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MORTGAGE FINANCING

Financial Health of the Federal Housing Administration's Mutual Mortgage Insurance Fund

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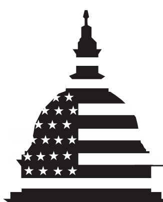

GAO/T-RCED-00-287

Mr. Chairman and Members of the Subcommittee:

We are here today to discuss the financial health of the Mutual Mortgage Insurance Fund (the Fund) of the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA). Through the Fund, FHA operates a single-family insurance program that, since its creation in 1934, has helped millions of Americans buy a home. Last fiscal year alone, FHA insured 1.3 million single-family mortgages, totaling $125 billion. By the end of September 1999, FHA had commitments of almost half a trillion dollars in single-family mortgage insurance. The Fund, which is financed through insurance premiums, operates without cost to the American taxpayer.

Ten years ago, following an economic downturn during the 1980s that resulted in severe losses, particularly on loans made in the oil-producing states, the Fund was estimated to have a negative economic value, and its future was in doubt. To help place the Fund on a financially sound basis, the Congress enacted legislation in November 1990 that required the Secretary of HUD to, among other things, raise insurance premiums and suspend the rebates, called distributive shares, that FHA borrowers had been eligible to receive under certain circumstances. The legislation also required the Secretary to take steps to achieve a capital ratio of 2 percent by November 2000[1] and to maintain or exceed that ratio at all times thereafter. In the most recent actuarial study of the Fund, Deloitte & Touche estimated its economic value at $16.6 billion at the end of fiscal year 1999. This represents 3.66 percent of the amount of mortgages that FHA insured—well above the required minimum of 2 percent. However, it is not clear what level of reserves would be adequate to ensure the financial health of the Fund.

In today's robust economy, the Fund's economic value appears to have reached its highest level in at least 20 years, and several proposals have been made to use what some are calling excess reserves or to take other actions that could result in a change in the value of the Fund. However, the level of reserves that would be adequate to ensure that the Fund could withstand losses as severe as those FHA experienced in the 1980s is not clear at this time. This Subcommittee and the House Subcommittee on Housing and Community Opportunity have asked us to undertake work that would help determine what level of reserves would allow the Fund to withstand certain economic downturns. Our statement today is based on reports we have issued over the last 5 years. (See app. I for related GAO products.) Specifically, our statement today will focus on (1) the activities of FHA's home mortgage insurance program, (2) how the reserves of the Fund are estimated, (3) our views on determining an adequate level of reserves, (4) actions that the Congress and the Secretary of HUD have taken or could take to influence the level of reserves, and (5) the impact that actions affecting the level of reserves could have on the federal budget.

In summary:

[1]The act defined the capital ratio as the ratio of the Fund's capital, or economic net worth, to its unamortized insurance-in-force. However, the act defined unamortized insurance-in-force as the remaining obligation on outstanding mortgages—a definition generally understood to apply to amortized insurance-in-force. FHA has calculated the 2-percent capital ratio using unamortized insurance-in-force as it is generally understood—which is the initial amount of mortgages. All capital ratios reported here are measured using unamortized insurance-in-force as it is generally understood.

- FHA is a major source of financing for the single-family housing market—overall as well as for some specific groups, particularly low-income and other homebuyers who may not have much cash for a down payment but are otherwise able to afford a loan.[2] FHA's home mortgage insurance program has helped people become homeowners through the use of a mutual insurance fund that, until the 1990s, returned profits (distributive shares) to homebuyers.
- The reserves that FHA is required to maintain consist of current capital resources--primarily nonmarketable Treasury securities--plus estimates of the net present value of future cash flows from the activity of the Fund. Deriving estimates of the value of future cash flows requires professional judgment and, in practice, relies on complex economic models.
- Determining what reserve levels would ensure the financial soundness of the Fund requires additional study. When the Congress, in 1990, first established the 2-percent reserve requirement, the Fund was experiencing unusual losses. Today, the Fund appears to be enjoying its highest level of reserves in the last 20 years. To help the Congress decide on an appropriate level of reserves for the future, we are now conducting analyses that will model economic scenarios that you may wish the Fund to withstand. For example, losses that FHA experienced in the 1980s following unusually high claims resulting from foreclosures in the oil-producing states may provide an indication of the reserve levels that might be needed for the Fund to remain financially sound.
- There are a number of actions that the Congress and the Secretary of HUD have taken and could take to influence the level of reserves. For example, both the Secretary and the Congress have changed insurance premiums. The Secretary has also taken actions to limit losses from the management of foreclosed properties and to enhance FHA's oversight of lenders. The Congress has set maximum loan-to-value ratios and required the Secretary to suspend payment of distributive shares. Any of these actions may have affected the value of the Fund. In addition, the Congress and the Secretary could take actions in the future that could reduce the value of the fund, including reducing premiums, changing underwriting standards to reach more homebuyers, or reinstituting the payment of distributive shares.
- Actions taken by the Secretary of HUD or the Congress that influence the Fund's reserve levels will also affect the federal budget. In short, any proposal that seeks to use reserves, if not accompanied by a reduction in other spending or an increase in receipts, will result in a decline in the federal budget surplus.

Let me start by briefly explaining the reason for mortgage insurance programs like FHA's, the concept of mutuality, and the recent history of the Mutual Mortgage Insurance Fund.

FHA Is a Major Source of Single-Family Mortgage Insurance

FHA was created in 1934 to broaden homeownership, shore up and protect lending institutions, and stimulate employment in the building industry. While the mortgage market has changed over time, FHA continues to be a major source of financing for single-family homes, particularly for minority, low-income, and first-time homebuyers. HUD reported in March of this year that it set a record in 1999, insuring an additional 1.3 million mortgages worth $125 billion and bringing the total number of mortgages it now insures to about 6.7 million. HUD also reported that

[2]A "low-income" borrower is one whose income is no greater than 80 percent of the median income in the Metropolitan Statistical Area in which the borrower lives.

almost 38 percent of the loans insured by FHA in 1999 were made to minority homebuyers and over 80 percent of new FHA-insured loans were made to first-time homebuyers. As we reported last year, FHA is more likely than the Department of Veterans Affairs or private mortgage insurers to insure loans for minority and first-time homebuyers.[3] FHA is also more likely to insure loans for low-income homebuyers, many of whom might not qualify for private mortgage insurance. In line with its original role to shore up lenders and provide employment, FHA continues to offer insurance in areas suffering from economic hardship under the same terms that it does in areas with more robust economies. Private mortgage insurers, by contrast, offer insurance under more restrictive terms when an area is experiencing economic hardship. As a result, they are likely to provide less insurance in these areas.

FHA provides most of its single-family insurance through a program supported by the Mutual Mortgage Insurance Fund. The Fund is a mutual fund in that any income received in excess of the amounts required to cover initial insuring costs, operating expenses, and losses due to claims may be paid to borrowers after they pay their mortgages in full or voluntarily terminate their FHA insurance. In accordance with this principle, from 1943 to 1990, FHA rebated these so-called excess funds to borrowers as distributive shares. In 1990, however, the Congress suspended the payment of these shares after the Fund became weakened by losses resulting from high foreclosure rates in economically stressed regions, particularly in the oil-producing states during the 1980s. The decline in the value of the Fund during the 1980s contrasts with the relative health the Fund has enjoyed for most of its history. While the economic value of the Fund at the beginning of the 1980s was estimated to be $3.4 billion, or 5.3 percent of the insurance-in-force, by 1990, the Fund was estimated to have a negative economic value of $2.7 billion. In 1990, the Congress not only suspended the payment of distributive shares but also required the Secretary to raise premiums and take other actions to build up a reserve to protect the Fund in case of future downturns.

Reserve Estimates Are Based on Professional Judgment

Estimating the value of the reserves involves extensive professional judgment. The 1990 reforms defined the reserves or economic value of the Fund as the current cash available to the Fund plus the net present value of future cash flows expected to result from mortgages insured under the Fund. In practice, the Fund has been measured as current capital resources[4] plus the net present value of future cash flows. Investments in nonmarketable Treasury securities represent the largest component of FHA's current capital resources. From the overall perspective of the government, these FHA assets are offset by corresponding liabilities of the U.S. Treasury.

Estimating the net present value of future cash flows is a complex actuarial exercise that requires extensive professional judgment. Cash flows into the Fund from premiums and the sale of foreclosed properties; cash flows out of the Fund to pay claims on foreclosed mortgages, premium refunds, and administrative expenses. See figure 1. The future cash flows are

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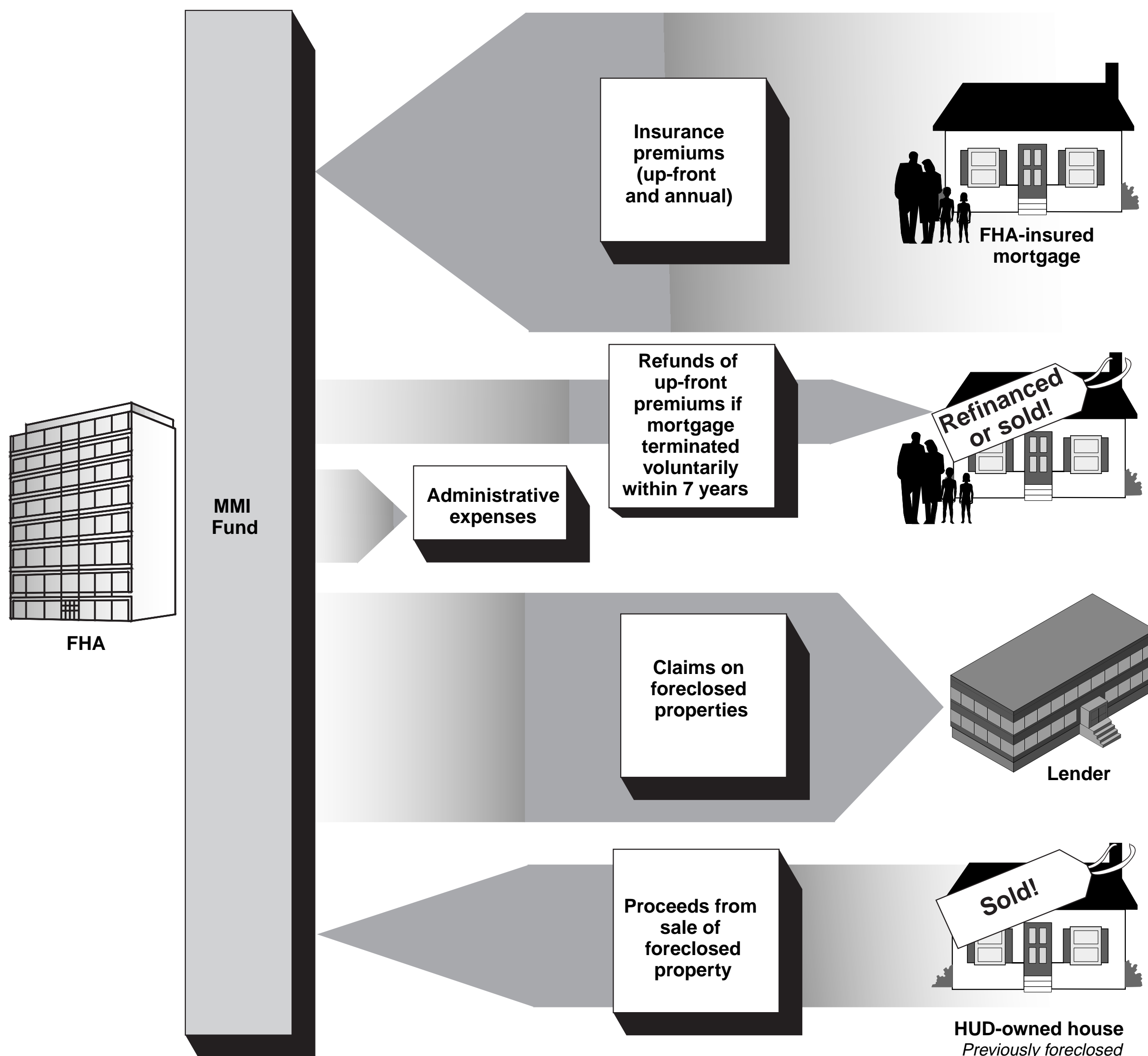
[3] *Homeownership: Results of and Challenges Faced by FHA's Single-Family Mortgage Insurance Program* (GAO/T-RCED-99-133, Mar. 25, 1999).

[4] According to HUD, the Fund's capital resources for 1999 were $14.3 billion including fund balances with the U.S. Treasury of $3.6 billion, investments in U.S. Treasury securities of $14.7 billion, net credit program receivables and related foreclosed property of $2.8 billion, interest receivable from U.S. government securities of $0.2 billion, and other assets of $0.2 billion, minus net receivables and payables including borrowings from the U.S. Treasury, other liabilities, claims payable, premium refunds payable, and debentures issued to claimants of $ 7.1 billion.

estimates based on a number of assumptions about the future, including predictions of mortgage defaults and the likelihood that those holding FHA-insured mortgages will prepay their loans. These predictions are based on elaborate models that use past relationships between defaults and prepayments and certain economic variables, such as changes in house prices. To the extent that these relationships are different in the future, the actual defaults and prepayments will differ from the estimates. Moreover, the estimating procedures make many other assumptions. For example, the estimates usually assume that no changes will take place in FHA's program and that future economic variables--specifically, changes in house prices, unemployment rates, or mortgage rates--will take on certain values. If HUD changes its program or these economic values are different from those forecasted, then the actual default and prepayment experience is also likely to be different from that used in estimating the reserves.

Figure 1: Cash Flows of the Mutual Mortgage Insurance Fund



The 1990 reforms required the Secretary of HUD to take steps to ensure that by November 2000 the Fund would build a reserve or increase its economic value–or capital--to at least 2 percent of the insurance-in-force and that this capital ratio would remain at 2 percent or more thereafter. In addition, an independent actuarial review is required annually to estimate the economic value of the Fund and the capital ratio. This review was performed by Price Waterhouse--now PricewaterhouseCoopers—for fiscal years 1989[5] through 1998 and by Deloitte & Touche in 1999. For fiscal years 1993 and 1994, we estimated capital ratios that were similar to those calculated by Price Waterhouse.[6] The independent actuarial reviews show that the estimated capital ratio has risen from a low of –0.9 percent of the insurance-in-force in 1990--a time when the economic

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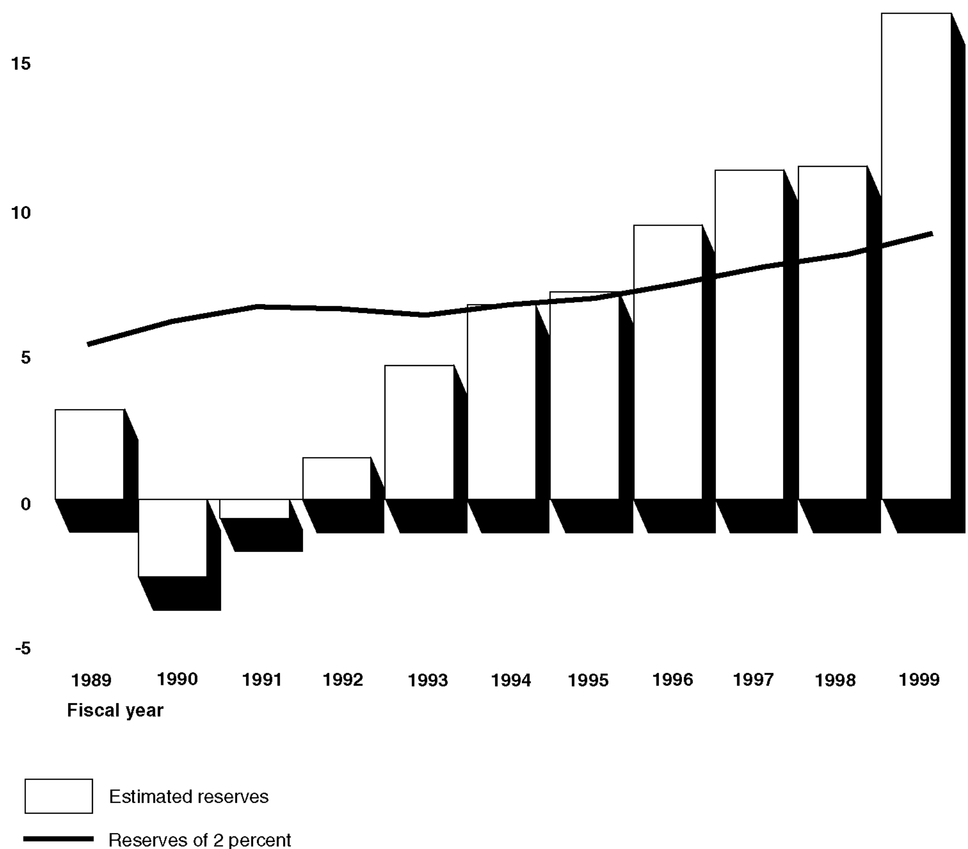
[5]Price Waterhouse estimated the value of the fund for fiscal year 1989 at HUD's request.

[6]*Mortgage Financing: Financial Health of FHA's Home Mortgage Insurance Program Has Improved* (GAO/RCED-95-20, Oct. 18, 1994) and *Mortgage Financing: FHA Has Achieved Its Home Mortgage Capital Reserve Target* (GAO/RCED-96-50, Apr. 12, 1996).

value of the Fund was negative--to a high in 1999 of 3.66 percent of the insurance-in-force. As figure 2 shows, in the early 1990s, estimated reserves were lower—sometimes far lower—than the level of reserves that would have been needed to meet a 2-percent capital ratio. In 1990, for example, estimated reserves were almost $9 billion lower than needed to meet a 2-percent capital ratio. However, the graph tells a very different story for the second half of the 1990s. Beginning in 1995, the estimated reserves exceeded the level needed to meet a 2-percent capital ratio. As the decade progressed, FHA insured a larger volume of loans, but the annual estimated reserves grew well beyond the levels needed to meet a 2-percent capital ratio. As a result, in 1999, Deloitte & Touche estimated that the Fund had reserves of $16.6 billion—a level more than 80 percent higher than the $9 billion level needed to meet a 2-percent capital ratio. While the increase in the reserves throughout most of the 1990s was due, in part, to legislative and other changes to FHA's single-family mortgage insurance program, the favorable prevailing and forecasted economic conditions were primarily responsible for the improvement.

Figure 2: Comparison of Reserves Equaling 2 Percent of Insurance-in-Force and Estimated Reserves: 1989-99



Source: GAO's analysis of PricewaterhouseCoopers and Deloitte & Touche data.

What Constitutes Adequate Reserve Levels Has Not Received Enough Study

Determining what constitutes an adequate reserve level is essentially a question of what kinds of adverse economic conditions--moderately severe or catastrophic--the reserve should be able to withstand, and this issue has not received much attention recently. By statute, the Fund is supposed to be actuarially sound; however, the legislation does not define actuarial soundness. In the actuarial review of the Fund conducted by Price Waterhouse for fiscal year 1989, the researchers concluded that actuarial soundness would be consistent with a reserve that could withstand adverse, but not catastrophic, economic downturns. They further concluded that the Treasury implicitly covers catastrophic risk. In other words, they concluded that policyholders should pay premiums high enough to cover some moderate level of adverse experience, but that taxpayers should shoulder the additional risk imposed by such severe conditions as the oil-producing states experienced in the 1980s. By contrast, rating agencies have taken the position, when evaluating private mortgage insurers, that they should have enough capital to withstand

catastrophic risk. These agencies have, therefore, measured the capital adequacy of these firms against their ability to withstand downturns such as the oil-producing states encountered in the 1980s. While the Fund can ultimately rely on the taxpayer, in many ways the Fund faces more risk than private mortgage insurers. Generally, compared with private insurers, the Fund insures more low-income borrowers, provides insurance for mortgages with lower down payments, and insures essentially 100 percent of the mortgage amount, whereas private insurers generally cover only about 20 percent of the mortgage amount. Finally, private insurers tend to cease insuring new business when mortgage markets go bad, whereas FHA remains in the market, helping to cushion the downturn. However, requiring FHA to hold capital equivalent to that held by private mortgage insurers would likely impair FHA's public purpose.

Because little analysis has been done to determine the level of protection provided by the 2-percent reserve requirement, we believe that further study is needed on whether that requirement or some other requirement is adequate. As we mentioned earlier, we are undertaking work that would help determine what level of reserves would allow the Fund to withstand certain economic downturns. As part of this work, we are in the process of estimating the Fund's reserve and expect to report our findings in 2001. At that time, we also plan to report on the degree of protection provided by the 2-percent minimum reserve ratio. For example, we plan to assess whether a 2-percent reserve ratio would be adequate to protect the Fund from a downturn comparable to the one in the 1980s. We understand that the Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) are also conducting analyses that will shed light on the current size of the reserves and on the level of adversity the Fund could withstand.

The Congress and HUD Have Taken Actions That Affect the Value of the Fund's Reserves

The Congress has taken actions in the past that are likely to have changed the economic value of the Fund and might take additional actions in the future that could have an effect on the value of the Fund. The 1990 reforms, which were designed to improve the actuarial soundness of the Fund, made significant changes in the way premiums were set. The reforms reinstituted annual premiums and required that premiums vary with the riskiness of the loan. This legislation also called for phased-in reductions of the maximum allowable up-front premium in the ensuing years. Subsequently, the Congress has taken action to

- lower the maximum up-front premium from 2.25 percent to 2 percent for first-time homebuyers who receive home ownership counseling before purchasing a home,
- raise the maximum limits on the size of the loans FHA can insure–for high-cost areas this limit was raised to almost $220,000 in January 2000--and
- have FHA implement a new loss mitigation program that encourages lenders to take actions to lower defaults on FHA-insured mortgages.

The Secretary of HUD has also taken actions in the past that are likely to have affected the level of reserves and, even without additional legislation, could make further changes in the program such as the following:

- The Secretary could authorize the payment of distributive shares. In 1990, after the Fund began experiencing substantial losses, the Congress required FHA to stop paying distributive shares until the Fund had accumulated adequate reserves. While the Fund has attained the required minimum reserves since the end of fiscal year 1995, an adequate level of reserves has not yet been defined.

- The Secretary could use his discretion to reduce premiums below the maximum levels set by the Congress. In 1997, HUD reduced the up-front premium from the maximum of 2 percent to 1.75 percent for first-time homebuyers who receive home ownership counseling; however, the annual premium, paid monthly, has not changed since the end of fiscal year 1992.

- The Secretary could also adjust underwriting standards, and in January 1998, he directed lenders to tighten the underwriting standards for adjustable-rate mortgages.

- The Secretary could take action to better manage HUD's portfolio of foreclosed properties and improve its oversight of lenders. For example, HUD has gone from managing foreclosed properties internally to contracting for most of the management and sales functions of its property disposition program.

Changes such as these, whether made by the Secretary of HUD or the Congress, would be likely to affect the future economic value of the Fund. Recent actuarial reviews of the Fund have cited the rise in the loan limit, the loss mitigation program, and the changes in underwriting standards for adjustable-rate mortgages as actions that are likely to increase the value of the Fund. These reviews have also cited the reduction in premiums for first-time homebuyers as an action that may reduce the revenue flowing into the Fund and thus its value.

Actions That Affect the Reserves Have an Impact on the Federal Budget

Under 1990 credit reform legislation, FHA's budget is required to reflect the subsidy cost to the government of FHA's loan insurance activities for that year.[7] Credit reform was intended to ensure that the full cost of credit activities for the current budget year would be reflected in the federal budget so that the executive branch and the Congress could consider these costs when making annual budget decisions. To accommodate the differing statutory requirements of budgeting for the subsidy cost of insuring the loans and maintaining a 2-percent reserve, OMB and FHA have allowed reserves to accumulate in the Fund in the form of interest-bearing Treasury securities. At the end of fiscal year 1999, FHA held nearly $15 billion in Treasury securities. These securities represent a claim on the U.S. Treasury to cover future losses to the Fund. From the perspective of the U.S. Treasury, these securities represent a liability. From the

[7]The subsidy cost is the estimated net cost to the government, in present value terms, of FHA-insured loans over the entire period the loans are outstanding.

standpoint of the government as a whole, the securities represent a debt owed by one part of the federal government to another. By investing in nonmarketable Treasury securities, FHA makes funds available to other federal programs. Each year that the Fund runs a surplus, the budget surplus for the federal government, as a whole, is higher than it would otherwise have been if FHA had not been insuring profitable loans. When the total federal budget was in a deficit (as it was for most of the 1990s), that deficit was lower than it would have been if the Fund had not been realizing a surplus at the same time.

If the Congress or the Secretary of HUD adopts policies, such as lowering premiums, paying distributive shares, or loosening underwriting standards, that reduce the profitability of the Fund, the negative subsidy[8] amount reported in FHA's budget submission and the Fund's reserve will both be lower.[9] Some of these policies—lowering premiums and paying distributive shares—would affect FHA's cash flows immediately. Thus, the amount of money available for FHA to invest in Treasury securities would be lower. The Treasury in turn would have less money available for other purposes, and the overall surplus would decline. If the amounts of cash flowing out of the Fund exceeded current receipts, FHA would be required to redeem its investments in Treasury securities to make the required payments. The Treasury, then, would be required to either increase borrowing from the public or use general tax revenues to meet its financial obligations to FHA. In either case, the annual budget surplus would be lower.

Budgetary scoring for budget control purposes under the 1990 Budget Enforcement Act[10] is required only when a law is enacted; actions taken by the Secretary under existing authorities are not scored for budget control purposes, even though they may affect the budget surplus or deficit. Under the Budget Enforcement Act, if a new law is enacted that creates additional mandatory spending or reduces receipts, its costs must be offset by reductions in other mandatory programs, increases in revenues, or a combination of the two. Whether and how the proposals under discussion would be scored depends on the exact wording of the new law and is determined by OMB for Budget Enforcement Act purposes. However, any action taken by the administration or the Congress to reduce FHA's reserves, if not accompanied by a similar reduction in other government spending or by an increase in receipts, will result in either a reduction in the surplus or an increase in any existing deficit.

In closing, Mr. Chairman, the Fund has accumulated significant reserves over the last 10 years. These reserves were built up from premiums paid by borrowers that exceeded the Fund's costs, proceeds from the sale of foreclosed properties, and interest earned on Treasury securities. The borrowers who paid these premiums--many of whom had lower incomes or used their FHA-insured mortgage to buy their first homes--have not only paid for their insurance but have also contributed to the budget surplus we are enjoying today. We believe that before actions are taken that could affect the reserve levels, the first question that needs to be addressed is whether the levels that the Fund is enjoying today, during economically prosperous times, are sufficient to withstand certain levels of future loan performance that may be worse than expected. Thus, we urge caution about taking any action in these surprisingly strong economic

[8]Negative subsidies mean subsidy costs are less than zero, i.e., the program is operating at a profit.
[9]If the Congress were to use the Fund's reserves to fund other programs, the reserves would be lower, but there would be no effect on the negative subsidy amount reported in FHA's budget submissions.
[10]As part of the effort to control federal budget results, the Budget Enforcement Act of 1990, as amended, created controls over laws changing or creating mandatory spending (basically entitlements) and receipts.

times that could not easily be reversed if the actual default and prepayment experience turned out to be worse than forecasted.

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

Related GAO Products

Mortgage Financing: Level of Annual Premiums That Place a Ceiling on Distributions to FHA Policyholders (GAO/RCED-00-280R, Sept. 8, 2000).

Single-Family Housing: Stronger Measures Needed to Encourage Better Performance by Management and Marketing Contractors (GAO/T-RCED-00-180, May 16, 2000, and GAO/RCED-00-117, May 12, 2000).

Single Family Housing: Stronger Oversight of FHA Lenders Could Reduce HUD's Insurance Risk (GAO/RCED-00-112, Apr. 28, 2000).

Homeownership: Information on Single-Family Loans Sold by HUD (GAO/RCED-99-145, June 15, 1999).

Homeownership: Achievements of and Challenges Faced by FHA's Single-Family Mortgage Insurance Program (GAO/T-RCED-98-217, June 2, 1998).

Homeownership: Results of and Challenges Faced by FHA's Single-Family Mortgage Insurance Program (GAO/T-RCED-99-133, Mar. 25, 1999).

Homeownership: Management Challenges Facing FHA's Single-Family Housing Operations (GAO/T-RCED-98-121, Apr. 1, 1998).

Homeownership: Information on Foreclosed FHA-Insured Loans and HUD-Owned Properties in Six Cities (GAO/RCED-98-2, Oct. 8, 1997).

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

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

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

Homeownership: Mixed Results and High Costs Raise Concerns about HUD's Mortgage Assignment Program (GAO/RCED-96-2, Oct. 18, 1995).

Mortgage Financing: Financial Health of FHA's Home Mortgage Insurance Program Has Improved (GAO/RCED-95-20, Oct. 18, 1994.

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