is extinguished. If a PMI receives a waiver, the PMI still can write new business, but the regulator imposes restrictions and conditions on the PMI. According to state regulators we interviewed, they consider a number of factors when deciding to grant a waiver. In general, waivers are granted if the state regulator decides that the PMI can return to profitability. Requirements for PMIs that have been granted waivers differ by state, but may include increased frequency of financial reporting, actuarial reviews, remediation plans, and regulatory approval of dividend payments. Prior to breaching the 25:1 ceiling or MPP requirement, three of the four largest PMIs applied for and were granted waivers by many of the 16 states that require them.

The enterprises also impose financial requirements on PMIs. Before the financial crisis, the enterprises required PMIs to maintain at least an AA-rating from two credit rating agencies. However, the enterprises consider this requirement to be obsolete because no PMIs currently meet the rating level. Instead, the enterprises have established remediation plans that include alternative requirements for the PMIs. These remediation plans allow the PMIs to continue insuring loans that are eligible for purchase by the enterprises, but include provisions intended to increase PMI transparency and reporting. Although each plan is different, the enterprises and PMIs told us that the plans generally required enhanced disclosure, regular meetings with the enterprises, and specific actions, including

- raising capital;
- maintaining a minimum level of liquid assets;
- obtaining waivers from state capital requirements; or
- creating subsidiaries licensed in states where waivers were not granted.

⁴⁰In some situations where PMIs were not granted state waivers, they established subsidiaries to conduct business in that state, subject to the approval of the PMI's domiciliary state and the subsidiary's ability to meet the requirements of the state in which it will conduct business.

In contrast to the PMIs, the statute that established FHA's 2 percent capital ratio requirement does not define consequences if the ratio falls below the required level. In 2012 and again in 2013, legislation was introduced that would require FHA to develop an emergency capital plan to restore the Fund's fiscal solvency and provide monthly reports to Congress on the condition of the Fund and any remediation steps taken that month.⁴¹ However, as of August 2013, this legislation had not been enacted.

State regulators and the Federal Housing Finance Agency (the regulator and conservator for the enterprises) have been considering ways to strengthen the financial condition requirements for PMIs, including capital requirements. The National Association of Insurance Commissioners has formed a working group that has been considering proposed capital requirements that would vary depending on the risk characteristics of the loans being insured (such as the loan-to-value ratio and borrower credit score). More specifically, PMIs would need to hold more capital for riskier loans than for loans with less risk. This approach contrasts with the fixed risk-to-capital ratio that currently applies. Eight PMIs issued a joint statement to the working group agreeing with this basic approach. The Federal Housing Finance Agency also has been working with the enterprises to develop new capital requirements for PMIs. Agency officials told us that the current risk-to-capital ratio requirements were not sufficient because they do not account for differences in loan risks, provide assurance of financial viability under severe stress scenarios, or differentiate between liquid and illiquid capital (that is, capital readily available to pay claims or not). The officials said that they expect to issue the new requirements by the end of 2013.

⁴¹H.R. 4264, the FHA Emergency Fiscal Solvency Act of 2012, was introduced in the House of Representatives in March 2012 and passed the House of Representatives on September 11, 2012. It was referred to the Senate, but was not voted on. H.R. 1145, the FHA Emergency Fiscal Solvency Act of 2013, was introduced in the House of Representatives in March 2013; H.R. 2767, the Protecting American Taxpayers and Homeowners Act of 2013, was introduced in the House of Representatives in July 2013; and S. 1376, the FHA Solvency Act of 2013, was introduced in the Senate in July 2013.

Features of the Regulatory Framework for Private Insurers Could Enhance Oversight of FHA

Certain features of the states' regulatory framework for PMIs could enhance oversight of FHA by increasing transparency and accountability. Although the PMI industry's reserving practices have limited applicability to FHA, separately disclosing reserve components for FHA would provide additional insight into FHA's financial condition that is not readily apparent with current reporting. PMI capital requirements also have limited applicability to FHA because they involve concepts that are not meaningful in the context of a federal program. However, certain consequences PMIs face for not meeting capital requirements—remediation plans and additional reporting—could be applied to FHA to enhance agency accountability.

Industry Practices and Requirements Have Limited Applicability to FHA's Fund

The PMI industry's reserving practices and capital requirements have limited applicability to FHA's Fund because some of the underlying purposes and concepts are not pertinent to a federal credit program. For example, two of the liabilities that PMIs record under statutory accounting principles—unearned premium reserves and contingency reserves—are intended, in part, to protect policyholders by limiting payment of excessive dividends to stockholders, which reduce capital. The unearned premium reserve does this by matching revenues with the time periods in which they are earned rather than when they are received. This prevents PMIs from using unearned premiums to increase the surplus from which they pay dividends. The contingency reserve serves a similar purpose by setting aside half of earned premiums for 10 years. Because FHA does not pay dividends and virtually all of the premium revenues FHA receives remain in the Fund, a reserve for the purpose of preserving capital by preventing dividend payments is not needed.

A third liability that PMIs record, the loss reserve, also has limited applicability to FHA's Fund because its purpose is to demonstrate to regulators that PMIs have sufficient resources today to pay claims to policyholders for anticipated losses on already-delinquent loans. The loss reserve is therefore a tool to mitigate a PMI's liquidity risk—the risk of not having the capacity and perceived capacity to meet demands for cash. FHA does not face the same liquidity risk that PMIs do because the Fund's financing account holds balances to cover expected future claims on existing loans, and FHA can draw upon permanent and indefinite budget authority to pay claims, if necessary. In addition, FHA includes

estimates of losses on delinquent loans (and performing loans) in its liability for loan guarantees.⁴²

Certain PMI reserves have other purposes that are pertinent to FHA, but FHA addresses them by other means. Although most unearned premium is not refundable, an additional purpose of the unearned premium reserve is to reflect a PMI's refund liability in the event that the mortgage insurance policy is cancelled before premiums are fully earned. FHA accounts for premium refunds by including the amount of premiums that are expected to be refunded in its estimates of future cash flows. One purpose of the contingency reserve is to build up a capital buffer to help cover claims during economic downturns. While not fixed to a percentage of premiums like the contingency reserve, FHA's capital reserve account holds all premiums in excess of anticipated claims and is available to pay higher-than-anticipated claims. Furthermore, calculating the current levels of these reserves would be difficult. For example, determining FHA's contingency reserve liability is complicated by the fact that this liability may be reduced if incurred losses exceed 35 percent of earned premiums—a threshold FHA likely exceeded in recent years.⁴³

PMI capital requirements also have limited applicability to FHA because they rely on definitions and components of capital that are not directly

⁴²Although the purpose of the loss reserve has limited applicability to FHA, it is nevertheless possible to calculate a loss reserve amount for the Fund. According to FHA data, the risk-in-force for loans 90 days or more delinquent or in foreclosure or bankruptcy as of September 30, 2012, was \$107.7 billion. According to FHA, the estimated transition-to-claim rate for those loans was nearly 72 percent, and the estimated loss severity was about 61 percent. Using these data, the loss reserve would have been \$47 billion as of September 30, 2012.

⁴³FHA likely exceeded the 35 percent threshold because (1) although FHA does not calculate incurred losses or earned premiums as a PMI does, FHA's claims payments as a percentage of premiums collected have exceeded 40 percent each year dating back to fiscal year 2000; and (2) our review of PMI financial statements indicated that using claims payments as a percentage of premiums collected (instead of incurred losses as a percentage of earned premiums) would tend to understate the actual loss ratio.

relevant to FHA's operating environment.⁴⁴ Specifically, PMIs use statutory surplus and contingency reserves from the statutory financial statements they file with insurance regulators to determine their capital. Statutory surplus includes components that FHA's Fund does not have, including capital stock and gross paid-in and contributed surplus, which reflect the various means that PMIs use to raise capital.⁴⁵ FHA's capital does not have these components and consequently, they cannot be calculated for FHA. For example, as a federal agency, FHA does not have stock or stockholders. FHA's capital comes almost exclusively from premiums and minimal interest income. For PMIs, retained earnings—an entity's net income since its inception—increase statutory surplus, and dividends paid to stockholders decrease it. The retained earnings or losses component of PMIs' capital is somewhat similar to the net position of FHA's Fund.⁴⁶ However, FHA's net position reflects estimates of lifetime premiums net of claims, while PMIs' retained earnings reflect, among other things, revenues earned and losses incurred (on delinquent loans) to date.

⁴⁴Nevertheless, because PMI capital requirements are expressed as a proportion of either risk-in-force or unamortized insurance-in-force, it is possible to calculate the dollar amount of capital that FHA would need under these requirements. For example, according to FHA data, as of September 30, 2012, FHA had a risk-in-force on performing loans of \$961.3 billion. Applying a 25:1 risk-to-capital ratio to this amount, FHA would need \$38.4 billion in capital. However, because FHA makes recoveries on foreclosed properties, FHA's effective risk-in-force could be 30-35 percent lower. If FHA's risk-in-force was reduced by this amount, FHA would need from \$25.0 billion to \$26.9 billion in capital. However, for the reasons previously cited, calculating FHA's actual capital level using the PMI definition of capital is problematic.

⁴⁵The capital stock amount represents the number of authorized shares of capital stock issued multiplied by the par value of each share, as set forth in the articles of incorporation. Gross paid-in and contributed surplus is the amount of capital received in excess of the par value of the stock issued.

⁴⁶The net position of the Fund is reflected in the capital reserve account balance, which holds (in present value terms) the estimated lifetime revenues in excess of estimated lifetime losses across all loan cohorts.

Industry Practice of Separately Disclosing Reserve Components Could Increase Transparency of Risks Facing FHA's Fund

Although specific PMI reserving practices have limited applicability to FHA, the concept of separately disclosing reserve components as PMIs do could be applied to the Fund. For example, the PMI loss reserve and unearned premium reserve focus on the timing of specific cash flows—the loss reserve on claims that are likely to be paid on delinquent loans in the near-term and the unearned premium reserve on premiums as they are earned over time. In contrast, FHA has a single reserve from a financial accounting perspective, the liability for loan guarantees, which combines estimates of future claims payments with estimates of future premiums and recoveries over a 30-year period into a single number.⁴⁷ While a single number is a useful measure of lifetime costs and aligns with federal budget requirements, it provides limited insight into the timing of specific cash flows and, therefore, the degree of uncertainty in the estimate.

As of September 30, 2012, the liability for loan guarantees for forward mortgages in FHA's Fund was \$37 billion. That is, claims payments on loans that were insured as of that date were expected to exceed future premiums and recoveries on foreclosed properties by \$37 billion on a present value basis over the next 30 years. However, the timing of claims payments, premiums, and recoveries is not evident from this figure. This information is important for more fully understanding the Fund's financial status because estimates of near-term cash flows are inherently more certain than estimates of longer-term cash flows. Disclosing the timing of specific cash flows would help illustrate the extent to which estimates of claims payments, premiums, and recoveries in the liability for loan guarantees are concentrated in the near term or longer term and therefore more or less certain.

The uncertainty of longer-term cash flow estimates also applies to FHA's future business activity, which is estimated to help offset losses on its existing loans. The fiscal year 2012 actuarial review found that the economic value of the Fund's forward mortgages without the fiscal year 2013 book of business was negative \$13 billion, meaning that the present value of estimated future cash flows on the existing portfolio exceeded current resources available to pay claims by that amount. The actuary estimated that FHA's future business will generate positive economic

⁴⁷As previously noted, PMIs generally do not take possession of foreclosed properties and therefore do not make recoveries.

value, which will help rebuild the Fund's capital resources. In its fiscal year 2012 annual report to Congress, FHA said it foresaw little risk that it would not be able to pay claims based on projections of its future business.⁴⁸ However, like all long-term projections, the actuary's estimates rest on assumptions that are inherently uncertain.

As previously noted, differences in the level of certainty between near-term and longer-term cash flows underscore the importance of this information for assessing financial condition. The liability for loan guarantees is built upon a 30-year schedule of key cash flows—claims, premiums, and recoveries. Accordingly, separately disclosing these component parts and showing how they vary over time could provide additional insight into the financial condition of the Fund. Such disclosure would be consistent with information reported on the timing of cash flows for federal social insurance programs, which also rely on long-term estimates.⁴⁹ It would also be consistent with federal internal control guidance for communicating with external groups.⁵⁰ This guidance discusses the importance of communicating relevant information to Congress and others so that they can better understand the agency, including its mission, goals, objectives, and risks.

Accountability Component of Industry Capital Requirements Could Strengthen Oversight of FHA

Unlike PMIs, which may be required to undertake actions such as remediation plans and additional reporting to state regulators as conditions of doing business when they do not meet capital requirements, FHA is not subject to such enhanced accountability measures. As previously stated, PMIs that have not met their capital or other requirements have had to provide additional reporting, more frequently

⁴⁸FHA based this conclusion on simulations of economic scenarios and projected FHA mortgage volume, which showed a nearly 95 percent chance that the forward loan component of the Fund would have positive capital resources each year over the next 7 years.

⁴⁹Social insurance programs, such as Social Security and Medicare, report projections of cash flows as supplemental information to the consolidated financial statements of the U.S. government. See GAO, *Financial Audit: U.S. Government's Fiscal Years 2012 and 2011 Consolidated Financial Statements*, [GAO-13-271R](#) (Washington, D.C.: Jan. 17, 2013).

⁵⁰GAO, *Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (Washington, D.C.: November 1999) and *Internal Control Management and Evaluation Tool*, [GAO-01-1008G](#) (Washington, D.C.: August 2001).

meet with regulators, and in some cases develop remediation plans to continue writing new business. For example, remediation plans may lay out a PMI's plan for restoring its capital to the required level through capital contributions from the parent company, premium increases, and underwriting changes. In contrast, FHA has not been in compliance with its capital ratio requirement since 2009 and is not estimated to reach compliance until 2017. Yet failure to comply with the requirement does not trigger a defined process or set of steps to be taken by FHA. FHA's annual reports to Congress in 2009 through 2011 described steps it already had taken to improve the Fund's financial condition, including premium and underwriting changes. However, FHA did not issue a plan of action to restore the Fund's capital ratio, including implementation time frames and estimated outcomes, until it submitted its 2012 annual report to Congress.

Requiring a capital restoration plan when the capital ratio approaches or falls below the required level could strengthen oversight of FHA by prompting the timely development and analysis of corrective actions and by providing benchmarks against which Congress could monitor progress of implementation. As noted earlier, legislative proposals that contain such a requirement have been introduced but have not been enacted. In addition, past congressional actions have emphasized the importance of remediation plans for financial institutions. For example, the Deficit Reduction Act of 2005 required the Federal Deposit Insurance Corporation to establish and implement a restoration plan when its Deposit Insurance Fund was either projected to fall or actually fell below the minimum level.⁵¹ The Dodd-Frank Wall Street Reform and Consumer Protection Act required the establishment of remediation requirements, including capital restoration plans, for certain institutions facing financial distress.⁵²

Conclusions

FHA, like other mortgage market participants, suffered major losses as a result of the recent housing crisis and may require additional funds in the near future. These circumstances have focused attention on oversight of FHA's single-family mortgage programs, including the practices and requirements FHA follows in managing the Fund. Although PMIs also

⁵¹Pub. L. No. 109-171, § 2108.

⁵²Pub. L. No. 111-203, § 166.

experienced financial distress and some stopped issuing new policies, the PMI regulatory framework provides a basis for comparison and offers alternative practices and requirements to consider in deliberating on potential FHA reforms. However, the applicability of certain PMI practices and requirements to FHA is fundamentally limited because their underlying purposes or components are not directly relevant in FHA's operating environment.

Nonetheless, the PMI regulatory framework has features that, if applied to FHA, could enhance transparency of the Fund's financial condition and congressional oversight of FHA's operations. First, the concept of separately disclosing reserve components as PMIs do could be applied to the Fund. FHA's liability for loan guarantees—which FHA calculates and reports annually as required—has certain limitations. In particular, it does not show the timing of the different cash flows that comprise the liability for loan guarantees—claims, premiums, and recoveries—and therefore does not reveal the extent to which FHA may be relying on less certain future revenue to offset more certain near-term losses. Disclosing this information could enhance congressional oversight of FHA's financial condition and would be consistent with reporting practices of other federal programs and federal internal control guidance. Second, accountability mechanisms like those included in PMI capital requirements also could enhance congressional oversight of the Fund. Unlike PMIs, which must obtain waivers and submit remediation plans when they have not met or are at risk of not meeting capital requirements, FHA does not have a defined process it must follow. In 2012, FHA provided Congress with a set of planned actions to address its capital shortfall, but had not done so in prior years. A capital restoration plan requirement triggered by noncompliance with the Fund's statutory capital requirements could help ensure prompt action by FHA and focus Congress's monitoring efforts should this situation arise in the future. This type of requirement is contained in legislative proposals currently before Congress and would be consistent with prior congressional actions for certain financial institutions and government entities.

Matter for Congressional Consideration

To strengthen FHA accountability for complying with the Fund's statutory capital requirement, Congress should consider requiring that FHA submit a capital restoration plan and regular updates on plan implementation whenever the capital ratio falls below 2 percent as calculated in the annual actuarial review of the Fund, or the Fund's financial condition does not meet other congressionally-defined requirements.

Recommendation for Executive Action

To provide additional perspective on the Fund's financial status, FHA should disclose estimates of the individual cash flows associated with the liability for loan guarantees (premiums, claims, and recoveries), including their value for each year of the 30-year estimation period.

Agency Comments and Our Evaluation

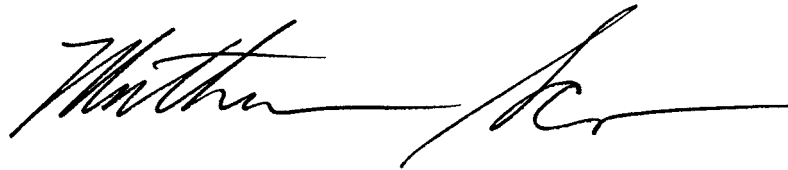
We provided a draft of this report to HUD and the Federal Housing Finance Agency for their review and comment. We received written comments from HUD, which are reprinted in appendix II. HUD also provided a technical comment, which we incorporated into the final report. The Federal Housing Finance Agency had no comments on the draft report.

In its letter, HUD agreed with our recommendation to disclose the component parts of the liability for loan guarantees—claims, premiums, and recoveries. However, HUD suggested an alternative to disclosing cash flows for each year of the 30-year estimation period, as we recommended. Specifically, HUD proposed separately disclosing the liability for loan guarantees for delinquent loans and performing loans, which would implicitly break down losses into the near term (those arising from currently delinquent loans) and the longer term (reflecting potential loss projections on currently performing loans). HUD said that this approach would give a clearer picture of the Fund's financial status at a given point in time. HUD's suggestion is broadly consistent with our recommendation and could provide useful information. However, it does not clearly include the separate disclosure of claims, premiums, and recoveries and would not provide as much perspective on the timing of cash flows as the approach we recommend. Our recommendation, which calls for a more detailed disclosure of cash flow values for each year over the 30-year estimation period, would provide greater insight into the Fund's financial condition by illustrating the uncertainty of future losses and revenue. For this reason, we made no change to our recommendation.

We also provided excerpts of the draft report to the National Association of Insurance Commissioners, the Mortgage Insurance Companies of America and its three member companies (Radian Guaranty, Genworth, and Mortgage Guaranty Insurance Corporation), and United Guaranty for technical review. We received technical comments from the Mortgage Insurance Companies of America on behalf of its members and from United Guaranty, which we incorporated into the final report as appropriate.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to the Secretary of Housing and Urban Development and the Acting Director of the Federal Housing Finance Agency. In addition, the report will be available at no charge on the GAO website at <http://www.gao.gov>.

If you or your offices have any questions about this report, please contact me at (202) 512-8678 or sciremj@gao.gov. 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.

A handwritten signature in black ink, appearing to read "Mathew Scirè", with a long horizontal flourish extending to the right.

Mathew Scirè
Director, Financial Markets and Community Investment

Appendix I: Objectives, Scope, and Methodology

We examined the Federal Housing Administration's (FHA) financial condition requirements for the Mutual Mortgage Insurance Fund (Fund) and compared them with those used by private mortgage insurers (PMI). Specifically, we discuss (1) how the reserving practices and capital requirements of FHA's Fund compare with those for the PMI industry and (2) how, if at all, applicable PMI reserving practices and capital requirements could enhance oversight of FHA's Fund.

To address the first objective, we identified and reviewed reserving practices and capital requirements pertinent to FHA and PMIs. We reviewed generally accepted accounting principles for federal entities and federal statutes that apply to FHA's Fund. We also reviewed statutory accounting principles, generally accepted accounting principles for nongovernmental entities, Fannie Mae and Freddie Mac policies, and state statutes and regulations that apply to PMIs. We interviewed mortgage market participants and stakeholders, including officials from FHA, insurance regulatory agencies in three selected states (North Carolina, Pennsylvania, and Wisconsin), the National Association of Insurance Commissioners, major PMIs, a PMI trade association, Fannie Mae, Freddie Mac, and the Federal Housing Finance Agency to confirm our understanding of the practices and requirements. We selected the three states based on the market share of PMIs domiciled in those states and the diversity of state requirements for PMIs. These states were the domiciliary states and primary regulators for PMIs that accounted for 90 percent of the PMI market. We compared and contrasted the practices and requirements for FHA and PMIs along several dimensions, including the financial measures used, the frequency of associated reporting, and the regulatory consequences of noncompliance. In addition, we examined scholarly articles and industry reports to determine possible reasons for any differences between FHA and PMI practices and requirements. Finally, to provide additional context, we reviewed actuarial and financial reports showing the extent to which FHA and selected PMIs met their respective capital requirements from 2001 through 2012. For this analysis, we reviewed the four largest PMIs, which accounted for 78 percent of the PMI market in 2012, as well as three PMIs that ceased writing new business due to capital constraints during the time frame. We obtained these data from FHA's annual actuarial reviews, PMIs' public reports, and PMI officials.

To address the second objective, we reviewed statutes, regulations, and accounting standards that currently apply to FHA and PMIs. We also reviewed information FHA currently reports on the Fund's financial condition, including annual actuarial reviews of the Fund, HUD

appendixes to the President's budget, and FHA's audited financial statements. To determine the extent to which PMI reserving practices and capital requirements could be applied to FHA's Fund, we considered factors such as the compatibility of underlying concepts and calculations with FHA's operations. We analyzed data from FHA on the volume and performance of the mortgages it has insured through the end of fiscal year 2012 to calculate a loss reserve for FHA in the manner of a PMI. Specifically, FHA provided data on the amortized insurance-in-force on loans that were 90 or more days delinquent or in foreclosure as well as the assumptions used in the President's budget on the percentage of those loans that will eventually result in a claim and the estimated loss severity. We also analyzed FHA data on its risk-in-force on performing loans, estimated recovery rates, and total amortized insurance-in-force as of the end of fiscal year 2012 to calculate the dollar amount of capital that FHA would need under PMI capital requirements. To assess the reliability of the data we obtained from FHA, we conducted reasonableness checks on data elements and discussed the sources and interpretation of the data with FHA officials. We determined that the data we used were sufficiently reliable for purposes of characterizing the financial condition of the Fund. In addition, we interviewed mortgage insurance regulators in the selected states to identify the information PMIs report under their current practices and requirements that regulators find useful in assessing financial condition. Additionally, to determine whether features of the PMI regulatory framework could enhance Fund oversight, we interviewed FHA officials, major PMIs, and other industry analysts to obtain their perspectives on the potential for increasing transparency and better understanding the Fund's financial condition. We also identified relevant criteria in GAO's *Standards for Internal Control in the Federal Government* and *Internal Control Management and Evaluation Tool* as well as examples of remediation plan requirements enacted by Congress for other financial institutions and government entities.¹

We conducted this performance audit from February 2013 to September 2013 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe

¹GAO, *Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (Washington, D.C.: November 1999) and *Internal Control Management and Evaluation Tool*, [GAO-01-1008G](#) (Washington, D.C.: August 2001).

that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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

AUG 19 2013

Mr. Mathew J. Scirè
Director
Financial Markets and Community Investment
Government Accountability Office
441 G Street, NW
Washington, DC 20548-0001

Dear Mr. Scirè:

Thank you for the opportunity to respond to the draft GAO -13-722 report of July 29, 2013, entitled, "FHA Mortgage Insurance: Applicability of Industry Requirements Is Limited, but Certain Features Could Enhance Oversight." This letter is in response to the Recommendation for Executive Action in the draft.

Recommendation:

To provide additional perspective on the Fund's financial status, FHA should disclose estimates of the individual cash flows associated with the liability for loan guarantees (premiums, claims, and recoveries), including their value for each year of the 30-year estimation period.

HUD Response:

FHA agrees with the recommendation to disclose the liability for loan guarantees in terms of premiums, claims and recoveries. However, FHA suggests an alternative to the 30-year estimation period to ensure the best possible accuracy and to provide data that will best indicate future cash flow. FHA suggests that the guarantees be split into delinquent versus performing, which implicitly breaks down losses into the near-term— those arising from currently delinquent loans, and the longer term – reflecting potential loss projections on currently performing loans. FHA believes that such an approach will give a clearer picture of the Fund's financial status at a given point in time.

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We appreciate the efforts of the GAO to review our work and progress to strengthen the MMI Fund, and welcome future recommendations that will support those efforts.

Sincerely,



Carol J. Galante
Assistant Secretary for Housing-
Federal Housing Commissioner

Appendix III: GAO Contact and Staff Acknowledgments

GAO Contact

Mathew J. Scire` (202) 512-8678 or sciremj@gao.gov

Staff Acknowledgments

In addition to the contact named above, Robert Dacey (Chief Accountant), Marcia Carlsen and Steve Westley (Assistant Directors), Anne Akin, Don Brown, Stephen Brown, Jason Kelly, Melissa Kornblau, Aaron Livernois, John McGrail, Barbara Roesmann, Jena Sinkfield, Andrew Stavisky, and Frank Todisco made key contributions to this report.

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