United States Government Accountability Office
Washington, DC 20548

March 7, 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

Subject: *Overview of GAO's Past Work on FHA's Single-Family Mortgage Insurance Programs*

The Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA) has helped millions of families purchase homes through its single-family mortgage insurance programs, which insure private lenders against losses on mortgages that finance purchases of properties or refinance existing FHA mortgages. In recent years, FHA has experienced a dramatic increase in its market role, partly because other mortgage market segments contracted during the recent financial crisis. At the same time, it has faced fiscal challenges. Since 2009, FHA has not met its statutory capital reserve requirements—essentially, a floor below which reserves should not fall.[1] Additionally, although FHA's single-family insurance programs historically produced budgetary receipts for the federal government, a weakening in the performance of FHA-insured loans could increase the possibility that FHA will require funds to help cover its costs on insurance issued to date.

The increased reliance on FHA mortgage insurance highlights the need for FHA to better ensure that it has the proper controls in place to minimize financial risks while meeting the housing needs of borrowers. 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. Because of continuing uncertainty over the resolution of Fannie Mae and Freddie Mac, the potential impact of their resolution on FHA, and concerns about FHA's financial condition, in February 2013 we included FHA in this high-risk area, now called "modernizing the U.S. financial regulatory system and the federal role in housing

[1]Unless otherwise stated, references to years are fiscal years.

On May 30, 2013, we revised the figure on p. 8 by removing a dotted line designated as the minimum capital ratio and more clearly reflecting the negative economic value in 2012.

finance."[2] To ensure that Congress has a complete picture of FHA and the role it plays in the mortgage market, you asked us to summarize our prior work on this agency.

Scope and Methodology

This report summarizes our prior work in the following areas: (1) FHA's market share, (2) FHA's financial condition, (3) FHA's loan requirements (such as down payments), (4) FHA's oversight of lenders and appraisers, (5) FHA's management of delinquent loans and foreclosed properties, (6) FHA's risk-assessment efforts, (7) challenges related to FHA's human capital and information systems, and (8) FHA's reverse mortgages. See enclosure I.

To complete this work, we generally relied on two of our reports—a November 2011 report on FHA's risk assessment and human capital management and a September 2010 report on FHA's financial condition.[3] We included excerpts from other of our reports, where relevant. For a complete list of these reports, see enclosure II. Each of these reports includes a detailed scope and methodology. We also relied on information in HUD's 2012 annual report to Congress on the financial status of the Mutual Mortgage Insurance Fund and the 2012 actuarial review of the Mutual Mortgage Insurance Fund. [4] We obtained other FHA and HUD documents to update some of our analysis, update the status of our prior recommendations, and provide current information on FHA's single-family mortgage insurance programs.

We performed the work on which this report was based 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 the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

FHA was established in 1934 under the National Housing Act to broaden homeownership, shore up and protect lending institutions, and stimulate employment in the building industry. The agency has played a particularly large role among first-time and minority homebuyers. FHA also generally is thought to promote stability in the market by helping ensure the availability of mortgage credit in areas

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[2]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. See GAO, *High-Risk Series: An Update*, GAO-13-283 (Washington, D.C.: Feb. 14, 2013).

[3]See GAO, *Federal Housing Administration: Improvements Needed in Risk Assessment and Human Capital Management,* GAO-12-15 (Washington, D.C.: Nov. 7, 2011); and *Mortgage Financing: Opportunities to Enhance Management and Oversight of FHA's Financial Condition,* GAO-10-827R (Washington, D.C.: Sept. 14, 2010).

[4]See Department of Housing and Urban Development, *Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance Fund, Fiscal Year 2012* (Washington, D.C.: Nov. 16, 2012); and Integrated Financial Engineering, Inc., *Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year 2012,* report prepared for the Department of Housing and Urban Development (Rockville, Md: Nov. 5, 2012).

that may be underserved by the private sector or that are experiencing economic downturns.

FHA's single-family mortgage insurance programs insure private lenders against losses on home mortgages. FHA insures a variety of mortgages for initial home purchases and refinancing. It also insures reverse mortgages, which permit persons 62 years and older to borrow against their home equity. FHA provides most of its single-family mortgage insurance through programs supported by the Mutual Mortgage Insurance Fund (insurance fund).

FHA's single-family insurance programs are administered by the Deputy Assistant Secretary for Single Family Housing, who reports to the Assistant Secretary for Housing-Federal Housing Commissioner. Within the Office of Single Family Housing, headquarters offices develop policy and manage oversight functions. FHA's four homeownership centers—in Atlanta, Georgia; Denver, Colorado; Philadelphia, Pennsylvania; and Santa Ana, California—undertake many of the day-to-day functions associated with loan endorsement, processing, and lender oversight.

Summary

Among other things, our past work discusses FHA's financial condition and steps the agency has taken to improve its financial condition. As housing prices began to decline at the end of 2006 and conventional mortgage lenders tightened their underwriting standards, more homebuyers began taking advantage of FHA-insured loans, which tend to have less strict underwriting standards and require lower down payments, as compared with conventional loans. As a result, FHA's share of the market increased. In 2006, FHA insured approximately 4.5 percent of purchase mortgages.[5] At its peak in 2009, it insured 32.6 percent of purchase mortgages. In 2011, its share of purchase mortgages fell to 26.5 percent.

As FHA's market share grew, the economic value of FHA's insurance fund declined dramatically. Specifically, it declined from about $21 billion at the end of 2007 to less than $4 billion by the end of 2009. At the end of 2012, the fund's economic value was negative. As a consequence, the insurance fund's capital ratio fell to negative 1.44 percent in 2012, far below the statutory minimum of 2.0 percent. As the capital ratio declined, the insurance fund's condition also worsened from the federal budgetary perspective. This has heightened the possibility that FHA may require additional funds from the Department of the Treasury (Treasury) to have sufficient reserves for all future insurance claims on its existing portfolio.

In recent years, FHA has taken several actions intended to shore up its financial position and minimize defaults, such as increasing down-payment requirements for certain loans in 2010 and raising premiums on insured mortgages multiple times. (FHA proposed its most recent premium increase in January 2013.) However, such changes, which could make it more difficult to obtain mortgage insurance, can affect the types of borrowers FHA serves and the role it plays in the mortgage market,

[5]In the 5 years prior to 2006, FHA's share of purchase mortgages had reached a high of 14.2 percent.

which traditionally has been to support underserved populations. As we have previously reported and highlighted in our 2013 high-risk report, further actions could be taken to help restore FHA's financial soundness and clarify its future role in the market, such as defining the economic conditions the insurance fund should be expected to withstand without funding from the Treasury.[6] We also have recommended that FHA improve it risk-assessment efforts and human capital management.[7] The agency has taken multiple actions to address these recommendations, but some are yet to be completed.

Agency Comments

We provided a draft of this report to HUD for its information and to seek confirmation of any new information not previously reported. The agency provided technical comments, which we incorporated where appropriate.

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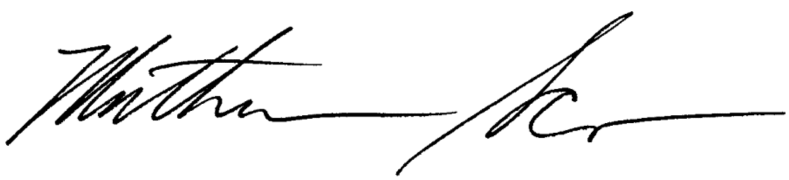
If you or your staff have any questions or wish to discuss the material in this report further, please contact me at (202) 512-8678 or sciremj@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff members who made major contributions to this report include A. Paige Smith, Assistant Director; Cory Marzullo; John McGrail; Josephine Perez; Barbara Roesmann; and Jena Sinkfield.



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Director, Financial Markets and
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Enclosures–2

[6]See GAO-13-283 and GAO, *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).

[7]GAO-12-15.

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FHA Single-Family Mortgage Insurance

FHA Loan Volume and Market Share

Background

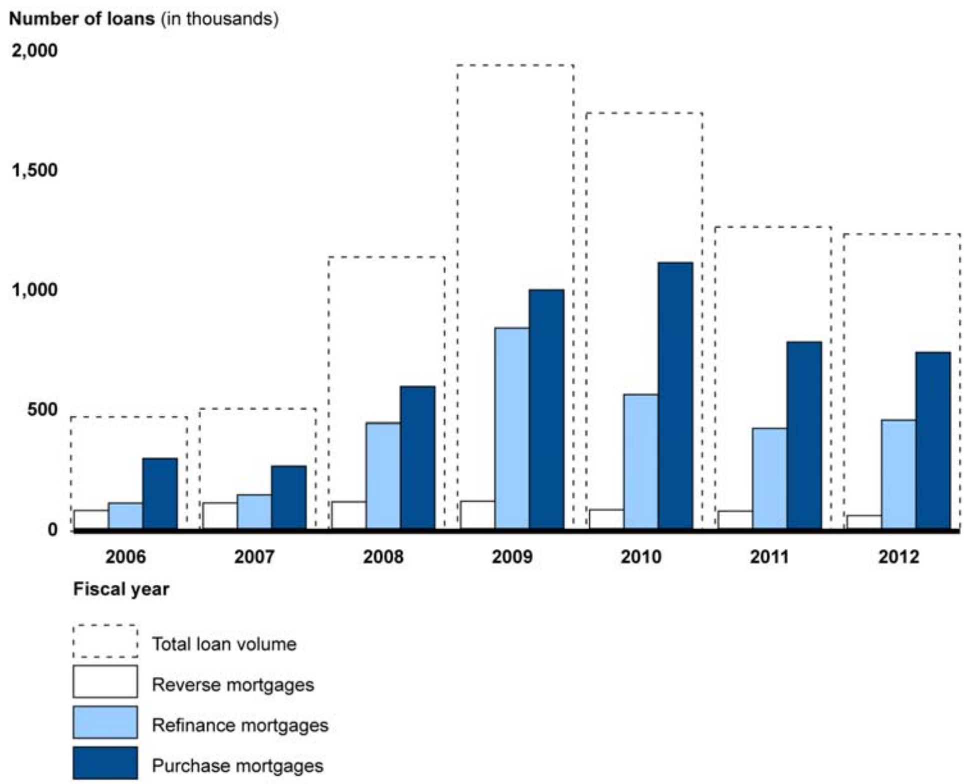
Mortgage insurance protects lenders against losses in the event of default. Not all loans require mortgage insurance; lenders usually require insurance when a homebuyer has a down payment of less than 20 percent of the value of the home. FHA, the Department of Veterans Affairs (VA), the U.S. Department of Agriculture's Rural Housing Service (RHS), and private mortgage insurers provide mortgage insurance.

FHA insures a variety of mortgages for initial home purchases (purchase mortgages) and refinancing. It also insures reverse mortgages, which are loans against a borrower's home available to persons 62 years or older. Many FHA-insured loans are to low-income, minority, and first-time homebuyers.

FHA Loan Volume

FHA's loan volume grew considerably from 2006 to 2010 and has since remained high. FHA insured almost half a million loans, totaling $70 billion in mortgage insurance, in 2006. (This was low compared to prior years; from 2000 to 2005, FHA's loan volume ranged from about 521,000 to about 1.2 million loans.) For 2009, the agency insured about 1.9 million loans, totaling more than $361 billion in mortgage insurance. The number of loans dropped in 2012 to about 1.2 million, or about $227 billion in mortgage insurance (see fig.).

FHA Loan Volume, 2006-2012

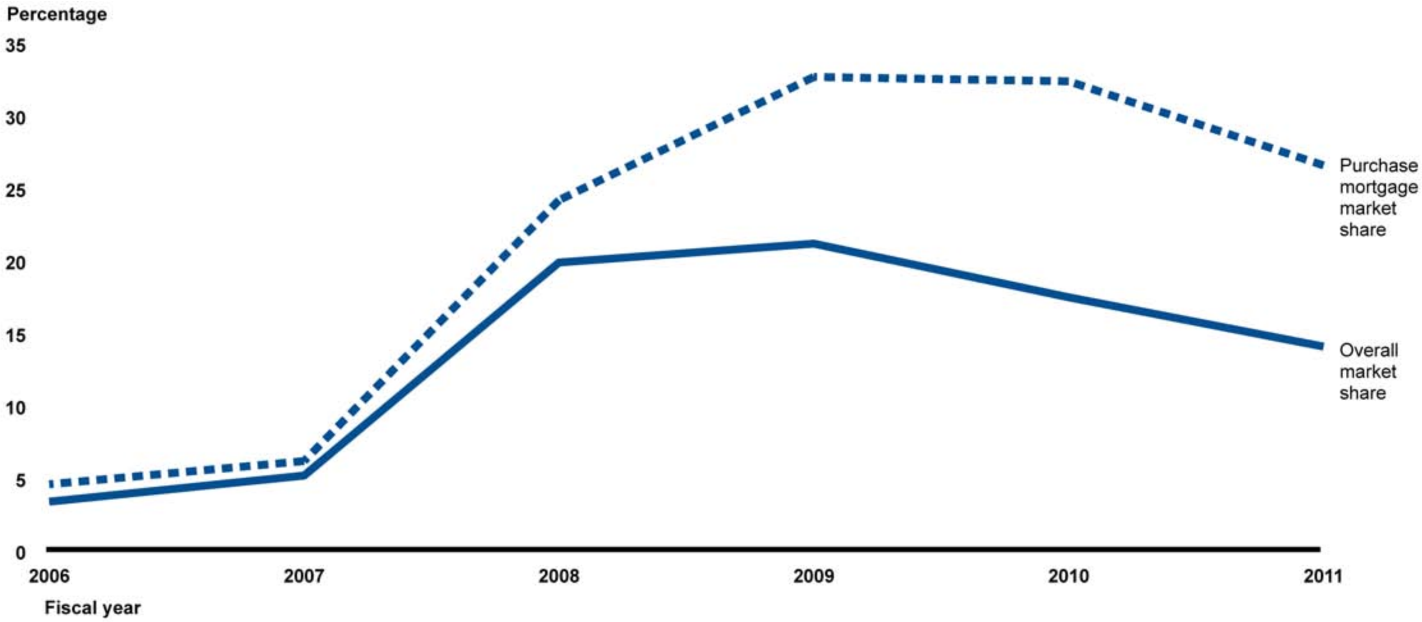


Source: GAO analysis of FHA data.

FHA Market Share

Looking at all mortgages (both insured and uninsured), FHA's overall market share, in terms of number of loans, increased from 3.3 percent in 2006 to a high of 21.1 percent in 2009 and decreased in 2011 to 14 percent. (These data do not include reverse mortgages; as we discuss later, FHA currently insures nearly 100 percent of reverse mortgages.) Similarly, FHA's market share of all purchase mortgages increased from 4.5 percent in 2006 to a high of 32.6 percent in 2009. (In the 5 years prior to 2006, FHA's share of purchase mortgages was as high as 14.2 percent.) In 2011, FHA's market share of purchase mortgages was 26.5 percent (see next fig.). In recent years, the contraction of other segments of the mortgage market and legislated increases in the loan amounts eligible for FHA insurance resulted in higher demand for FHA-insured mortgages.

FHA Market Share, 2006-2011



Source: GAO analysis of FHA data.

When focusing just on the insured market, FHA's presence is even more significant. According to *U.S. Housing Market Conditions*, FHA insured approximately 54 percent of insured mortgages in calendar year 2011. (The data do not include mortgages insured by RHS.) Specifically, FHA insured 757,025 home purchase loans in 2011. That same year, VA guaranteed 379,885 loans, and private mortgage insurers issued 266,690 certificates of insurance.

FHA's Customers

The agency has played a particularly large role among first-time and minority homebuyers. Over the last 4 years, FHA has insured more than 3.5 million home purchase loans, 2.8 million of which were for first-time homebuyers. In 2012, about 78 percent of these loans went to first-time homebuyers, about 32 percent of whom were minorities. According to HUD analysis of 2011 Home Mortgage Disclosure Act data, FHA has continued to lead the market in support of minority homeownership. While FHA insurance was used for approximately 27 percent of all home purchase loans in 2011, FHA-insured loans accounted for 50 percent of loans to African-American borrowers and 49 percent of loans to Hispanic borrowers.

FHA Single-Family Mortgage Insurance

Measures of Financial Condition and Factors Affecting It

Background

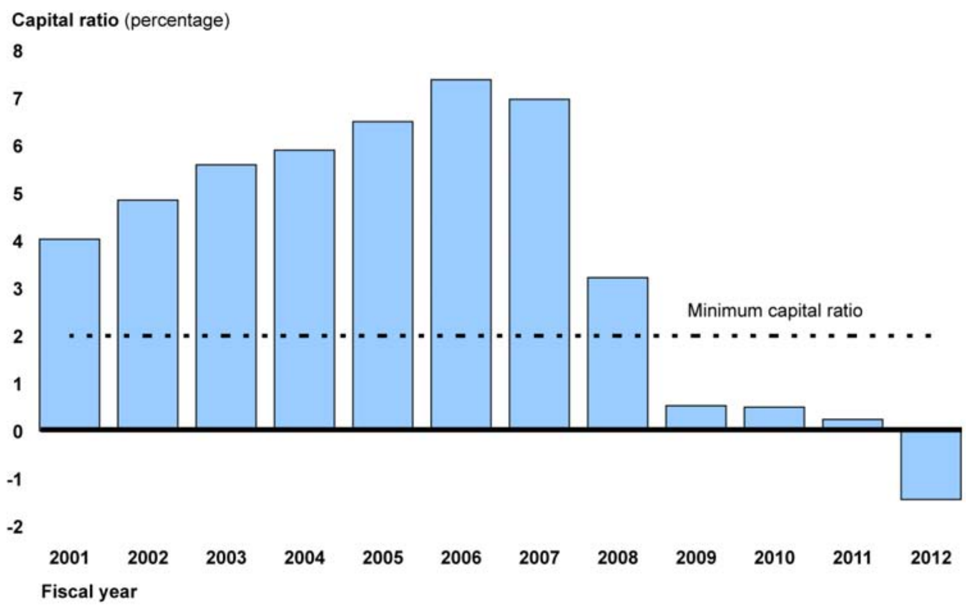
The Omnibus Budget Reconciliation Act of 1990 required the HUD Secretary to ensure that FHA's Mutual Mortgage Insurance Fund attained a capital ratio (the ratio of the insurance fund's economic value to insurance obligations) of at least 2 percent by November 2000 and maintained at least that ratio at all times thereafter. The Omnibus Budget Reconciliation Act and later, the Housing and Economic Recovery Act of 2008, required HUD to annually obtain an independent actuarial review of the economic net worth and soundness of the insurance fund.

Under the Federal Credit Reform Act of 1990, FHA must estimate the net lifetime costs (credit subsidy costs) of its loan insurance program and include the costs to the government in its annual budget. Credit subsidy costs represent the net present value of expected lifetime cash flows, excluding administrative costs. For a mortgage insurance program, cash inflows include fees and premiums charged to insured borrowers and proceeds from sales of foreclosed properties, and cash outflows include payments to lenders to cover the cost of claims. When estimated cash inflows exceed expected cash outflows, a program is said to have a negative credit subsidy rate and generates offsetting receipts that reduce the federal budget deficit. When the opposite is true, the program is said to have a positive credit subsidy rate, and therefore requires appropriations.

Capital Ratio

The insurance fund's capital ratio dropped sharply in 2008 and 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 insurance-in-force, or insurance obligations (the denominator of the capital ratio). According to annual actuarial reviews of the insurance fund, the capital ratio fell from about 7 percent in 2006, to 3 percent in 2008, and below 2 percent in 2009. In 2012, the capital ratio fell below zero to negative 1.44 percent (see next fig.).

Estimates of the Insurance Fund's Capital Ratio, 2001-2012



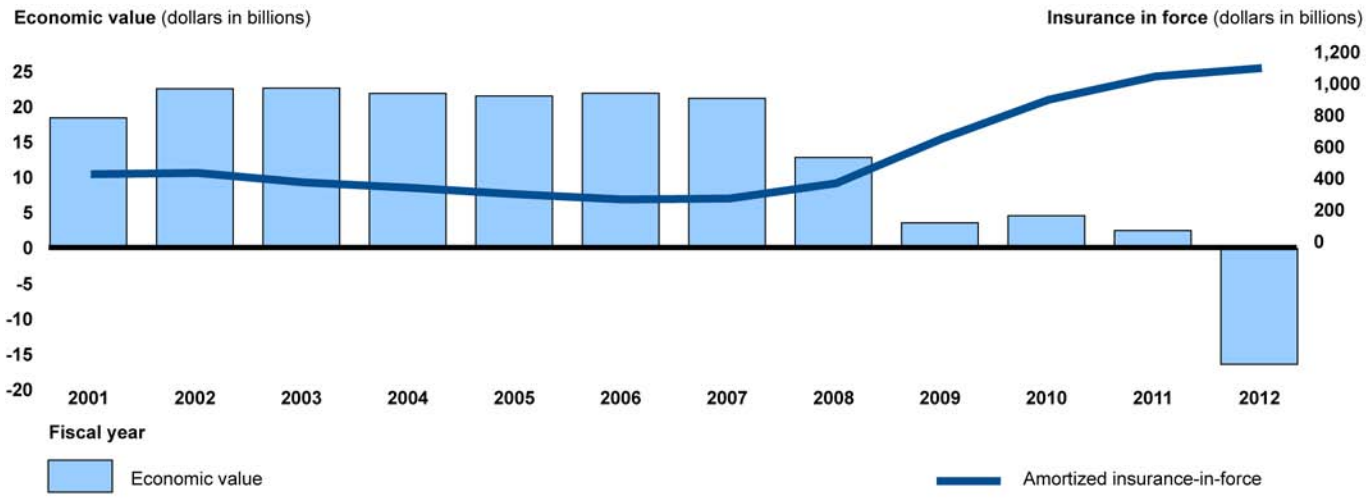
Source: GAO analysis of FHA data.

In reviewing the components of the capital ratio, the combination of a relatively stable economic value (the numerator of the ratio) and declining insurance-in-force (the denominator of the ratio) over much of the past decade increased the capital ratio. However, since 2008, the economic value has fallen as the insurance-in-force has risen, dramatically lowering the capital ratio. Economic value represents the insurance fund's existing capital resources (total assets less total liabilities) plus the net present value of its existing portfolio of insured mortgages.

An independent actuary hired by HUD produces the estimates of future cash flows. The estimates are based on econometric models that use historical experience to model the relationship between loan performance and various factors, most importantly expectations for future house prices and interest rates. For 2012, the actuarial review estimated that future cash flows for every loan that FHA currently insured would be negative

$46.6 billion. Because FHA's existing capital resources were only $30.4 billion, the resulting economic value was negative $16.3 billion (see next fig.).

Estimates of the Insurance Fund's Economic Value and Insurance-in-force, 2001-2012



Source: GAO analysis of FHA data.

The 2012 actuarial analysis projects that the capital ratio will be positive by 2014 and will go above 2.0 percent in 2017 (see table). The forecast was based on assumptions such as the level of future lending activity and house prices for multiple years, which are difficult to predict. The forecast also assumed no changes in policy or other actions by FHA that might accelerate "recovery" time. (As discussed later, FHA plans policy changes that may accelerate increases to the ratio.)

Actuarial Projections of Present and Future Capital Ratios

Year	Insurance-in-force (billions)	Economic net worth (billions)	Capital ratio
2012	$1,131	-$16.3	-1.4%
2013	1,230	-5.3	-0.4
2014	1,291	2.0	0.2
2015	1,314	9.7	0.7
2016	1,352	19.7	1.5
2017	1,401	30.7	2.2
2018	1,441	42.0	2.9
2019	1,467	53.9	3.7

Source: HUD/FHA.

While the Omnibus Budget and Reconciliation Act requires that FHA maintain the minimum ratio at all times, it does not specify the time frames for re-attaining the 2 percent level should FHA fall below it. In a 2010 report, we recommended that Congress consider establishing such a time frame, taking into account FHA's statutory operational goals and role in supporting the mortgage market during periods of economic stress (see GAO-10-827R). In 2001, we evaluated the adequacy of the 2-percent requirement for the capital ratio (see GAO-01-460). We identified several scenarios under which the 2-percent ratio would not be adequate, including a scenario in which the nation experienced a downturn or a scenario in which FHA experienced higher-than-normal foreclosure rates. We recommended that Congress or HUD consider defining the types of economic conditions under which the insurance fund would be expected to meet its commitments without borrowing from the Treasury (drawing on permanent and indefinite budget authority). Recent events suggest that the 2-percent capital requirement may not be adequate to avoid the need for Treasury support under severe stress scenarios. Implementing this recommendation would be an important step not only in addressing FHA's long-term financial viability, but also in clarifying FHA's role.

Some Factors Affecting Recent Estimates and Future Financial Condition

In the 2012 annual report to Congress on the insurance fund, HUD cited three factors that drove changes to the most recent estimate of FHA's financial position:

- First, the estimates of house price appreciation for the 2012 actuarial study were significantly lower than those used for 2011. The difference accounted for an estimated $10.5 billion reduction in the value of the insurance fund (compared with the actuary's 2011 projection of what the fund's economic value would be at the end of 2012).

- Second, the continued decline in interest rates causes a substantial loss of revenue. Premium revenues from an existing portfolio go down when more borrowers pay off their mortgages to refinance into lower rates. The capital ratio calculation does not include those borrowers who refinance into new FHA-insured loans. In addition, actuarial projections include higher claim expenses when interest rates stay low because borrowers with higher mortgage rates who are unable to refinance become more willing to default. The effects of continued low interest rates resulted in a reduction of $8 billion in the estimated economic value of the insurance fund (versus the previous year's projections).

- Third, FHA directed the actuary to adjust the way losses from defaulted loans and reverse mortgages were reflected in the economic value of the insurance fund. This resulted in an estimated $10 billion reduction to the economic value, compared with the 2011 projections.

In addition to explaining the factors that led to changes in estimates from 2011 to 2012, the actuarial analysis also highlighted factors that will have longer-term effects on the financial condition of the insurance fund.

- **Single-family books of business insured before 2010**. According to the annual report, loans insured before 2010 continue to be the prime source of stress on the insurance fund, with $70 billion in future claim payments attributable to the 2007-2009 books of business. Losses per-dollar of insured loans peaked for the 2007 book, the year that also experienced the greatest total decline in home values. When that book is finally closed, its total costs (including losses) are expected to exceed 11.3 percent of the initial dollar volume of loans insured. While the 2008 book has a lower loss-per-dollar (7.7 percent), that book was three times as large as 2007. Therefore, the 2008 book has expected dollar losses that are more than twice those of the 2007 book ($13.2 billion versus $6.4 billion).

- **Seller-funded down-payment assistance**. The annual report noted that Congress prohibited the use of seller-funded down-payment assistance starting in January 2009. Borrowers who make small or no down payments are more likely to default on mortgage obligations. The report further noted that the effect of loans with seller-funded down-payment assistance remains measureable on the insurance fund. They are expected to cost the insurance fund more than $15 billion. The actuary estimated that if FHA had not participated in seller-funded down payment loans, the economic value of the insurance fund would be positive $1.77 billion. Problems associated with these loans were well-documented. A March 2005 HUD contractor study found that property sellers who provided down payment assistance through nonprofits often raised sale prices of the homes involved to recover the required payments that went to the organizations.

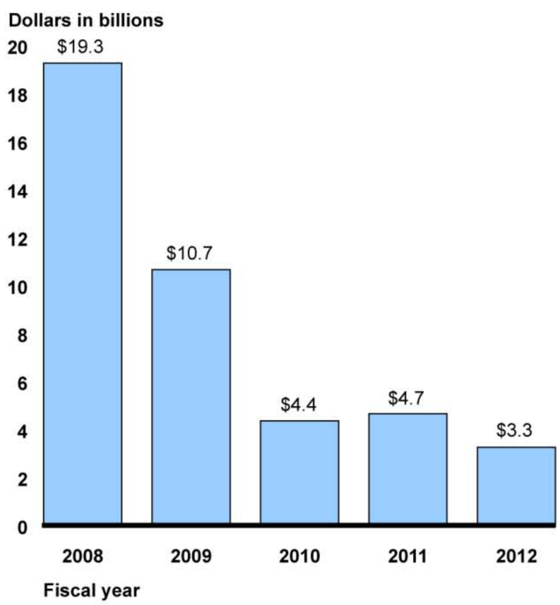
We too reported on the risks associated with FHA-insured loans with such assistance (see GAO-06-24). We found that loans with this type of assistance had inflated prices and defaulted more often than loans without such assistance. In October 2007, FHA published a rule that prohibited seller-funded down-payment assistance. Subsequently, the rule was struck down by the courts on procedural grounds. As noted previously, Congress ultimately prohibited the use of this assistance.

Capital Reserves

As the capital ratio declined, the insurance fund's condition also worsened from the federal budgetary perspective. FHA annually estimates the subsidy costs of its loan insurance program (and also reestimates, or annually updates, prior analyses). Historically, FHA estimated that its loan insurance program was a negative subsidy program (that is, estimated cash inflows exceeded expected cash outflows). On the basis of these estimates, FHA accumulated substantial balances in a capital reserve account, which holds reserves in excess of those needed for estimated credit subsidy costs and helps cover unanticipated increases to those costs (such as higher-than-expected claims). Funds needed to cover estimated subsidy costs are accounted for in the insurance fund's financing account. (Balances in the capital reserve and financing accounts may not be equal to the insurance fund's economic value, as defined in the actuarial review, in part because the Federal Credit Reform Act requires the Office of Management and Budget to use certain economic assumptions for the budget. The independent actuarial review may not use the same assumptions.)

However, in recent years, FHA covered large upward reestimates (which reflect higher subsidy costs and lower revenues) with transfers from the capital reserve account to the financing account. As a result, balances in the capital reserve account fell dramatically, from $19.3 billion at the end of 2008 to an estimated $3.3 billion at the end of 2012 (see next fig.). At the end of 2012, the financing account held approximately $35.1 billion, approximately three times more than it held at the end of 2008.

End-of-year Balances in the Insurance Fund's Capital Reserve Account, 2008-2012



Source: GAO analysis of FHA data.

If the reserve account were to be depleted, FHA would need to draw on permanent and indefinite budget authority to cover additional increases in estimated credit subsidy costs. The President's budget for 2013 contained a $9.3 billion upward reestimate in FHA's credit subsidy costs for the insurance fund. The budget indicated that the reestimate would deplete FHA's capital reserve account in 2012, potentially causing FHA to draw on $688 million in permanent and indefinite budget authority. However, according to FHA, the agency ultimately did not need to draw on this authority because of premium increases and higher-than-anticipated loan volumes. In its 2012 report to Congress, HUD noted that information (the insurance fund valuation) in the forthcoming President's budget for 2014 will determine the adequacy of the capital balance in the insurance fund and the need to draw on permanent and indefinite budget authority in the current fiscal year. The President's budget is expected to be released in the spring of 2013.

FHA Single-Family Mortgage Insurance

FHA Underwriting Requirements, Premium Rates, and Insurance Coverage

Background

When making FHA-insured loans, lenders must comply with FHA's underwriting criteria. (Underwriting refers to a risk analysis that uses information collected during the origination process to decide whether to approve a loan.) In general, FHA borrowers purchasing a home currently must make a cash investment (down payment) of at least 3.5 percent of the purchase price of the home. This investment may come from the borrowers' funds or from certain third-party sources.

FHA's insurance fund is supported by borrowers' insurance premiums. FHA has the authority to establish and collect a single up-front premium and annual premiums on the remaining insured principal balance of the loan. Annual premiums vary based on the amount of the down payment, the size of the loan, and the length of the mortgage term. Borrowers are permitted to finance their up-front mortgage insurance premiums (as well as some of their closing costs).

Underwriting and Down Payments

In underwriting FHA-insured loans, lenders evaluate potential borrowers' credit history, available assets to close the mortgage loan, and their likelihood of default, among other things.

In recent years, FHA took steps to tighten its underwriting standards, including raising down-payment requirements. Specifically:

- In September 2009, FHA announced changes to its streamline refinance loans that, according to FHA, have reduced early payment defaults.
- In October 2010, FHA increased down-payment requirements for borrowers with lower credit scores. Borrowers with credit scores of 500-579 must make a down payment of at least 10 percent. Furthermore, anyone with a credit score below 500 is ineligible for an FHA-insured loan.
- In February 2012, FHA published a rule proposing to reduce allowable seller contributions at closing, thereby helping to ensure that buyers put more of their own funds into the home purchase. (As noted previously, Congress eliminated seller-funded down payments in 2009.)
- In January 2013, FHA
  - Announced that it would raise its minimum down-payment requirement from 3.5 to 5.0 percent for loans of $625,500 or more. FHA also increased the annual premium for these loans to the statutory maximum (see Insurance Premiums below).
  - Announced that it will require manual underwriting on loans for borrowers with credit scores below 620 and debt-to-income ratios above 43 percent.

Down-payment requirements and credit scores are important tools to help offset the risk of borrower default. For example, down-payment requirements affect the loan-to-value (LTV) ratio—the mortgage amount divided by the value of the home. LTV ratios are important because of the direct relationship that exists between the amount of equity borrowers have in their homes and the likelihood of default. In 2005, we found that mortgages with higher LTV ratios (those with smaller down payments, or little equity) and lower credit scores generally were riskier than mortgages with lower LTV ratios and higher credit scores (see GAO-05-194).

Insurance Premiums

In recent years, FHA has increased insurance premiums to help improve the financial condition of the insurance fund. Most recently (in January 2013), FHA announced two changes to the premium structure:

1. Effective April 1, 2013, FHA will increase the annual insurance premiums most borrowers pay between 0.05 and 0.10 percentage points. Current annual premiums range from 0 to 1.5 percent. The annual premium for loans of $625,500 or more will be set at the statutory maximum (see next table). FHA also will raise annual premiums on smaller loans, but these premiums will remain below the maximum. FHA expects that the premium increases—$13 per month for the average insured borrower—will add significant revenue to the insurance fund and help limit FHA's market share, while at the same time being modest enough so that they will not affect borrower access to credit or threaten the housing recovery.

Increases to FHA Annual Premiums Effective as of April 1, 2013

Base loan amount	Loan-to-value	Previous mortgage insurance premium	New mortgage insurance premium	Statutory maximum
Term greater than 15 years				
Less than or equal to $625,500	Less than or equal to 95%	1.20%	1.30%	1.50%
Less than or equal to $625,500	Greater than 95%	1.25	1.35	1.55
Greater than $625,500	Less than or equal to 95%	1.45	1.50	1.50
Greater than $625,500	Greater than 95%	1.50	1.55	1.55
Term less than or equal to 15 years				
Less than or equal to $625,500	78.01 to 90%	0.35%	0.45%	1.50%
Less than or equal to $625,500	Greater than 90% to less than or equal to 95%	0.60	0.70	1.50
Less than or equal to $625,500	Greater than 95%	0.60	0.70	1.55
Greater than $625,500	78.01 to 90%	0.60	0.70	1.50
Greater than $625,500	Greater than 90% to less than or equal to 95%	0.85	0.95	1.50
Greater than $625,500	Greater than 95%	0.85	0.95	1.55
Any amount	Less than or equal to 78%	0	0.45	1.50

Source: FHA.

2. Effective June 3, 2013 on new loans, FHA will require that borrowers continue to pay annual premiums, regardless of loan value. Previously, premiums could be eliminated after loans (principal amounts) declined to 78 percent of their original value.

FHA can continue to raise up-front and annual premiums to the statutory maximums (generally 3 percent of the original insured principal mortgage amount for up-front premiums and between 1.5 and 1.55 percent of the remaining insured principal amount for annual premiums). However, as we reported in June 2007, raising premiums could cause lower-risk borrowers to choose more competitive (lower priced) loans from other sources, leaving FHA to insure relatively more higher-risk borrowers (see GAO-07-708).

Insurance Coverage

FHA is obligated to pay private lenders for almost all losses resulting from foreclosures on single-family homes insured under the insurance fund (12 U.S.C. Sec. 1710). Therefore, loan requirements such as underwriting standards and down-payment requirements are critical components to limiting risk exposure. In comparison, VA guarantees losses from 25 to 50 percent of a loan. In 1997, we analyzed the implications of reducing FHA's insurance guarantee to VA's coverage levels and found that FHA would be insuring better-quality loans with less loss exposure. As a result, FHA's capital reserve ratio likely would increase, enhancing the insurance fund's ability to maintain financial self-sufficiency. However, we also found that private lenders likely would raise interest rates and make fewer higher-risk, FHA-insured loans because they could incur greater losses. Lenders likely would serve fewer low-income, first-time, and minority homebuyers—the types of homebuyers for which FHA historically has been the primary lender (see GAO/RCED-97-93). Reducing FHA's insurance coverage would require congressional action.

GAO Accountability * Integrity * Reliability

FHA Single-Family Mortgage Insurance

FHA Oversight of Lenders and Appraisers

Background

As of September 2011, almost 3,700 lending institutions were approved to participate in FHA's mortgage insurance programs for single-family homes. Virtually all of these lending institutions had direct endorsement authority, meaning that they could underwrite loans and determine their eligibility for FHA mortgage insurance without FHA's prior review. However, direct endorsement lenders are still subject to review of loan paperwork before endorsement and reviews of the loan after endorsement. They can apply to participate in the Lender Insurance program, which enables high-performing lenders to approve mortgages for FHA insurance without a pre-endorsement review. As of September 2011, about 20 percent of direct endorsement lenders participated in the Lender Insurance program.

FHA maintains and manages a roster of real estate appraisers authorized to conduct appraisals for FHA-insured mortgages. As of the end of 2012, 52,002 appraisers were listed on the roster.

Recent Enhancements

FHA relies on private lenders to underwrite the loans it insures and on private appraisers to appraise the value of the homes being financed. In November 2011 (GAO-12-15), we reported that FHA had made changes to several processes intended to help ensure that these lenders and appraisers followed its policies and procedures.

- FHA enhanced the criteria it uses to select loans for post-endorsement technical reviews of underwriting quality. Since May 2010, the agency has considered high-risk borrower or loan characteristics. For example, loans to borrowers with low credit scores and certain types of refinanced loans could merit review.
- FHA began using a more risk-based approach to select lenders and appraisers for review. For example, FHA increased the number of risk factors used to target lenders for review. The risk factors included loan volume, product type, process (direct endorsement or lender insurance), performance, and peer group performance. In addition, since March 2010 FHA has considered factors such as the appraiser's volume and past sanctions, as well as the type of property being appraised, when targeting appraisers for review.

Post-endorsement reviews can result in indemnification agreements—requiring the lender to repay FHA for any losses that it incurs after a loan defaults and the property has been sold. In November 2011, we reported that FHA issued 645 indemnification agreements in 2010.

Appraiser reviews may result in a variety of actions, ranging from notices of deficiency for minor processing errors to required education to removal from FHA programs. In November 2011, we reported that in 2010 FHA had issued 1,044 notices of deficiency, required 477 appraisers to take education, and removed 89 appraisers from FHA programs.

Proposed Actions

In its 2012 annual report to Congress, FHA proposed new authorities (requiring congressional action) that it stated would enhance FHA's ability to hold lenders accountable for noncompliance with FHA policy and provide greater flexibility for FHA to change policies and procedures as emerging needs and trends were identified.

- **Indemnification authority for direct endorsement lenders.** This change would allow FHA to seek indemnification from direct endorsement lenders, which represent 70 percent of all FHA approved lenders. Currently, FHA only has authority to require indemnification for lenders approved to participate in the Lender Insurance program. According to FHA, with this authority, the agency will be able to require indemnification from all of its approved lenders for loans that do not comply with its guidelines. FHA has been seeking this authority since 2010.

- **Revised standard for indemnification for fraudulent activity**. This change would eliminate the “knew or should have known” standard relating to fraud or misrepresentation. While Fannie Mae and Freddie Mac require lenders to retain all fraud-related risk, FHA only holds lenders accountable for fraudulent activity if they “knew or should have known” it occurred. According to FHA, providing proof to meet this standard limits FHA’s ability to hold lenders accountable for fraud. Removal of the standard would greatly improve FHA’s ability to avoid unnecessary losses from fraudulent activity.

- **Authority to terminate origination and underwriting approval**. FHA would enhance its ability to review lender performance. If a lender was found to have an excessive rate of early defaults or claims, FHA would have greater flexibility in terminating the approval of the lender to originate or underwrite single-family mortgages for FHA insurance. FHA has been seeking this authority since 2010.

- **Revised compare ratio requirement**. FHA has sought greater flexibility in establishing the metric by which it compares lender performance so that it can more effectively assess lender performance during all market conditions. Specifically, FHA would be able to compare a lender’s rate of early defaults and claims (for insured single-family mortgage loans) with the rates of other lenders on any basis determined appropriate. Examples of metrics include geographic area, varying underwriting standards, or populations served.

GAO Accountability * Integrity * Reliability

FHA Single-Family Mortgage Insurance

FHA's Management of Delinquent Loans and Foreclosed Properties

Background

Common measures of loan performance are delinquency, default, and foreclosure rates. A loan becomes delinquent when a borrower does not make one or more scheduled monthly payments. Loans in default generally are delinquent by 90 or more days—the point at which foreclosure proceedings become a strong possibility.

When home buyers fall behind on their mortgage obligations, FHA instructs mortgage servicers (typically large financial institutions) to assist the home buyers in bringing their mortgage payments current, because foreclosure proceedings can impose high costs on financial institutions and homeowners. These efforts are referred to as "loss mitigation."

If an FHA-insured mortgage goes into foreclosure, FHA pays the lender for virtually all the losses associated with the loan. FHA polices and processes for managing properties in foreclosure are called asset management.

Loss Mitigation

In our June 2012 report, we found that several agencies, including FHA, were not conducting analyses to determine the effectiveness of their loss-mitigation actions. The experiences of Treasury, Fannie Mae, and Freddie Mac and our econometric analysis strongly suggested that such analyses can improve outcomes and cut program costs. Therefore, we recommended that FHA periodically analyze the effectiveness and the long-term costs and benefits of its loss-mitigation strategies and actions to more fully understand their strengths and risks and protect taxpayers from absorbing avoidable losses to the maximum extent possible. (See GAO-12-296.) Consistent with this recommendation, FHA conducted analysis of its loss-mitigation options and announced revisions in November 2012 that were designed to reduce the number of full claims against the insurance fund. FHA's new loss-mitigation strategies are outlined below.

Before taking formal loss-mitigation actions, FHA requires loan servicers to address delinquencies through an early intervention process. Servicers may come to an informal or formal forbearance arrangement with borrowers to reinstate loans through repayment plans. (Forbearance refers to refraining from exercising a legal right.) Informal forbearance plans are oral agreements covering 3 months or less. Formal forbearance plans are written agreements covering more than 3 but less than 6 months. If borrowers are not able to reinstate their loans through a forbearance plan, servicers must consider the borrowers for a loss-mitigation action. These actions can take the following form:

- **Special forbearance.** A written agreement that combines a suspension or reduction in monthly mortgage payments for a minimum of 12 months with a repayment period. Available to unemployed borrowers who are at least three mortgage payments delinquent.
- **Loan modifications**. A permanent change to one or more of the terms of the loan: change in interest rate, capitalization of past due amounts, extension of mortgage term, or reamortization of balance due. If resetting the interest rate at the market rate and amortizing the new loan over 30 years can reduce the borrower's monthly payment by the greater of 10 percent or $100, servicers are to offer a loan modification with those terms. This option is available to currently employed borrowers who had loss of income or had living expenses increase but have sufficient surplus income. Generally, a trial period of 3 months applies.
- **Home Affordable Modification Program (FHA-HAMP)**. Borrowers for whom a standard modification is not sufficient may qualify for a HAMP-style modification under authority provided to HUD in 2009. FHA-HAMP modifications bring borrowers' monthly payments down to 80 percent of the current monthly payment but to no less than 25 percent of income by reducing interest rates to the market rate,

extending the loan term to 30 years, and, if necessary, deferring principal. Rather than capitalizing past due amounts, servicers can advance funds on behalf of the borrower to reinstate the loan (called a partial claim). Under FHA-HAMP, if the borrower's current interest rate is at or below the market rate and the current mortgage payment is at or below the target monthly payment, servicers may advance funds—up to 30 percent of the loan balance without modifying the loan—on behalf of a borrower to cover past due amounts.

- **Preforeclosure sales and deeds-in-lieu of foreclosure**. Under a preforeclosure sale agreement (also called a short sale), FHA accepts the proceeds of the sale as satisfying the mortgage debt, as long as the net proceeds (sales price minus certain costs) are at least 84 percent of the appraised value. A deed-in-lieu of foreclosure is a voluntary transfer of a property from the borrower to FHA for a release of all obligations under the mortgage.

According to FHA, the agency has expanded its Distressed Asset Stabilization Program, another loss-mitigation strategy. FHA-insured loans are sold competitively at a price generally below the outstanding principal balance. FHA requires the loan purchaser to delay foreclosure for at least 6 additional months, during which time the new servicer can work with the borrower to find an affordable solution to avoid foreclosure.

Foreclosures

FHA relies on management and marketing contractors to manage its foreclosed properties. These contractors conduct property inspections, perform ongoing maintenance, and market properties. We reported in November 2011 (GAO-12-15) that FHA's inventory of active properties had increased 85 percent, from 27,747 at the end of 2006 to 51,292 at the end of 2010. According to a recent Monthly Report to the FHA Commissioner on Business Activity, FHA had 37,977 foreclosed properties as of the end of December 2012. Because of the number of foreclosed properties they manage, proper oversight of management and marketing contractors is important.

In April 2002, we reported on procedures for beginning foreclosure, conducting foreclosures, and selling foreclosed properties of several agencies, including FHA. (See GAO-02-305.) However, for FHA specifically, the procedures could delay the start of critical steps necessary to preserve the value of foreclosed properties and sell them quickly. That is, while Fannie Mae, Freddie Mac, VA, and RHS made one entity responsible for the custody, maintenance, and sale of foreclosed properties, FHA divided these responsibilities between its mortgage servicers and management and marketing contractors, which largely operated independently of one another. As a result, we made a number of recommendations to help FHA streamline its procedures, ensure prompt property maintenance and marketing strategies, and minimize foreclosure losses. For example, we recommended that HUD establish unified property custody as a priority for FHA.

Proposed FHA Actions Related to Loss Mitigation and Foreclosures

In its November 2012 annual report to Congress on the insurance fund, FHA proposed revisions to its loss-mitigation and foreclosure processes.

- **Streamlining the short-sale process.** FHA plans to revise its policy and remove certain barriers for borrowers in obtaining a short sale on their FHA-insured mortgages.

- **Expanding the claim without conveyance pilot program.** Consistent with our April 2002 recommendations, FHA piloted a program for lenders to sell foreclosure properties secured by nonperforming FHA-insured loans to third-parties (at a reserve price slightly below the property value) without being conveyed to FHA. Because FHA's analysis has shown that this method of disposing of properties yielded lower losses for the insurance fund than selling them through FHA's normal disposition process, FHA plans to expand the program.

- **Strategies to further improve recoveries.** FHA proposed several steps to increase use of loss-mitigation options and reduce unnecessary asset-disposition losses. For example, the agency planned to promote modification and short-sale strategies for delinquent borrowers through a marketing campaign.

- **Authority to transfer servicing.** To help make loss mitigation more effective, FHA sought authority to require any of the following actions when a servicer underutilized FHA's loss-mitigation tools, or when the agency deemed the action necessary to protect the interests of the insurance fund: (1) transfer servicing from the current servicer to a specialty servicer designated by FHA; (2) require a servicer to enter into a subservicing arrangement with an entity identified by FHA; or (3) require a servicer to engage a third-party contractor to assist in some aspect of loss mitigation such as borrower outreach. According to FHA, such authority would permit the agency to better avoid losses from poor servicing of FHA-insured loans, yielding better results for borrowers and FHA.

FHA Single-Family Mortgage Insurance

FHA's Risk Assessment

Background

To improve its risk-assessment strategy, in 2010 FHA established the Office of Risk Management and Regulatory Affairs headed by a Deputy Assistant Secretary who reports directly to the Assistant Secretary for Housing-FHA Commissioner. FHA also hired a consultant to assist a unit—the Office of Risk Management—within the larger office, and produce a comprehensive report and recommend best practices for its structure and operations.

In 2009, FHA's Office of Single Family Housing had implemented a new system of management control for risk assessment, the internal quality control initiative. For the areas identified as high-risk, staff developed plans to document control objectives and established a monitoring strategy that involved submitting quarterly reports on the effectiveness of the controls, including the status of any mitigation efforts.

Our Prior Work

In November 2011 (GAO-12-15), we reported on several weaknesses in FHA's risk-assessment efforts.

1. FHA's risk-assessment strategy was not integrated throughout the organization. While the consultant had recommended that FHA integrate risk assessment and reporting throughout the organization, the Office of Single Family Housing's quality control activities and the Office of Risk Management's activities remained separate efforts. FHA officials noted that until the Office of Risk Management set up a governance process, the integration suggested by the consultant would not be possible. In the meantime, FHA officials stated they were making every effort to help ensure that the Office of Risk Management's activities complemented program office activities.
2. Contrary to HUD guidance, the Office of Single Family Housing had not conducted an annual, systematic review of risks to its program and administrative functions since 2009. According to an official in this office, management intended to conduct an annual assessment but changes in senior leadership in the office and the few staff available to perform assessments (because of attrition and increased workload) hampered these efforts.
3. The Office of Single Family Housing's risk-assessment efforts did not include procedures for anticipating potential risks presented by changing conditions. The consultant's report proposed a reporting process and templates for identifying emerging risks. Office of Risk Management officials told us that once they were operational, risk committees would determine the exact design and content of these reports and templates.

We concluded that all these factors limited FHA's effectiveness in identifying, planning for, and addressing risk. Therefore, we recommended that FHA (1) integrate the internal quality control initiative of the Office of Single Family Housing into the processes of the Office of Risk Management, (2) conduct an annual risk assessment, and (3) establish ongoing mechanisms—such as using report templates from the consultant's report—to anticipate and address risks that might be caused by changing conditions.

FHA's Recent Actions

FHA has begun addressing recommendations made by the contractor hired to identify best practices for the Office of Risk Management. For instance, in June 2012 it finalized the delegations of authority needed for the Office of Risk Management and Regulatory Affairs to establish and maintain risk-management policies, activities, and controls for FHA. It also has formed a Single Family Credit Risk Committee and an Operational Risk Committee. Credit risk is risk related to borrower default or lender default. Operational risk is risk related to people, processes, technology, external events, and reputation. In addition, FHA has purchased a performance evaluation tool that is used to generate monthly reports that include modeling, surveillance, and analytics of the FHA portfolio.

FHA also has begun addressing our November 2011 recommendations. Specifically, consistent with our recommendations, FHA has taken the following actions:

- **Integrating risk-assessment efforts.** FHA has begun integrating its quality control initiatives into the processes of the Office of Risk Management. For example, according to its charter, the Operational Risk Committee will develop a process to integrate these efforts. In addition, the Office of Risk Management and Regulatory Affairs is reviewing the results of quality control activities as it prepares baseline operational risk assessments.

- **Conducting an annual risk assessment.** FHA has developed a plan for conducting an inaugural risk assessment for the Office of Single Family Housing. It includes preparing baseline operational risk assessments and visiting the homeownership centers (field offices that perform many day-to-day functions associated with loan endorsement, processing, and lender oversight) and headquarters offices to update them. FHA plans to complete the inaugural risk assessment by September 2013.

- **Establishing ongoing mechanisms to anticipate risks.** As noted above, FHA has created committees to address credit and operational risks. The charters for both committees indicate that they are to discuss and address emerging risks. And, as part of the annual risk-assessment process mentioned above, FHA plans to identify emerging risks.

However, some of the initiatives taken in response to our recommendations have not been completed or put fully in place. They are critical to FHA's efforts to assess and manage risk.

FHA Single-Family Mortgage Insurance

Challenges Related to Human Capital and Information Systems

Background

FHA's Office of Single Family Housing has staff at headquarters and four homeownership centers—Atlanta, Georgia; Denver, Colorado; Philadelphia, Pennsylvania; and Santa Ana, California. Headquarters staff develop policy and manage oversight functions, while homeownership center staff undertake many of the day-to-day functions associated with loan endorsement, processing, and lender oversight.

More than 40 information technology (IT) systems support FHA's single-family insurance programs. Their uses include processing loans and financial and performance reporting. However, FHA has reported that these systems are outdated, unable to sustain the increasing volume of insurance applications, and costly to maintain.

Human Capital

In November 2011 (GAO-12-15), we reported that single-family loan volume had grown significantly from 2006 to 2010, but staffing levels for the Office of Single Family Housing had remained relatively constant. FHA's single-family staff increased 8 percent from 2006 to 2010 (see next table). Staff at homeownership centers (in the field)—which accounted for almost 80 percent of the single-family workforce—increased about 4 percent.

Single Family Housing Staff Levels, 2006-2010

	2006	2007	2008	2009	2010	Percentage change from 2006 to 2010
Headquarters	163	162	145	157	212	30
Homeownership centers	769	734	797	780	799	4
Single Family Housing total	**932**	**896**	**942**	**937**	**1,011**	**8**

Source: FHA.

Note: According to HUD's 2013 budget justification, in 2011, single-family staff increased to 1,075—294 at headquarters and 781 at the homeownership centers.

We also identified weaknesses in FHA's human capital management. While FHA had addressed staffing and training needs and succession planning to some extent, it lacked plans that strategically addressed future workforce needs, including replacing retiring staff.

- Leading organizations use workforce planning practices that include defining critical skills and skill gaps, but FHA's approach did not have mechanisms for doing so. Although FHA previously had a workforce plan that identified critical competencies, analyzed gaps, and proposed comprehensive strategies to address these gaps, it had not created another such plan. Instead, FHA relied on occasional studies and annual managerial assessments of staffing and training needs.

- FHA also did not have a current succession plan. (A plan for 2006-2009 had identified mission-critical positions, analyzed existing staff competencies, assessed the number of retirement-eligible employees, and determined the probability of near-term retirements.) We noted that succession planning was particularly important because, as of July 2011, almost 50 percent of Single Family Housing staff at headquarters were eligible to retire in the next 3 years. The percentage of staff eligible to retire at the homeownership centers was even higher—63 percent (see next table).

Percentage of FHA Staff Eligible to Retire within the Next 1, 2, and 3 Years, as of July 2011

Entity	Eligible to retire within 1 year	Eligible to retire within 2 years	Eligible to retire within 3 years
Single-family headquarters staff	39	45	47
Homeownership centers	54	58	63

Source: GAO analysis of FHA data.

We concluded that without a more comprehensive workforce planning process that included succession planning, FHA's ability to systematically identify future workforce needs and plan for upcoming retirements was limited. We recommended that FHA develop workforce and succession plans for the Office of Single Family Housing.

Since our November 2011 report, FHA has developed a workforce analysis and succession plan that identifies gaps in mission-critical competencies and additional steps that need to be taken, although the timing of many of these steps is not specified. Completing these steps is critical to ensuring that the agency has adequate staff to effectively oversee its mortgage insurance programs.

Information Systems

In our November 2011 report, we summarized FHA's efforts to improve its IT systems. Recent increases in FHA's business volume had exacerbated its IT constraints. A consultant FHA hired to examine technology constraints and identify risks related to processing workloads (for single-family programs) reported in 2009 that critical elements of IT infrastructure were at capacity, causing work slowdowns and poor customer service. For example, network overloads slowed systems in the afternoon, when work hours overlapped at the homeownership centers (which are in different time zones). To partially address these issues, HUD upgraded the mainframe's system capacity and made changes to certain applications to improve response time. Nevertheless, during a period in which transaction levels continued to increase, FHA had reached the limit of hardware and software capacity on IT systems.

To address system constraints, in August 2009 FHA identified five critical initiatives for its single-family insurance programs. These included: (1) implementing a standard automated underwriting system to evaluate loan applications and associated data to determine eligibility for insurance and (2) replacing the Computerized Home Underwriting Management System (CHUMS)—FHA's major underwriting system—with an off-the-shelf system that would enable the agency to decrease processing times, increase data accuracy, and provide better service to its customers.

In January 2010, FHA began working on key aspects of the five initiatives as part of its "FHA Transformation" efforts, which HUD initially estimated would cost $281 million over the next 5 years. For example, the agency began replacing CHUMS. At that time, we noted that FHA had major components to complete. To meet its goal of replacing CHUMS with a new platform, FHA also would have to migrate functions and applications associated with loan origination and underwriting, lender approval and monitoring, and loan servicing and administration. In addition to these CHUMS components, several other IT systems would have to be moved to the new platform.

Moreover, the audit of FHA's 2012 and 2011 financial statements identified a significant deficiency related to IT systems, and stated that FHA management and the HUD Office of the Chief Information Officer should mitigate persistent IT control deficiencies. A significant deficiency is one or a combination of deficiencies in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. The audit report noted that expensive and manual compensating controls, including monthly reconciliations of data among the interfaced systems, were needed to manage the numerous systems and that security and access controls had weaknesses. (We noted in November 2011 that the large number of systems resulted in hundreds of interfaces, which meant that changing one system required extensive effort to maintain the interfaces across systems. The multiple systems and interfaces also presented challenges for maintaining appropriate accessibility levels, security controls, and privacy standards.)

FHA Single-Family Mortgage Insurance

Home Equity Conversion Mortgage Program (Reverse Mortgages)

Background

FHA currently insures nearly all reverse mortgages. A reverse mortgage permits persons 62 years and older to borrow against their homes' equity. In 2012, FHA insured 54,591 reverse mortgages under its Home Equity Conversion Mortgage (HECM) program. Beginning in 2009, HECM loans were insured under FHA's Mutual Mortgage Insurance Fund. In 2012, HECMs totaled $78 billion. In comparison, FHA's portfolio of forward mortgages exceeded $1 trillion.

The Housing and Economic Recovery Act of 2008 (HERA) made several modifications to the HECM program, including changing how origination fees are calculated and increasing the loan limit.

Our Prior Work

In July 2009 (GAO-09-836), we found that the higher loan limit enacted by HERA might increase the potential for losses. To calculate the amount of funds available to a borrower, lenders start with a limiting factor of home value or the HECM loan limit, whichever is lower. The increase in the HECM loan limit meant that relatively more borrowers would have their HECM capped by the home's value, rather than the loan limit. The potential for losses is higher with such a loan because the projected loan balance is more likely to exceed the projected home value. When this effect is combined with declining home prices, the potential for losses increases. Combined with borrowers opting to receive more of their equity upfront, HECM loan performance declined dramatically in recent years. The independent actuary projected the economic value of the HECM portfolio to be negative $2.8 billion at the end of 2012.

Challenges and Proposed FHA Actions

In its November 2012 annual report to Congress on the insurance fund, FHA identified a number of challenges facing HECMs.

- **More borrowers maximizing upfront draw.** The vast majority of recent borrowers take out 80 percent or more of the maximum amount possible in one initial cash draw. Research performed by the independent actuaries indicates that HECM loans with such high up-front draws are twice as likely to have a tax-and-insurance default (discussed below) than loans with initial draws of 60 percent, and four times as likely as loans with initial draws of 40 percent.

- **Tax and insurance defaults.** For many homeowners, taking all eligible cash up front results in insufficient cash flow in later years for property upkeep, taxes, and insurance. This affects program performance by increasing defaults resulting from borrowers being unable or unwilling to make tax and insurance payments. The incidence of tax and insurance defaults has increased in recent years.

- **Increased property conveyance rates.** The conveyance rate upon termination increased sharply during this past year. Research indicates that this was directly tied to falling home prices. Owners and estate executors faced with mortgage balances greater than property value at the time of borrower exit from the home are less willing to market and sell the property than those with positive equity in the home. In such cases, there is no financial benefit from managing the property sale and so those responsible for the home are more likely to convey the property to HUD for sale. Property management and marketing costs associated with the disposition of homes conveyed to HUD typically cost approximately 12 percent of property value and thus increase the severity of loss for FHA.

- **Longevity risk.** Borrower mortality and loan termination speeds are now estimated to be slower than previous predictions, increasing the likelihood that loan balances will exceed property values at time of loan termination. Using these updated longevity predictions results in a lower economic value for the HECM portfolio in the actuarial calculations.

FHA has made or proposed changes to the HECM program designed to address some of these challenges. In January 2013, FHA issued guidance stating that it was eliminating the standard, fixed-rate HECM, thereby reducing the maximum amount of funds available to a HECM borrower. Further, FHA's annual report to Congress proposed additional revisions to the program, including reducing the amount borrowers can draw at the time the HECM loan is originated and issuing new incentives for estate executors of HECM borrowers to dispose of properties themselves rather than conveying them to HUD.

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