Mr. Chairman and Members of the Subcommittee:

We are here today to discuss the single-family mortgage insurance program of the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA). FHA insured over 1 million mortgages, representing over $90 billion in single-family mortgage insurance during fiscal year 1998—ending the fiscal year with a total of about $380 billion in single-family mortgage insurance outstanding. Many changes have occurred in the single-family housing finance system since FHA was established in 1934 to insure housing loans made by private lenders. These changes include the advent of modern private mortgage insurance, the development of a secondary mortgage market, and the emergence of a number of public- and private-sector initiatives designed to expand affordable housing opportunities for homebuyers. Given these developments, an ongoing debate has centered on FHA's role in today's single-family housing finance system. Critics of FHA contend that other housing finance players, such as private mortgage insurers, are filling the need once filled exclusively by FHA. Supporters of FHA argue that its single-family program, which has insured at least 24 million home mortgages since its inception, remains the only way for some families to become homeowners and should be expanded.

My statement today is based primarily on reports we have issued over the last 3 years[1] and will (1) discuss the activities of FHA's home mortgage insurance program, including the extent to which home buyers use FHA insurance, the characteristics of these home buyers—including whether they were first-time home buyers—and how many of them might also qualify for private mortgage insurance; (2) compare the insurance terms available through FHA's principal single-family mortgage insurance program with private mortgage insurance and guarantees from the Department of Veterans' Affairs (VA); and (3) examine the challenges FHA faces in ensuring the financial health of its Mutual Mortgage Insurance Fund—the insurance fund supporting most FHA-insured single-family mortgages.

In summary:

- FHA is a major participant in the single-family housing market—overall as well as for some specific market segments, particularly lower-income and

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

other homebuyers who may have less cash for a down payment but are otherwise able to afford the loan.[2]

  - In 1997, FHA insured over 33 percent of the loans for which lenders required mortgage insurance.
  - In 1996, FHA insured a greater percentage of the home loans made to low-income homebuyers than did either the VA or the private market. This also held true for loans to minorities—FHA insured 30 percent of these loans in 1996, with private companies insuring 14 percent and VA insuring 6 percent.
  - Two-thirds of the loans FHA insured in 1995 probably would not have qualified for private mortgage insurance on the basis of the loan-to-value and qualifying ratios of the loans FHA insured.
- The FHA and VA programs allow borrowers to make smaller down payments and have higher total-debt-to-income ratios than do private mortgage insurers. FHA's program differs from both the private mortgage insurers' and VA's programs: Only FHA allows borrowers to finance closing costs in the mortgage. FHA insures loans only up to a maximum amount of $208,800,[3] while VA-guaranteed loans generally cannot exceed $203,000. Private mortgage insurers will insure larger loans than either FHA or VA. FHA provides nearly full insurance coverage to lenders, while VA and private insurers do not.
- While FHA's Mutual Mortgage Insurance Fund is financially healthy and has surpassed the legislative target for reserves, FHA faces challenges in reducing the losses it incurs on foreclosed properties and maintaining its financial self-sufficiency in the face of economic and other factors that could adversely affect future program costs.

Before I discuss these issues in greater detail, let me briefly explain the reasons for mortgage insurance programs like FHA's and how the programs decide which loans they will insure.

FHA's Single-Family Mortgage Insurance Program

Lenders typically require mortgage insurance when a homebuyer has a down payment of less than 20 percent of the value of the home. In these cases, the loan-to-value (LTV) ratio of the mortgage is higher than 80 percent. Most lenders require mortgage insurance for these loans because they are more likely to default than are loans with lower LTV ratios. If a loan with mortgage insurance defaults, the lender may foreclose on the

[2]"Low-income" refers to a borrower with an income no greater than 80 percent of the median income in the Metropolitan Statistical Area where the borrower is located.

[3]Alaska, Hawaii, Guam, and the Virgin Islands may have even higher loan limits because the Congress has designated these states and territories as special high-cost areas, allowing FHA to set its loan limits there up to 50 percent higher than the limits applicable elsewhere.

loan and collect all or a portion of the losses from the insurer. In 1996, lenders required mortgage insurance for nearly 40 percent (or about 1.5 million) of the 3.8 million mortgages borrowers took out, according to information collected by banking regulatory agencies through requirements contained in the Home Mortgage Disclosure Act (HMDA).[4]

Private mortgage insurers, FHA, and VA provide virtually all single-family mortgage insurance. In general, private insurers operate standard programs for typical borrowers and special affordable programs for qualified borrowers who have fewer down payment funds and need increased underwriting flexibility.[5] FHA provides most of its single-family mortgage insurance through the Section 203(b) program. This program has not required any federal funds to operate because FHA has collected enough revenue from insurance premiums and foreclosed property sales to cover claims and other expenses. FHA also operates some smaller, specialized single-family mortgage insurance programs. A primary goal of FHA's single-family programs is to assist households that may be underserved by the private market. VA provides insurance through its Home Loan Guaranty Program only to U.S. veterans and their families.

FHA, VA, and private mortgage insurers provide lenders with guidelines for deciding whether or not a mortgage is eligible for mortgage insurance. In addition, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) establish their own guidelines—including requirements for mortgage insurance under certain circumstances—for the loans they will purchase in the secondary mortgage market.[6] A borrower's ability to repay the mortgage is often evaluated by computing the ratios of the borrower's total debt burden and housing expenses to his/her income (known as "qualifying ratios"). The "total-debt-to-income ratio" compares all of the borrower's long-term debt payments, including housing expenses, with his or her income. The "housing-expense-to-income ratio" compares the borrower's expected housing expenses with his or her income.

[4]This figure is based on mortgages reported by lenders pursuant to the HMDA requirements. However, the number of mortgages written in 1996 is somewhat higher because HMDA collects information on most, but not every, mortgage.

[5]Underwriting is the process of analyzing a borrower's willingness and ability to repay a loan.

[6]Fannie Mae and Freddie Mac are government-sponsored enterprises that provide a secondary market for many home mortgages. Because most mortgage lenders want to sell some or all of the loans they make in the secondary market, they apply Fannie Mae's and Freddie Mac's underwriting standards to the loans they issue.

The HMDA database contains information on mortgages insured through FHA's principal single-family mortgage insurance program—the Section 203(b) program—in addition to loans insured through FHA's smaller single-family mortgage insurance programs but does not distinguish between them. Consequently, my testimony today on FHA's market share, the characteristics of FHA borrowers, and the borrowers who may have qualified for private mortgage insurance pertain to all single-family loans FHA has insured.

FHA Single-Family Mortgages

FHA has been a major player in single-family home financing for over 60 years, and it remains so today—particularly in certain market segments. Between 1986 and 1990, FHA was the largest insurer of single-family mortgages. The factors contributing to FHA's large market share during these years include an increase in FHA's maximum loan limit in 1988 and the economic downturns in some areas of the country that decreased the availability of private mortgage insurance. Except for FHA's loan limit, the terms under which FHA and VA mortgage insurance are available, such as the maximum LTV ratio, generally do not vary across different geographic locations.[7] However, private mortgage insurance companies may change the conditions under which they will provide new insurance in a particular geographic area to reflect the increased risk of losses in an area experiencing economic hardship.

Throughout the 1991 through 1997 period, private mortgage insurers had a greater share of all insured single-family mortgages than FHA or VA. In 1997, private mortgage insurers' share was 54.2 percent, FHA's was 33.3 percent, and VA's was 12.5 percent. This change may be a result, in part, of the increased premiums for FHA insurance implemented pursuant to the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508). Premiums were increased because a 1990 independent actuarial study of the FHA Fund indicated it would eventually have a negative net worth if its reserves for covering future losses were not replenished.

FHA Is an Important Source of Mortgage Insurance in Certain Markets

In reporting on FHA's role,[8] we found that in 1994, FHA is a particularly important source of mortgage insurance for low-income, minority, and first-time homebuyers. In addition, we estimated that 66 percent of FHA's borrowers in 1995 might not have qualified for private mortgage insurance

[7]FHA's loan limit may differ among geographic areas to reflect differentials in the cost of housing.

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

for the loans they received, based on the loan-to-value and qualifying ratios of FHA's borrowers that year. However, it is important to note that, as with home buyers in general, most low-income and minority homebuyers who obtained mortgages in fiscal year 1996 did not have insured mortgages because they made down payments of 20 percent or greater. Data for 1996 from HMDA, the Mortgage Insurance Companies of America (MICA), and HUD showed that FHA-insured loans are concentrated to a greater extent on borrowers with these same characteristics than are loans insured by private mortgage insurers. Specifically, we estimate the following on the basis of HMDA, MICA, and HUD data for loans in 1996:[9]

- FHA insured a greater percentage of the home loans made to low-income homebuyers than did either the VA or the private insurers. Specifically, of the 984,495 home loans made to low-income homebuyers, FHA insured 23 percent, VA insured 5 percent, and private companies insured 14 percent; the remaining loans to low-income homebuyers were not insured. For just FHA, low-income homebuyers received about 39 percent of FHA-insured loans.
- FHA insured 30 percent of all loans made to minority homebuyers, and such homebuyers represented about 31 percent of FHA-insured loans. FHA insured a higher percentage of loans for minority borrowers in 1996 than did private mortgage insurers (14 percent) and substantially more than did the VA (6 percent).
- About 74 percent of FHA-insured loans in 1996 were made to first-time homebuyers. FHA insured a higher percentage of loans for first-time homebuyers than its overall share of the insured home purchase market.
- While 63 percent of FHA-insured loans made in 1996 had LTV ratios exceeding 95 percent, only about 7 percent of conventional loans below the maximum FHA loan limit had LTV ratios exceeding 95 percent in 1997.

Single-Family Mortgage Insurance Terms Offered by FHA, Private Insurers, and VA Are Different

In our 1996 report on FHA's role, we reported that the FHA, private mortgage insurers, and VA mortgage insurance programs differed in terms of maximum LTV ratios and mortgage amounts, the financing of closing costs, and the amount that each will pay lenders to cover the losses associated with foreclosed loans. Specifically, we reported the following:

[9]We adjusted HMDA data for our comparisons with Mortgage Insurance Companies of America data on private mortgage insurers' loans. HMDA data include approximately 93 percent of all FHA-insured home purchase loans. The mortgage insurance companies' data, however, include nearly all loans insured by private mortgage insurers. To determine the relative share of the market of loans in the HMDA database held by FHA and private mortgage insurers, HMDA data were increased by a relevant percentage. Also, we deleted some mortgage insurance companies' and HMDA data that were not valid or were of poor quality.

- While both FHA and VA could insure loans with LTV ratios that exceed 100 percent (because of the financing of closing costs or other fees), private mortgage insurers did not offer insurance for loans with LTV ratios greater than 97 percent. Following our 1996 report, both Fannie Mae and Freddie Mac announced the introduction of conventional 97-percent LTV mortgage products that offer many of the advantages of FHA's single-family program. Both programs—Fannie Mae's "Flexible 97 Mortgage" and Freddie Mac's "Alt 97 Mortgage"—allow down payments as low as 3 percent that can be funded through gifts, unsecured loans from relatives, or grants from nonprofit organizations or local governments.
- FHA allows borrowers to finance most closing costs, but private mortgage insurers and VA do not. Both FHA and VA allow borrowers to finance their insurance premiums.
- FHA may insure loans only up to a maximum that varies depending on local housing costs, ranging from $115,200 for much of the country to $208,800 for certain areas with higher housing costs. VA-guaranteed loans generally cannot exceed $203,000, while private mortgage insurers will insure larger loans than either FHA or VA.
- While FHA protects lenders against nearly 100 percent of the loss associated with a foreclosed mortgage, private mortgage insurers and VA limit their coverage to a portion of the mortgage balance. Private mortgage insurers generally cover only 20 to 35 percent, and VA covers only 25 to 50 percent, of the mortgage balance plus other costs, even if a loss exceeds that amount.

FHA's Single-Family Mortgage Insurance Fund Faces Challenges

While FHA's Mutual Mortgage Insurance Fund is financially healthy and has surpassed the legislative target for reserves, FHA faces challenges today, including reducing the losses it incurs on foreclosed properties and maintaining financial self-sufficiency in the face of economic and other factors that could adversely affect future program costs. To the extent that FHA can improve the efficiency of its lending operations, it will improve its ability to maintain financial self-sufficiency in an uncertain future and meet the needs of lower-income borrowers by either increasing the number of borrowers served or reducing the cost of their mortgage insurance.

FHA's Insurance Fund Exceeds Statutory Reserve Targets

One of the challenges FHA's single-family mortgage insurance program has faced successfully has been restoring the financial health of the Fund—the insurance fund supporting 91 percent of the dollar value of FHA-insured single family mortgages outstanding at the end of fiscal year 1997. At the

end of fiscal year 1990, Price Waterhouse estimated that the Fund's economic value/reserves[10] was a negative $2.7 billion. However, as of September 30, 1998, PricewaterhouseCooper's recent actuarial study[11] reported that the Fund's economic value/reserves had reached $11.4 billion, an improvement of about $14 billion. Over time, insurance premiums and other income have more than covered costs. The recent study also reported that the Fund's capital reserve ratio (economic value/reserves as a percentage of value of outstanding loans) was 2.71 percent, surpassing the legislative target for reserves (a 2-percent capital ratio) in advance of the legislatively set target date of November 2000. PricewaterhouseCoopers estimated that the Fund's capital ratio will be 3.40 and its economic value/reserves about $14.6 billion by fiscal year 2000.[12]

Losses Incurred by FHA on Foreclosed Single-Family Properties Are Large

Each year, mortgage lenders foreclose on a portion of the FHA-insured mortgages that go into default and file insurance claims with HUD for their losses. FHA has always received enough in premiums from borrowers and other revenues to more than cover these losses. The Fund finances the losses it sustains, thereby ultimately reducing its ability to withstand economic downturns and possibly resulting in higher premiums for FHA borrowers. The impact that foreclosures can have on the financial health of the Fund was demonstrated during the 1980s. Until that time, the Fund had been relatively healthy. However, in the 1980s, losses were substantial, primarily because foreclosure rates were high in economically stressed regions, particularly in the Rocky Mountain and Southwest regions. In June 1990, HUD announced that, while the Fund was financially solvent, it had been steadily eroding from a net worth in constant 1989 dollars of $7.8 billion in 1980 to $2.6 billion in 1989. By the end of fiscal year 1990, the fund's economic value/reserves were estimated at about a negative $2.7 billion. If the Fund is unable to finance program and administrative costs, the U.S. Treasury would have to directly cover lenders' claims and administrative costs.

More recently, the claims FHA paid in fiscal year 1998 were higher than expected. Actual claim payments for single-family insured loans totaled

[10]The current assets available to the Fund, plus the net present value of all future cash inflows and outflows expected to result from mortgages insured under the Fund.

[11]An Actuarial Review for Fiscal Year 1998 of the Federal Housing Administration's Mutual Mortgage Insurance Fund, Final Report, March 1, 1999, PricewaterhouseCoopers LLP. As a result of a merger with another firm, Price Waterhouse was renamed PricewaterhouseCoopers.

[12]The Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) required the Secretary of Housing and Urban Development to endeavor to ensure a capital ratio of 2 percent by November 2000 and maintain that ratio or a higher one at all times thereafter.

about $5.3 billion, much higher than the $2.2 billion projected for fiscal year 1998 in the fiscal year 1999 budget. Similarly, actual property acquisitions, properties sold, and the end of fiscal year 1998 inventory of HUD-owned single-family properties were higher than projected. Actual property acquisitions were about $5.3 billion, compared with the $4.0 billion projected; properties sold were about $4.5 billion, compared with the $4.2 billion projected; and, the September 30, 1998 inventory of properties totaled about $2.8 billion, compared with the $1.8 billion projected. Notwithstanding these unexpected financial results, given current economic conditions, we would expect the financial position of FHA's single-family mortgage insurance program to continue to improve.

Annual audits of FHA's financial statements have identified weaknesses in FHA's ability to manage the risks associated with troubled single-family insured mortgages.[13] The annual audit of FHA's fiscal year 1998 financial statements[14] —the most recent available—continues to identify a material internal control weakness applicable, in varying degrees, to both the single-family and multifamily programs. Specifically, the 1998 report states that FHA must continue to place more emphasis on early warning and loss prevention for insured mortgages by, among other things, using loss mitigation tools for the single-family insured portfolio before properties are foreclosed. According to the report, FHA does not have adequate systems, processes, or resources to effectively identify and manage risks in its insured portfolios. The timely identification of troubled insured mortgages is a key element of FHA's efforts to target resources on insured high-risk mortgages because FHA must identify its troubled insured mortgages before it can institute loss mitigation techniques that can reduce eventual claims. The report notes that FHA made significant progress in this regard during fiscal year 1998, including increasing its lender monitoring and enforcement activities, developing automated systems to monitor insured loan performance, and expanding the use of loss mitigation. Though the report states that these steps represent significant progress, their benefits have not yet been fully recognized because they are relatively new or still being developed.

[13]The Chief Financial Officers Act of 1990 and the Government Management and Reform Act of 1994 required HUD and some other agencies to annually prepare and subject to audit organizationwide financial statements. These reports are submitted to the Congress through the Office of Management and Budget. HUD's Office of Inspector General contracts with a public accounting firm to conduct annual audits of FHA's financial statements.

[14]Audit of the Federal Housing Administration's Fiscal Year 1998 Federal Basis Financial Statements, prepared by KPMG LLP for the Office of Inspector General (99-FO-131-0002, Mar. 12, 1999).

Other Factors That Could Affect the Financial Health of the Fund

As we have reported,[15] the Fund's ability to maintain the target ratio depends on many economic, program-related, and other factors that will affect the financial health of the Fund in the future. These factors include (1) economic conditions, (2) uncertainty surrounding the projections of the performance of FHA's streamlined refinanced[16] and adjustable rate mortgage loans, and (3) risks associated with the demand for FHA's loans. We also reported in May 1997[17] that reducing FHA's insurance coverage to the level permitted for VA home loans would likely reduce the Fund's exposure to financial losses, thereby improving its financial health.

Estimates of economic value/reserves of the Fund are sensitive to future economic conditions, particularly the appreciation rates for house prices. The Fund will not perform as well if the economic conditions that prevail over the next 30 years replicate those assumed in pessimistic economic scenarios. PricewaterhouseCoopers' estimate of the Fund's economic value/reserves for its pessimistic economic scenario is about $2.7 billion (or 24 percent) less than its estimate of $11.4 billion as of September 30, 1998, which would still represent a significant turnaround from the Fund's position in 1990.

Also, the substantial refinancing of FHA's loans and the growth in the number of FHA's adjustable-rate mortgages insured in recent years have created a growing class of FHA borrowers whose future behavior is more difficult to predict than that of the typical FHA borrower's. FHA's streamlined refinanced mortgages and adjustable rate mortgages accounted for about 32 percent of the dollar value of FHA's loans outstanding at the end of fiscal year 1997: Streamlined refinanced mortgages accounted for about 15 percent of the value of the outstanding loans and adjustable-rate mortgages for about 17 percent. FHA has had little experience with streamlined refinanced mortgages and adjustable-rate mortgages and the tendency for such loans to be foreclosed and/or prepaid.

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

[16]FHA's streamlined refinanced mortgages are those for which an FHA-insured mortgage loan has been repaid from the proceeds of a new FHA-insured loan using the same property as security. Borrowers often refinance mortgage loans to lower their monthly principal and interest payments when interest rates decline. FHA does not require appraisals and credit checks on these loans, and borrowers cannot obtain cash from the transaction except for minor adjustments not exceeding $250 at closing.

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

Because FHA-insured properties whose mortgages were streamlined refinanced did not have to be appraised, the initial LTV ratio of these loans—a key predictor of the probability of foreclosure—is unknown.[18] The impact of these loans on the financial health of the Fund is probably positive because they represent preexisting FHA business whose risk has been reduced through lower interest rates and lower monthly payments. However, the lack of experience with these loans increases the uncertainty associated with their expected foreclosure rates. In addition, new developments in the private mortgage insurance and secondary mortgage markets may increase the average risk of future FHA-insured loans. Homebuyers' demand for FHA-insured loans depends, in part, on the alternatives available to them. Some private mortgage insurers have begun offering mortgage insurance coverage on conventional mortgages with a 97-percent LTV ratio, which brings their terms closer to FHA's 97.75-percent LTV ratio on loans for properties exceeding $50,000 in appraised value. In addition, Fannie Mae and Freddie Mac have announced the introduction of conventional 97-percent LTV mortgage products that offer many of the advantages of FHA's single-family loans.

If Fannie Mae's and Freddie Mac's 97-percent LTV mortgages are successful in attracting those lower-risk borrowers who can choose between FHA and private insurance (because private insurers do not require an up-front mortgage insurance premium), they may be drawing away from FHA customers with better-than-average credit histories or payment-to-income ratios. In doing so, the remaining new FHA loans may become more risky, on average. If this effect is substantial, the economic value/reserves of the Fund may be adversely affected, and it may be more difficult for the fund to maintain a 2-percent capital ratio.

Lastly, FHA insures private lenders against nearly all losses resulting from foreclosures on the single-family homes it insures. However, VA, under its single-family mortgage guaranty program, covers only 25 to 50 percent of the original loan amount against losses incurred when borrowers default on loans, leaving lenders responsible for any remaining losses. In our May 1997 report,[19] we concluded that reducing FHA's insurance coverage to the level permitted for VA home loans would likely reduce the Fund's exposure to financial losses, thereby improving its financial health. As a result, the Fund's ability to maintain financial self-sufficiency in an uncertain future would be enhanced. However, reducing FHA's insurance

[18]Also, FHA's data do not indicate whether second mortgages exist on these properties.

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

coverage does pose trade-offs that affect lenders and borrowers as well as the very role FHA itself plays in stabilizing markets. The most likely affected borrowers would be low-income, first-time, and minority homebuyers and those individuals purchasing older homes.

To illustrate the financial impact of reducing FHA's insurance coverage, our report pointed out that if insurance coverage on FHA's 1995 loans were reduced to VA's levels and a 14 percent reduction in FHA's lending volume assumed, the economic values of the loans we estimate would be $52 million to $79 million greater than our estimate, assuming no coverage and volume reductions. Reducing FHA's insurance coverage would likely improve the financial health of the Fund because the reduction in claim payments resulting from lowered insurance coverage would more than offset the decrease in premium income resulting from reduced lending income. The amount of savings that would be realized by reducing FHA's insurance coverage would depend on future economic conditions, the volume of loans made, the relationship of the number of higher-risk and lower-risk borrowers who would leave the program, and whether some losses may be shifted from FHA to the Government National Mortgage Association.

In closing, Mr. Chairman, FHA's importance in the housing market—particularly for segments of the market that might not be able to buy homes without it—is substantial. It fills a role that the private market might not completely cover if FHA were not there—and it does so without needing federal funds. Nonetheless, we recognize, and FHA is certainly aware, that there is more it can do to better secure its long-term financial outlook.

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