MORTGAGE FINANCING

FHA and Ginnie Mae Face Risk-Management Challenges

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HIGHLIGHTS

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Why GAO Did This Study

In recent years, two components of HUD—FHA and Ginnie Mae—have played a major role in the single-family mortgage market. FHA insures lenders against losses from mortgage defaults. Ginnie Mae guarantees the timely payment of principal and interest for securities backed by federally insured or guaranteed mortgages. Due partly to the contraction of other mortgage market segments, FHA’s and Ginnie Mae’s business volumes have risen sharply. This growth highlights the need for these entities to properly manage financial risks while meeting the housing needs of borrowers.

This testimony discusses (1) changes in the financial condition of FHA’s insurance fund, the budgetary implications of these changes, and how FHA evaluates the fund’s financial condition; (2) steps FHA has taken to assess and manage risks; and (3) steps Ginnie Mae has taken to manage risks and estimate costs and revenues.

This testimony draws from GAO reports on FHA’s oversight capacity (GAO-12-15), the financial condition of FHA’s insurance fund (GAO-10-827R), and Ginnie Mae’s risk management (GAO-12-49). GAO also reviewed updated information on the fund’s condition as of September 30, 2011.

What GAO Recommends

GAO previously recommended that FHA and Ginnie Mae take additional steps to improve their risk management. FHA and Ginnie Mae agreed with these recommendations and said they had efforts under way to implement them.

View GAO-12-578T. For more information, contact Mathew J. Scirè at (202) 512-8678 or sciremj@gao.gov.

What GAO Found

For the third consecutive year, the Department of Housing and Urban Development’s (HUD) Federal Housing Administration (FHA) reported that the capital ratio for the Mutual Mortgage Insurance Fund—the ratio of the fund’s capital to its insurance obligations—has not met the 2 percent statutory minimum. FHA cited declines in the fund’s economic value due to higher-than-expected defaults, claims, and losses. At the same time, the other component of the ratio, insurance obligations, grew rapidly. The fund’s condition also worsened from a budgetary perspective, with balances in the fund’s capital reserve account reaching new lows. If the account were depleted, FHA would require more funds to help cover costs on insurance issued to date. FHA has indicated that it will narrowly avoid this scenario in fiscal year 2012. FHA enhanced methods for assessing the fund’s financial condition but has not fully addressed GAO’s 2010 recommendation for improving the reliability of its estimates. It relies on a single economic forecast, which does not fully account for variability in future house prices and interest rates. The approach GAO recommended would simulate numerous economic paths for house prices and interest rates to improve the reliability of its capital ratio estimates.

FHA has taken or plans steps to better assess and manage risk. It created a risk office in 2010 and hired a consultant to recommend best practices. FHA plans to establish committees to evaluate risks at enterprise-wide and programmatic levels. It began a quality control initiative for single-family housing, in which program and field offices assess and report on risks, and enhanced lender and appraiser reviews. While FHA’s consultant recommended integrating risk assessments, the quality control and risk office activities currently remain separate efforts. Also, since 2009, the Office of Single Family Housing has not updated assessments annually in accordance with HUD guidance. Without integrated and updated risk assessments that identify emerging risks, FHA lacks assurance it has identified all its risks. GAO recommended integrating quality control and risk office activities and updating assessments annually.

GAO and others have identified limited staff, substantial reliance on contractors, and the need for modernized information systems as risks that the Government National Mortgage Association (Ginnie Mae) may face. Ginnie Mae has several planned initiatives to enhance its risk-management processes related to gaps in resources, contracts, and issuers, but these plans have not been fully implemented. It will be important for Ginnie Mae to complete these initiatives as soon as practicable to enhance its operations. Also, in developing inputs and procedures for the model used to forecast costs and revenues, the agency did not consider certain practices identified in guidance for preparing cost estimates of federal credit programs. Ginnie Mae has not developed estimates based on the best available data, performed sensitivity analyses to determine which assumptions have the greatest impact on the model, or documented why it used management assumptions rather than available data. By not fully implementing certain practices, which GAO believes represent sound internal controls for models, Ginnie Mae’s model may not use critical data that could affect the agency’s ability to provide well-informed budgetary cost estimates and financial statements. GAO recommended that Ginnie Mae adopt these practices.
Chairman Latham, Ranking Member Olver, and Members of the Subcommittee:

I am pleased to be here today to discuss our work on the Department of Housing and Urban Development’s (HUD) Federal Housing Administration (FHA) and Government National Mortgage Association (Ginnie Mae). As you know, FHA insures private lenders against borrower defaults on mortgages that meet FHA criteria. FHA has helped millions of families purchase homes through its single-family mortgage insurance programs and insures almost all of its single-family mortgages under the Mutual Mortgage Insurance Fund (Fund). Ginnie Mae is a wholly owned government corporation in HUD that guarantees the timely payment of principal and interest on securities backed by pools of federally insured or guaranteed mortgages, including FHA-insured mortgages. Ginnie Mae’s guarantee of mortgage-backed securities (MBS) helps link capital markets to the nation’s housing markets.

FHA and Ginnie Mae have come to play a prominent role in mortgage financing in the wake of the 2007-2009 financial crisis, the housing downturn, and the contraction of the conventional mortgage market. However, FHA reported in November 2011 that, for the third consecutive year, the Fund was not meeting the statutory 2 percent capital reserve requirement, as measured by the Fund’s estimated capital ratio—that is, the Fund’s economic value divided by the insurance-in-force (outstanding insurance obligations). Although the Fund historically has produced budgetary receipts for the federal government, a weakening in the performance of FHA-insured loans has heightened the possibility that FHA could require additional funds to help cover its costs on insurance issued to date. Although Ginnie Mae has accumulated a capital reserve, the dramatic growth in outstanding Ginnie Mae-guaranteed MBS and the default of a major Ginnie Mae issuer in 2009 also have focused attention on the potential risks Ginnie Mae faces.1

1In August 2009, Ginnie Mae defaulted Taylor, Bean, and Whitaker Mortgage Corporation and took over the portfolio for approximately $26.2 billion in mortgages. In general, the actual costs of a defaulted portfolio for Ginnie Mae cannot be determined until insurance or guarantee claims are processed and the number of fraudulent or delinquent mortgages determined. However, according to its 2010 financial statements, Ginnie Mae estimated that its portfolio for all defaulted issuers (at that time about $4.5 billion) would result in net costs of $53 million.
My statement today is based on three prior GAO reports: a September 2010 report on FHA’s financial condition, and two reports from November 2011—one on FHA’s risk assessment and human capital management and one on Ginnie Mae’s risk management and cost modeling.² Specifically, I will discuss (1) how estimates of the Fund’s capital ratio changed in recent years and the budgetary implications of changes in the Fund’s financial condition, (2) how FHA and its actuarial review contractor evaluate the financial condition of the Fund, (3) steps FHA has taken to manage and assess risks, and (4) steps Ginnie Mae has taken to manage risks and estimate costs and revenues.

To do this work, we analyzed actuarial reviews of the Fund and federal budget documents, and interviewed FHA officials, staff from FHA’s actuarial review contractor, and housing market researchers. We also analyzed data on FHA’s business volume, market share, workload, and staff and contractor resources. We reviewed documentation on the proposed structure and functions of FHA’s Office of Risk Management and Regulatory Affairs and the Office of Single Family Housing’s internal quality control initiative. Further, we reviewed changes to FHA guidance that address risks associated with lenders and appraisers and documentation related to workforce and succession planning. For this testimony, we also reviewed updated information on the Fund’s condition as of September 30, 2011. Our study of Ginnie Mae assessed operational risks and financial exposure. We reported on Ginnie Mae volume and market share, reviewed guidance and Ginnie Mae’s credit subsidy calculations and estimation model, and interviewed agency officials and others. Our prior reports each include a detailed description of our scope and methodology.

The work on which this statement was based was performed from September 2009 to November 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our

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

Background

Under the Federal Credit Reform Act of 1990 (FCRA), FHA and other federal agencies must estimate the net lifetime costs—known as credit subsidy costs—of their loan insurance or guarantee programs and include the costs to the government in their annual budgets. Credit subsidy costs represent the net present value of expected lifetime cash flows, excluding administrative costs. 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. Generally, agencies must produce annual updates of their subsidy estimates—reestimates—on the basis of information about actual performance and estimated changes in future loan performance. FCRA recognized the difficulty of making credit subsidy estimates that mirrored actual loan performance and provides permanent and indefinite budget authority for reestimates that reflect increased program costs. Upward reestimates increase the federal budget deficit unless accompanied by reductions in other government spending or an increase in receipts.

The Omnibus Budget Reconciliation Act of 1990 required the HUD Secretary to take steps to ensure that the Fund attained a capital ratio of at least 2 percent by November 2000 and maintained at least a 2 percent ratio at all times thereafter. It also required an annual independent actuarial review of the economic net worth and soundness of the Fund. The annual actuarial review is now a requirement in the Housing and Economic Recovery Act of 2008, which also requires that the HUD Secretary annually report to Congress on the results of the review.

Federal agencies face a number of risks. Agencies with loan insurance programs, such as FHA, face credit risks that include borrower default

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3 For a mortgage insurance program, cash inflows consist primarily of fees and premiums charged to insured borrowers and proceeds from sales of foreclosed properties, and cash outflows consist mostly of payments to lenders to cover the cost of claims.

risk, which arises as borrowers become unable to make payments on insured mortgages. Agencies also face counterparty risk. That is, an agency may suffer losses due to weaknesses or uncertainties in the work of its counterparties, which include lenders and appraisers for FHA and issuers for Ginnie Mae. And all agencies face operational risks, the risk of loss resulting from inadequate or failed internal processes, deficiencies in staff numbers, training, and skills, or external events.

The 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 Fund’s economic value (the numerator of the ratio) and increased the insurance-in-force (the denominator of the ratio). According to annual actuarial reviews of the Fund, the capital ratio fell from about 7 percent in 2006 to 3 percent in 2008 and 0.5 percent in 2009 (see fig. 1). For 2010 and 2011, the ratios were 0.5 and 0.24 percent, respectively.

5Unless otherwise stated, the years shown are fiscal years.
In its November 2011 report to Congress, HUD cited several reasons for the declines from 2010 to 2011. These included the following:

- Home prices were expected to continue falling. Forecasts for the 2010 actuarial study predicted house price declines of about 2.8 percent before bottoming out in the middle of 2011. Forecasts for the 2011 actuarial study predicted declines of 5.6 percent for FHA’s single-family portfolio in 2011. Higher-than-expected declines in house values contributed to both higher defaults and claims and higher loss-on-claim than anticipated in 2010.

- More loans, particularly from the housing bubble years of 2006-2008 were in serious delinquency, and a significant percentage had been there for more than 1 year. Claims become the most likely outcome for extended delinquency loans, many of which are in foreclosure.

- For the first time, the actuarial calculations built in a factor recognizing the elevated redefault potential from the increased number of active loans with a previous serious delinquency (3 months or more).
The independent actuaries also made a decision to treat foreclosure actions likely affected by so-called robosigning problems as expected claims in 2012.\(^6\)

In reviewing the components of the capital ratio, the combination of a relatively stable economic value (numerator of the ratio) and a declining insurance-in-force (denominator) over much of the 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 (see fig. 2).

**Figure 2: Estimates of the Fund’s Economic Value and Insurance-in-force, 2001–2011**

<table>
<thead>
<tr>
<th>Year</th>
<th>Economic Value (dollars in billions)</th>
<th>Insurance in Force (dollars in billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>10</td>
<td>800</td>
</tr>
<tr>
<td>2002</td>
<td>12</td>
<td>900</td>
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<td>2009</td>
<td>20</td>
<td>1,600</td>
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<tr>
<td>2010</td>
<td>21</td>
<td>1,700</td>
</tr>
<tr>
<td>2011</td>
<td>22</td>
<td>1,800</td>
</tr>
</tbody>
</table>

At the same time, the Fund’s condition has worsened from a budgetary perspective. Historically, FHA has 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 budgetary account known as the capital reserve account, which holds reserves in excess of those needed for estimated credit subsidy costs and helps cover unanticipated costs.

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\(^6\)Robosigning refers to the practice of mortgage servicers having a small number of employees sign a large number of affidavits and other legal documents that mortgage companies subsequently submitted to courts and other public authorities to execute foreclosures. For more information, see GAO, *Mortgage Foreclosures: Documentation Problems Reveal Need for Ongoing Regulatory Oversight*, GAO-11-433 (Washington, D.C.: May 2, 2011).
However, in recent years, the capital reserve account has covered large upward reestimates of FHA’s credit subsidy costs through transfers to the financing account. As a result, balances in the capital reserve account fell dramatically—from $22 billion at the end of 2007 to an estimated $4.4 billion by the end of 2010 (see fig. 3). 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. FHA’s latest annual report to Congress raises the possibility that, if house prices were to decline in 2012, the expected future losses on the current, outstanding portfolio could exceed current capital resources. These would be offset by the expected net receipts from the new 2012 cohort of loans. But, according to HUD, if house prices were to decline in 2012 by an amount rivaling that of 2011, these new loans would not be expected to generate sufficient net receipts to offset any potential decline in value of the current outstanding portfolio, potentially necessitating assistance from the Department of the Treasury (Treasury). Under one stress scenario in which house prices decline by 13.7 percent in 2011, rather than the 5.6 percent assumed in the baseline scenario, and house prices decline another 1.3 percent in 2012, HUD estimates that it may require $13 billion in assistance from Treasury to ensure the financing account has sufficient loss reserves.

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7The financing account records lifetime cash flows for loans insured in 1992 and thereafter. It appears in the budget for informational and analytical purposes but is not included in the budget totals or budget authority or outlays.

8By the end of 2011, the balance in the capital reserve account rose slightly to $4.7 billion.
The President’s budget for 2013 contains a $9.3 billion upward reestimate in FHA’s credit subsidy costs for the Fund. The budget indicates that the reestimate will deplete FHA’s capital reserve account in 2012, causing FHA to draw on $688 million in permanent and indefinite budget authority. However, following the release of the budget, FHA indicated it may not need the $688 million, primarily because legal settlements with major lenders were expected to provide FHA with more than $900 million in compensation for losses associated with loans originated outside of FHA requirements, or for which FHA’s servicing requirements were violated. Even without the legal settlements, the President’s budget estimates that the capital reserve account would have a balance of more than $8 billion by the end of 2013. However, this estimate is based on long-term assumptions about house prices and interest rates that are inherently uncertain. Historically, FHA’s initial budget estimates for the single-family mortgage program have been too optimistic.
As we reported in September 2010, FHA and its actuarial review contractor enhanced their methods for assessing the Fund’s financial condition but still were addressing other methodological issues that could affect the reliability of estimates of the capital ratio. Annual actuarial reviews of the Fund use statistical models to estimate the probability that loans will prepay or result in insurance claims on the basis of certain loan and borrower characteristics (such as loan-to-value ratios and borrower credit scores) and key economic variables (such as house prices and interest rates). FHA and its contractor have enhanced these models in recent years, by incorporating additional variables related to loan performance and developed an additional model to predict loss rates on insurance claims. Also, consistent with recommendations we made in a prior report, in 2003, the actuarial reviews began to analyze the impact of more pessimistic economic scenarios—for example, nationwide declines in home prices—than they did previously.

However, the current methodology is significantly limited by its reliance on a single economic forecast to produce the estimate of the capital ratio that is used to determine if the Fund is meeting the 2 percent capital reserve requirement. This approach does not fully account for the variability in future house prices and interest rates that the Fund may face. As a result, baseline estimates of the capital ratio may tend to underestimate insurance claims and mortgage prepayments and therefore may overestimate the Fund’s economic value. In a November 2003 report, the Congressional Budget Office concluded that FHA could project the Fund’s cash flows more accurately by using an approach (stochastic simulation) that involves running simulations of hundreds of different economic paths to produce a distribution of capital ratio estimates.

Given the uncertainty that always surrounds estimates of future economic activity, the report we issued in 2010 recommended that HUD require the actuarial review contractor to use stochastic simulation of future economic conditions, including house prices and interest rates, to estimate the

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9The loan-to-value ratio is the ratio of the amount of the mortgage loan to the value of the home.


FHA faces risks resulting from its operations. FHA’s loan volume grew significantly from 2006 to 2010. In 2006, FHA insured almost half a million loans, totaling $70 billion in mortgage insurance. By 2010, it had more than tripled to 1.7 million loans insured or about $319 billion in mortgage insurance. During the same time period, FHA’s single-family staff increased 8 percent, from 932 employees in 2006 to 1,011 employees in 2010, while increases in key workload areas often surpassed 100 percent as follows:

- Staff in the homeownership centers’ Processing and Underwriting Division grew at a slower rate (22 percent) than key workload items, particularly volume-driven loan reviews (which increased by more than 100 percent).

- Increases in contractor staff and workload related to management of foreclosed or real estate-owned properties were substantial, but noncontractor staff levels increased at more modest levels.

- Loss mitigation actions more than doubled from 2006 to 2010, while loss mitigation staff levels remained relatively constant.\(^{12}\)

\(^{12}\)Loss mitigation actions seek to minimize losses from potential foreclosures by finding alternatives to foreclosure and helping homeowners retain their homes, if possible.
Although FHA has taken steps to assess credit and operational risks facing its single-family insurance programs, its current risk-assessment strategy is not comprehensive because it is not integrated across the agency and lacks annual assessments and mechanisms to anticipate changing conditions. To address credit risk and help improve the financial condition of the Fund (which is supported by borrower premiums), FHA raised premiums and made or proposed policy or underwriting changes. For example, in April 2011, FHA increased its annual insurance premiums from 0.85 percent to 1.10 percent for borrowers with 30-year loans with initial loan-to-value ratios of 95 percent or less and from 0.90 percent to 1.15 percent for borrowers with 30-year loans with initial loan-to-value ratios greater than 95 percent. Additionally, FHA increased down-payment requirements for borrowers with lower credit scores. FHA also has proposed reducing allowable seller contributions at closing, thereby helping to ensure that buyers put more of their own funds into the home purchase. Further, FHA has been revising its mortgage scorecard algorithm to recognize the effect of various risk elements not currently discerned by the scorecard and determine what cases warrant manual underwriting. According to FHA, these revisions are in the early stages, and no completion date has been set.

To address operational risks and improve its risk-assessment strategy, in 2010, FHA established the Office of Risk Management and Regulatory Affairs and created the position of Deputy Assistant Secretary for Risk Management and Regulatory Affairs, which reports directly to the Assistant Secretary for Housing-FHA Commissioner. To provide assistance to the Office of Risk Management (one of the offices within the Office of Risk Management and Regulatory Affairs) in developing a risk-

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13FHA recently announced a number of changes to its up-front and annual mortgage insurance premiums to take effect over the next few months. For example, FHA will increase the up-front premium for most of its single-family mortgages to 1.75 percent. In addition, to implement a statutory requirement, FHA will increase its annual premium for most mortgages by 0.1 percentage points. FHA also plans to use its preexisting statutory authority to increase by 0.25 percentage points the annual premium for mortgages exceeding $625,500. Further, FHA will cut its up-front and annual premiums for certain streamline refinancing mortgages—refinancings from one FHA-insured loan into another—to help some existing FHA borrowers take advantage of current low mortgage interest rates.

14The purpose of the algorithm is to objectively measure the borrower’s risk of default quickly and efficiently by examining the data the borrower provides on the loan application and the borrower’s credit score.
management strategy and organizational structure and establishing risk-management policies and processes, FHA hired a consultant to produce a comprehensive report and recommend best practices for its operation.¹⁵ According to FHA officials, FHA plans to adopt the consultant’s recommendation to establish an enterprise risk committee to address overall risk to the organization and a second tier of committees to address program and operational risks. In addition, in 2009 the Office of Single Family Housing implemented an internal quality control initiative at headquarters and the four homeownership centers. For the areas identified as high-risk, headquarters and the homeownership center divisions developed plans to document control objectives and established a monitoring strategy in which each homeownership center submits quarterly reports to headquarters on the effectiveness of the controls, including the status of any mitigation efforts.

However, FHA’s risk-assessment strategy raises several issues. First, FHA’s current risk-assessment strategy is not comprehensive because it is not integrated throughout the organization. While the consultant recommended that FHA integrate risk assessment and reporting throughout the organization, currently the Office of Single Family Housing’s quality control activities and the Office of Risk Management’s activities remain separate efforts. FHA officials noted that until the Office of Risk Management sets up a governance process, the integration suggested by the consultant would not be possible. In the meantime, FHA officials stated that every effort was being made to help ensure that the Office of Risk Management’s activities complemented program office activities. Second, contrary to HUD guidance, the Office Single Family Housing has not conducted an annual, systematic review of risks to its program and administrative functions since 2009. According to an official in this office, although management intended to conduct an annual assessment, the dates slipped because of changes in senior leadership in the Office Single Family Housing, and few staff were available to perform assessments (because of attrition and increased workload). Finally, the Office of Single Family Housing’s current risk-assessment efforts do not include procedures for anticipating potential risks presented by changing conditions. The consultant’s report proposes a reporting process and templates for identifying emerging risks and provides specific examples.

Office of Risk Management officials told us that, once they are operational, the risk committees eventually would determine the exact design and content of these reports and templates.

Moreover, implementation and integration of the new risk-assessment strategy and its planned tools has been slow because of delays in defining the Office of Risk Management’s authority, difficulty filling new staff positions in the Office of Risk Management, and changes in FHA leadership.

All these factors limit FHA’s effectiveness in identifying, planning for, and addressing risk. More specifically, without an integrated risk-assessment strategy, certain risks may not be fully addressed at the operational level in a way that minimizes risk to the insurance programs; without annual reassessments of its risks, the Office of Single Family Housing lacks assurance that its quality control efforts address all its risks; and without ongoing mechanisms in place to anticipate and address new or emerging risks, FHA lacks a systematic approach to help the agency identify, analyze, and formulate timely plans to respond most effectively to changed conditions and risks. Therefore, we recommended that FHA (1) integrate the internal quality control initiative of the Office of Single Family Housing into the operational risk processes of the Office of Risk Management, (2) conduct an annual risk assessment, and (3) establish ongoing mechanisms—such as use of the report templates from the 2010 consultant’s report—to anticipate and address risks that might be caused by changing conditions. FHA agreed with the recommendations and, as of January 2012, indicated that it either was working toward achieving the recommendations or had plans to do so in the very near future. For example, FHA said it would leverage or integrate existing risk management efforts as soon as the Office of Risk Management’s final governance structure and risk management strategies were in place. The agency also stated that the Office of Risk Management would conduct an annual risk assessment as a component of its overall risk management strategy. It stressed that ongoing mechanisms to anticipate and address risks related to changing conditions would be part of the office’s strategy.

FHA Has Taken Steps to Address Counterparty Risks but Continues to Face Human Capital Challenges

With growth in loan volume, the number of lenders and appraisers (or counterparties) participating in FHA’s single-family programs also has grown. The total number of FHA-approved lenders increased 24 percent, from 10,370 in 2006 to 12,844 in 2010. The number of FHA-approved appraisers increased approximately 67 percent from 33,553 in 2006 to 56,192 in 2010.
FHA has made recent changes to address risks posed by its lenders and appraisers. For example, on May 20, 2010, FHA stopped approving new loan correspondents. And as of January 1, 2011, existing loan correspondents could no longer participate in FHA programs. Former loan correspondents now can participate only as third-party originators through sponsorship by FHA-approved lenders. As a result, as of September 2011, the number of FHA-approved lenders had declined to about 3,700. Furthermore, the agency has increased the net worth requirement for approved lenders. On May 20, 2011, FHA increased the requirement for existing lenders to $1 million, except for lenders classified as small under the Small Business Administration’s size standards (their requirement increased to $500,000). As of May 20, 2013, FHA will require a net worth of $1 million for all lenders, plus 1 percent of the total loan volume in excess of $25 million, to a maximum required net worth of $2.5 million.

To help ensure that lenders and appraisers follow its policies and procedures, FHA also has enhanced the criteria used to select loans for reviews. Specifically, since May 3, 2010, the agency has considered high-risk loan or borrower characteristics, such as certain types of refinanced loans and loans to borrowers with low credit scores. Additionally, FHA increased the number of risk factors used to target lenders for review.

FHA also has revised its approach for overseeing appraisers.

FHA has addressed staffing and training needs and succession planning to some extent, but it lacks plans that strategically address future workforce needs, including replacing retiring staff. Although workforce planning practices used by leading organizations include defining critical skills and skill gaps, FHA’s current approach does not have mechanisms for doing so. FHA previously had a multiyear workforce plan that identified the critical competencies; analyzed skills and competencies, including gaps; and proposed comprehensive strategies to address these gaps, but it has not created another such plan. Instead, FHA has relied on

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16 Loan correspondents were lenders that originated FHA-insured loans—meaning that they could accept mortgage applications, obtain employment verifications and credit histories on applicants, order appraisals, and perform other tasks that precede the loan underwriting process—but did not have direct endorsement authority. Direct endorsement authority is the authority to underwrite loans and determine their eligibility for FHA mortgage insurance without HUD’s prior review.

17 Loan volume is defined as FHA single-family insured mortgages originated, underwritten, purchased, or serviced during the prior fiscal year.

18 Department of Housing and Urban Development, Strategic Workforce Plan, FY04 to FY08, Office of Housing, (Washington, D.C.: July 2004).
occasional Resource Estimation and Allocation Process studies and annual managerial assessments of staffing and training needs.\textsuperscript{19}

FHA also currently does not have a succession plan, although a plan for 2006–2009 identified mission-critical positions, analyzed existing staff competencies, assessed the number of retirement-eligible employees, and determined the probability of near-term retirements.\textsuperscript{20} Succession planning is particularly important because, as of July 2011, almost 50 percent of the Office 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.

While FHA has taken some steps to address succession planning, these steps have been limited. FHA implemented two initiatives focused on succession planning. The first, begun in 2010, was intended to help ensure that, at any given time, at least two additional supervisors, managers, or executives could perform the work of each supervisor, manager, or executive. However, this does not apply to staff positions beyond management. The second initiative also began in 2010. Its goal is to train and develop staff. Neither initiative assesses the number of retirement-eligible employees in critical positions as required by HUD guidance. According to FHA officials, as resources have dwindled, they have considered all their positions to be critical.

According to FHA officials, plans to update their workforce and succession plans were suspended. In 2007–2009, FHA had a workforce planning process designed to identify critical skill gaps and a strategy for addressing these gaps. According to the officials, HUD told FHA to stop this initiative in 2009 because HUD was going to implement a workforce planning process for the entire department. However, HUD’s effort never came to fruition because of funding shortages. Without a more comprehensive workforce planning process that includes succession planning, FHA’s ability to systematically identify the workforce needed for the future and plan for upcoming retirements is limited. Therefore, we

\textsuperscript{19}Resource Estimation and Allocation Process studies establish a staffing baseline for budget formulation and execution, strategic planning, organizational and management analyses, and ongoing management of staff resources.

recommended that FHA develop workforce and succession plans for the Office of Single Family Housing. FHA agreed, stating that it would develop a formal workforce plan and had efforts under way to develop a succession plan. For example, FHA indicated that it would conduct a comprehensive workforce analysis by the end of January 2012 to determine mission-critical positions, analyze skill gaps, and assess retirement eligibilities and probabilities.

Ginnie Mae has undertaken efforts to improve risk management, but as many of these efforts remain in planning or under development, they merit continued commitment and follow through from senior management. Ginnie Mae faces operational risk related to limited staffing and reliance on contractors in the context of increased market share and volume. And, while Ginnie Mae’s revenues exceeded its costs, and it has accumulated a capital reserve of about $14.6 billion, its modeling of estimated cost and revenues could be improved by incorporating certain practices, such as using the best available data, that we believe represent sound internal controls for models.

Ginnie Mae has taken steps to better manage operational and counterparty risks and has several initiatives planned or under way. GAO and others have identified limited staff, substantial reliance on contractors, and the need for modernized information systems as risks that Ginnie Mae may face. Ginnie Mae’s counterparty risk would stem from the failure of issuers of Ginnie Mae-guaranteed MBS to provide investors with monthly principal and interest payments.

Although Ginnie Mae’s market share and volume of MBS has increased in recent years, its (noncontractor) staff levels have been relatively constant during this time. In recent years, its actual staff levels have been below its authorized staff levels. Ginnie Mae’s internal control reviews for 2009 and 2010 identified a control deficiency due to employee vacancies, including multiple vacancies in certain positions relevant to internal controls. The 2011 internal control review had no findings related to employee vacancies. As part of a broad effort to address and mitigate its

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21 From calendar year 2007 to calendar year 2010, Ginnie Mae’s share of the MBS market increased from nearly 5 to 25 percent. As of 2010, Ginnie Mae guaranteed more than $1 trillion in outstanding MBS composed primarily of FHA-insured mortgages.
operational risks related to staffing levels, Ginnie Mae has incorporated some principles consistent with our internal control and management tool. Consistent with this guidance, Ginnie Mae has identified skill gaps in staff resources, developed a plan to hire additional staff, and made changes to its organizational structure. The President’s budget for 2012 requested $30 million for administrative expenses at Ginnie Mae, which included supporting 137 full-time equivalent positions (FTE). Ginnie Mae officials told us that, if this request was not approved, the agency would be forced to use its limited resources across its many risk-management efforts and would leave it with little capacity to conduct preventative or forward-looking analyses. The enacted 2012 budget provides $19.5 million for these administrative expenses and up to an additional $3 million, depending on the volume of Ginnie Mae’s guarantees.

Between 2005 and 2010, as Ginnie Mae’s volume and issuer activity increased, and staff levels remained largely the same, the agency increasingly relied on contractors. Contract obligations in 2010 were more than 14 times the contract obligations in 2005. According to Ginnie Mae officials, they have contracted out many functions because the agency has flexibility to use agency revenues to procure contractors. That is, statutorily Ginnie Mae has flexibility to spend funds for contracting expenses because these expenses can be funded from agency revenues without annual appropriations. Ginnie Mae depends on contractors to provide a variety of services, including those related to guaranteeing MBS, such as collecting data from issuers and processing monthly principal and interest payments to investors. In addition, Ginnie Mae relies on several contractors to take over the servicing responsibilities on pooled loans when issuers default. Ginnie Mae has used its own staff as well as third-party assessments of contracts, to oversee its contractors but plans to provide additional staff resources to supplement the third-party assessments. However, officials said that implementation of this plan has been put on hold due to changes in the Ginnie Mae budget. Additionally, Ginnie Mae has conducted risk assessments of its contracts and potential operational risks, and it plans to review the proposed recommendations and determine how to implement them.

Ginnie Mae has been working on an ongoing initiative to improve its information technology systems. According to officials, Ginnie Mae has been working on the first phase of its business process improvement initiative for the last few years based on a plan developed in conjunction with the Office of Management and Budget. The main goal of the initiative is to modernize the agency’s technology by consolidating processes and eliminating redundant systems. Some of the weaknesses included outdated data systems, a reliance on paper-based processes, and a lack of integrated data systems. According to Ginnie Mae, the first phase of the initiative resulted in the creation of nine new information technology system initiatives such as a system that allows Ginnie Mae to receive enhanced reporting and provide status information to issuers. Ginnie Mae has been drafting a strategy document for its ongoing initiative to look for additional improvement opportunities in its information technology systems.

To manage its counterparty risk, Ginnie Mae has processes in place to oversee MBS issuers that include approval, monitoring, and enforcement and has revised its approval and monitoring procedures. For example, in 2010, Ginnie Mae increased the minimum net worth requirement for issuers of Ginnie Mae-guaranteed MBS to $2.5 million. But, planned initiatives to enhance its risk-management processes for issuers, including its tracking and reporting systems, have not been fully implemented. These initiatives include a plan to develop a database for tracking the resolution and timing of findings from reviews of issuers. It will be important for Ginnie Mae to complete its initiatives related to operational and counterparty risk as soon as practicable. Our November 2011 report includes an appendix that contains a listing of Ginnie Mae’s planned and proposed initiatives and their expected completion dates.23

Ginnie Mae Has Not Yet Implemented Certain Practices for Modeling Costs and Revenues

In developing inputs and procedures for the model used to forecast costs and revenues, Ginnie Mae did not consider certain practices identified in Federal Accounting Standards Advisory Board (FASAB) guidance for preparing cost estimates of federal credit programs. Ginnie Mae has not developed estimates based on the best available data, performed sensitivity analyses to determine which assumptions have the greatest impact on the model, or documented why it used management

23GAO-12-49.
assumptions rather than available data. By not fully implementing practices in FASAB guidance that we believe represent sound internal controls for models, Ginnie Mae’s model may not be using critical data that could affect the agency’s ability to provide well-informed budgetary cost estimates and financial statements. This may limit Ginnie Mae’s ability to accurately report to Congress the extent to which its programs represent a financial exposure to the government.

We recommended in our November 2011 report on Ginnie Mae that the HUD Secretary direct Ginnie Mae to take steps to ensure its model more closely follows certain practices identified in FASAB guidance for estimating subsidy costs of credit programs. More specifically, Ginnie Mae should (1) assess and document that it is using the best available data in its model and most appropriate modeling approach; (2) conduct and document sensitivity analyses to determine which cash flow assumptions have the greatest impact on the model; (3) document how management assumptions are determined, such as those for issuer defaults and mortgage buyout rates; and (4) assess the extent to which management assumptions, such as those for issuer defaults and mortgage buyout rates, can be replaced with quantitative estimates. Ginnie Mae has indicated that it plans to implement all of our recommendations but has not provided a specific timeline. In addition, Ginnie Mae agreed with our observation about the importance of completing ongoing and planned initiatives for enhancing its risk-management processes, as soon as practicable, to improve operations.

Mr. Chairman, Ranking Member Olver, and Members of the Subcommittee, this concludes my prepared statement. I would be happy to respond to any questions that you may have at this time.

For further information about this testimony, 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 statement. Individuals making key contributions to this testimony include Paige Smith, Assistant Director; Andrew Pauline, Assistant Director; Steve Westley, Assistant Director; Dan Alspaugh; Nadine Garrick Raidbard; John McGrail; Marc Molino; José R. Peña; Beth Reed Fritts; Paul Revesz; and Barbara Roesmann.
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