



## Testimony

Before the Subcommittee on Housing and Community  
Opportunity, Committee on Financial Services  
House of Representatives

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# MORTGAGE FINANCING

## Actuarial Soundness of the Federal Housing Administration's Mutual Mortgage Insurance Fund

Statement of Thomas J. McCool, Managing Director  
Financial Markets and Community Investment



**G A O**

Accountability \* Integrity \* Reliability

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Madam Chairwoman and Members of the Subcommittee:

We are here today to discuss the results of our analysis of the financial health of the Mutual Mortgage Insurance Fund (Fund) of the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA). Through the Fund, FHA operates a single-family insurance program that helps millions of Americans buy homes. The Fund, which is financed through insurance premiums, has operated without cost to the American taxpayer. Last year, the Fund's economic value appeared to have reached its highest level in at least 20 years—prompting proposals to spend some of the Fund's current resources or reduce net cash flows into the Fund. Concerned about how the soundness of the Fund is measured and proposals to spend what some were calling “excess reserves,” you requested that we analyze the financial health of the Fund.

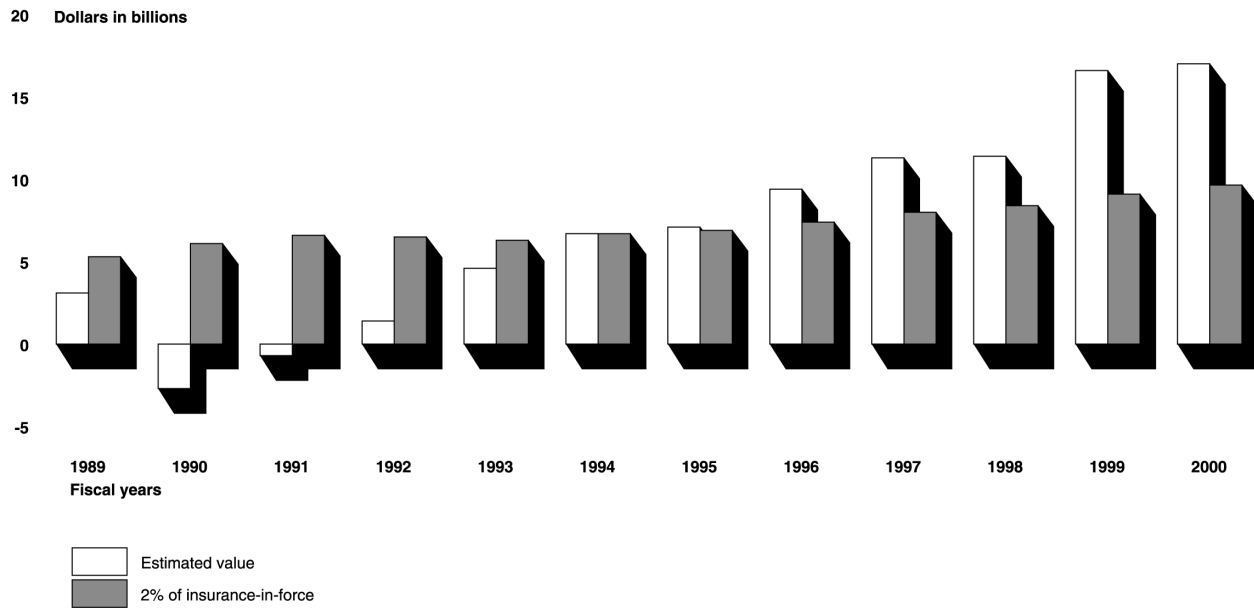
Since 1990 the economic health of the Fund has been assessed by measuring the economic value of the Fund—its capital resources plus the net present value of future cash flows—and the related capital ratio—the economic value as a percent of the Fund's insurance-in-force. For most of its history, the Fund was relatively healthy; however, in fiscal year 1990 the Fund was estimated to have a negative economic value, and its future was in doubt. To help place the Fund on a financially sound basis, Congress enacted legislation in November 1990 that required the Secretary of HUD to, among other things, take steps to achieve a capital ratio of 2 percent by November 2000<sup>1</sup> and to maintain or exceed that ratio at all times thereafter. The legislation also required the Secretary to raise insurance premiums and suspend the rebates, called distributive shares, that FHA borrowers had been eligible to receive under certain circumstances. As a result of the 1990 housing reforms, the Fund must not only meet capital ratio requirements, it must also achieve actuarial soundness; that is, the Fund must contain sufficient reserves and funding to cover estimated future losses resulting from the payment of claims on foreclosed mortgages and administrative costs. However, neither the legislation nor the actuarial profession defines actuarial soundness.

The 1990 FHA reforms required that an independent contractor conduct an annual actuarial review of the Fund. These reviews have shown that during the 1990s, the estimated economic value of the Fund grew substantially. As figure 1 shows, by the end of fiscal year 1995, the Fund attained an estimated economic value that slightly exceeded the amount required for a 2-percent capital ratio. Since that time, the estimated economic value of the Fund continued to grow and always exceeded the amount required for a 2-percent capital ratio. In the most recent review, Deloitte & Touche (Deloitte) estimated the Fund's economic value at about \$17.0 billion at the end of fiscal year 2000. This represents about 3.51 percent of the Fund's insurance-in-force—well above the required minimum of 2 percent.

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

**Figure 1: Comparison of Estimated Economic Value and 2 Percent of Insurance-in-Force, 1989-2000**



Source: GAO analysis of Price Waterhouse (now PricewaterhouseCoopers) and Deloitte & Touche data.

Concerned about the adequacy of the minimum 2-percent requirement and about proposals to spend what some were calling excess reserves, you asked us to determine the conditions under which an estimated capital ratio of 2 percent would be adequate to maintain the actuarial soundness of the Fund. Specifically, you asked us to (1) estimate the value of the Fund at the end of fiscal year 1999, given expected economic conditions, and compare our estimate to the estimate of the value of the Fund reported by HUD for that year; (2) determine the extent to which a 2-percent capital ratio would allow the Fund to withstand worse-than-expected loan performance due to economic and other factors; and (3) describe some options for adjusting the size of the Fund if the estimated capital ratio is different from the amount needed and describe the impact that these options might have on the Fund, FHA mortgagors, and the federal budget.

In summary:

- We estimate that the Fund had an economic value of about \$15.8 billion at the end of fiscal year 1999. This estimate implies a capital ratio of 3.20 percent of the unamortized insurance-in-force. Although we did not evaluate the quality of the 1999 estimates prepared by Deloitte, using a different method of analysis, we believe that Deloitte's estimates and ours are comparable because of the uncertainty inherent in forecasting and the professional judgements made in this type of analysis. Both of these estimates easily exceed the minimum required capital ratio of 2 percent that Congress set in 1990.
- Given the economic value of the Fund and the state of the economy at the end of fiscal year 1999, a 2-percent capital ratio appears sufficient to withstand moderately severe economic downturns that could lead to worse-than-expected loan performance. That is, under

economic scenarios that we developed to represent regional and national economic downturns that the nation experienced between 1975 and 1999, the estimated capital ratio fell by only slightly less than 0.4 percentage points. Some more severe downturns that we analyzed also did not cause the estimated capital ratio to decline by as much as 2 percentage points. However, in three more severe scenarios, an economic value of 2 percent of insurance-in-force would not have been adequate. Nonetheless, because of the nature of such analysis, we urge caution in concluding that the estimated value of the Fund today implies that the Fund would necessarily withstand any particular economic scenario under all circumstances.

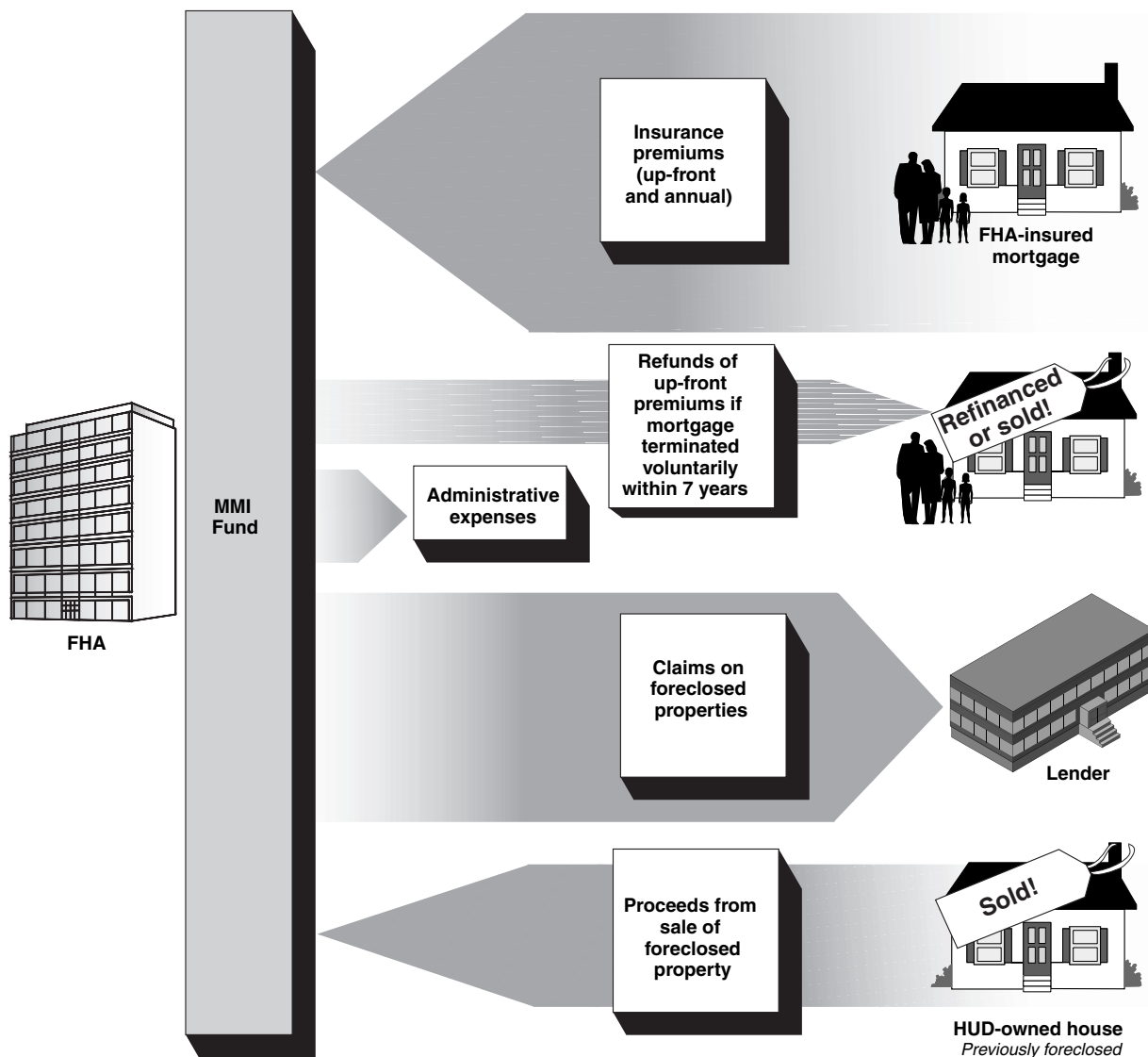
- Congress and the Secretary of HUD have taken and could take a number of actions to influence the economic value of the Fund. The impact that these actions have on the capital ratio and FHA borrowers is not always certain. However, actions that influence the Fund's reserve levels will also affect the federal budget. In short, any proposal that seeks to use reserves, if not accompanied by a reduction in other spending or an increase in receipts, will result in a decline in the federal budget surplus.

Let me start by describing our estimates of the Fund's economic value and capital ratio and how our estimates compare with estimates prepared by Deloitte & Touche.

### **The Fund's Capital Ratio Exceeds 3 Percent**

The economic value of the Fund consists of current capital resources and the net present value of future cash flows. Investments in nonmarketable Treasury securities represent the largest component of FHA's current capital resources. Estimating the net present value of future cash flows is a complex actuarial exercise that requires extensive professional judgment. Cash flows into the Fund from premiums and the sale of foreclosed properties; cash flows out of the Fund to pay claims on foreclosed mortgages, premium refunds, and administrative expenses. (See fig. 2.)

Figure 2: Cash Flows of the Mutual Mortgage Insurance Fund



At the end of fiscal year 1999, the Fund had capital resources of \$14.3 billion. Using our models and forecasts of likely values of key economic variables, we estimated that the Fund had a net present value of future cash flows of \$1.5 billion at that time. This yielded an estimated economic value of \$15.8 billion and a capital ratio of 3.20 percent. Given the inherent uncertainty of these estimates and the professional judgements involved, these numbers are comparable to those of Deloitte at the end of 1999, when Deloitte estimated that under expected economic conditions the capital value was \$16.6 billion and the capital ratio was 3.66 percent. Much of the difference seems to be the result of performing the analyses at different times. Because Deloitte performed its analysis before the end of fiscal year 1999, it had to estimate the

Fund's capital resources and insurance-in-force, while we were able to use the year-end values. In its recent estimates for 2000, Deloitte noted that in the actuarial review for fiscal year 1999, it had overestimated the Fund's capital resources by about \$1 billion. However, Deloitte did not restate the economic value and capital ratio for 1999; instead it adjusted the starting point for the 2000 estimate of economic value. If Deloitte had restated the economic value and capital ratio for fiscal year 1999, the 1999 values would likely have been smaller. Because Deloitte uses estimates for the Fund's capital resources and insurance-in-force, it is difficult to compare its estimates of the Fund's economic value and capital ratio over time.

**Table 1: Estimates of Capital Ratios for FHA's Mutual Mortgage Insurance Fund by GAO and Deloitte & Touche, End of FY 1999**

Dollars in millions

Estimate	Total capital resources	Future cash flows	Economic value	Unamortized insurance-in-force	Capital ratio (percent)
GAO	\$14,326	\$1,484	\$15,810	\$493,990	3.20
Deloitte	15,331	1,306	16,637	454,184	3.66

Source: GAO analysis and *Actuarial Review of MMI Fund as of FY 1999*, Deloitte & Touche.

The Fund's economic value principally reflects the large amount of capital resources that the Fund has accrued. Because current capital resources are the result of previous cash flows, the robustness of the economy and the higher premium rates throughout most of the 1990s accounted for the accumulation of these substantial capital resources. Good economic times that are accompanied by relatively low interest rates and relatively high levels of employment are usually associated with high levels of mortgage activity and relatively low levels of foreclosure; therefore, cash inflows have been high relative to outflows during this period.

The estimated value of future cash flows also contributed to the strength of the Fund at the end of fiscal 1999. As a result of relatively low interest rates and the robust economy, FHA insured a relatively large number of mortgages in fiscal years 1998 and 1999, and these loans make up a large portion of FHA's insurance-in-force. Because of their low interest rates and because forecasts of economic variables for the near future show house prices rising while unemployment and interest rates remain fairly stable, our models predict that these new loans will have low levels of foreclosure and prepayment. At the same time, we assume that many FHA-insured homebuyers will continue to pay FHA annual insurance premiums.<sup>2</sup> Thus, our

<sup>2</sup> Most borrowers with FHA-insured loans who received them prior to September 1983 were required to pay an annual insurance premium for the life of the loan. In addition, most borrowers who received FHA-insured loans after June 1991 are required to pay an annual insurance premium for up to the life of the loan, depending on loan type and the initial loan-to-value ratio of the loan. Borrowers who received FHA-insured loans between September 1983 and June 1991 were not required to pay annual mortgage insurance premiums.

models predict that cash flowing into the Fund from mortgages already in FHA's portfolio at the end of fiscal year 1999 will be more than sufficient to cover the cash outflows associated with these loans.

The future cash flows are estimates based on a number of assumptions about the future, including predictions of mortgage foreclosures and the likelihood that those holding FHA-insured mortgages will prepay their loans. These predictions are based on elaborate models that estimate past relationships between foreclosures and prepayments and certain economic variables, such as changes in house prices. To the extent that these relationships are different in the future, the actual foreclosures and prepayments will differ from the estimates. The estimating procedures make many other assumptions, and I will describe some of these limitations in greater detail later in my testimony.

### **The Actuarial Soundness of the Fund Depends on the Risks That Congress Wants the Fund to Withstand**

Although our estimates and Deloitte's estimates of the Fund's capital ratio under expected economic conditions are comparable, we cannot conclude on the basis of these estimates alone that the Fund is actuarially sound. Instead, we believe that to determine actuarial soundness one should measure the Fund's ability to withstand certain worse-than-expected conditions. According to our estimates, worse-than-expected loan performance that could be brought on by moderately severe economic conditions would not cause the estimated value of the fund at the end of fiscal year 1999 to decline by more than 2 percent of insurance-in-force. Some more severe downturns that we analyzed also did not cause the estimated capital ratio to decline by as much as 2 percentage points. However, a few more severe economic scenarios could result in such poor loan performance that the estimated value of the fund at the end of fiscal year 1999 could decline by more than 2 percent of insurance-in-force.

To help determine the Fund's ability to withstand certain worse-than-expected conditions, we generated economic scenarios that were based on economic events in the last 25 years and other scenarios that could lead to worse-than-expected loan performance in the future. Under each of these scenarios, we used our models to estimate the economic value of the Fund and the related capital ratio (see table 2). Most of the scenarios we looked at had only a small impact on the capital ratio. For example, the worst historical scenario we tested, one based on the 1981-82 national recession, lowered the capital ratio by less than 0.4 percentage points—about 20 percent of the required 2 percent minimum capital ratio. To see how the economic value of the Fund would change as the extent of adversity increased, we extended regional scenarios that were based on historical economic downturns experienced in three states—the west south central downturn based on Louisiana in the late 1980s, the New England downturn based on Massachusetts in the late 1980s and early 1990s, and the Pacific downturn based on California in the 1990s—to the nation as a whole. In extending the west south central and Pacific downturns, the estimated capital ratio was about 1 percentage point lower than in the base case. However, our models estimate that extending the New England downturn to the country as a whole would reduce the capital ratio by almost 2.4 percentage points. In another scenario, in which we specify that interest rates fall substantially, inducing refinancing, and then a recession sets in, leading to increased foreclosures, the estimated capital ratio fell substantially, by over 1.8 percentage points.

In one other scenario, the capital ratio fell by over 2 percentage points. In that scenario we assumed that foreclosure rates in 2000 through 2004 equal foreclosure rates from 1986 through 1990 for mortgages originated in the 10-year periods prior to 2000 and 1986, respectively.



**Table 2: Capital Ratios Under Expected and More Severe Economic Scenarios in Selected Locations**

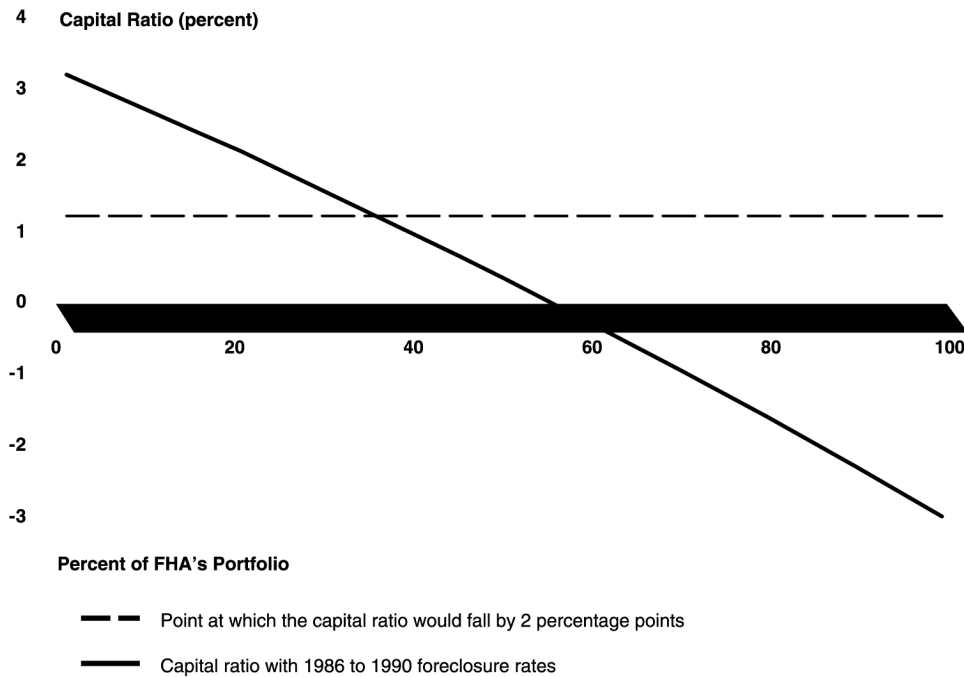
Scenario	Description	Capital ratio for scenarios in one region (percent)	Capital ratio for national scenarios (percent)
Expected economic conditions	Unemployment and interest rates vary as DRI forecasts; house price growth is adjusted for constant quality and slower growth <sup>a</sup>	NA	3.20
Historical regional downturns			
West south central downturn	House prices and unemployment rates change as they did in Louisiana from 1986 through 1990.	3.06	2.31
New England downturn	House prices and unemployment rates change as they did in Massachusetts from 1988 through 1992.	3.14	0.81
Pacific downturn	House prices and unemployment rates change as they did in California from 1991 through 1995.	2.89	2.16
Other national scenarios			
1981-82 Recession	For each state, house prices, unemployment rates, and interest rates change as they did from 1981 through 1985.	NA	2.81
Induced refinancing followed by a recession	Mortgage interest rates fall, inducing borrowers to refinance, and then a recession sets in, with a rising unemployment rate and falling house prices.	NA	1.37

Rising interest rate scenario	Mortgage and other interest rates from 2000 through 2004 are higher than under expected economic conditions.	NA	3.36
Scenario with foreclosure rates from the 1980s	Foreclosure rates in 2000 through 2004 equal foreclosure rates from 1986 to 1990 for mortgages originated in most recent 10-year period.	NA	0.92

<sup>a</sup>Standard and Poor's DRI is a private economic forecasting company.  
Source: GAO analysis.

Because none of our economic scenarios generated foreclosure rates as high as those experienced in the west south central states in the late 1980s, we applied these rates directly to our models, assuming that for the next 5 years foreclosure rates in most cases would be equivalent to those experienced by the west south central states in 1986 through 1990. Then we varied the proportion of FHA's portfolio experiencing these high foreclosure rates. As figure 3 shows, if about 36 percent of the portfolio experiences these rates, the estimated capital ratio would be 2 percentage points lower than the expected case; and if 55 percent of the portfolio experienced these rates, the economic value of the Fund would fall to zero.

**Figure 3: Capital Ratios Resulting From Applying the Average 1986-90 Foreclosure Rates in the West South Central Census Division to Varying Proportions of FHA's Insurance Portfolio in 2000-04**



Note: West south central mortgages made up 9 percent of FHA's portfolio in 1999. This analysis does not change foreclosure rates for streamline refinanced or adjustable rate mortgages because there are little data on these

products for the 10-year period prior to 1986. The west south central Census division includes Arkansas, Louisiana, Oklahoma, and Texas.

Source: GAO analysis.

As we have stated in the past, there is considerable uncertainty associated with any estimate of the economic value of the Fund because of uncertainty about the performance of FHA's loan portfolio over the life of the existing loans, which, in some cases, can be for 30 years. We believe that our models make good use of historical experience in identifying the key factors that influence loan foreclosures and prepayments and estimating the relationships between those factors and loan performance. In addition, we have relied on reasonable, and in some cases conservative, forecasts of economic variables, such as the rate of house price appreciation and the unemployment rate, in finding that the Fund's economic value in fiscal year 1999 appeared higher than necessary to withstand many adverse economic scenarios.

Nonetheless, several additional factors lead us to believe that Congress and others should apply caution in concluding that the estimated value of the Fund today implies that the Fund could withstand the economic scenarios that we examined under all circumstances. Our estimates and those of others are valid only under a certain set of conditions, including that loans FHA insured in recent years and loans it insured in the more distant past have a similar response to economic conditions, and that cash inflows associated with future loans at least offset cash outflows associated with those loans. Some specific factors beyond those incorporated in our models that could determine the extent to which the Fund will be able to withstand adverse economic conditions are as follows:

- **The performance of recent loans**—Over 40 percent of FHA's loan portfolio at the end of fiscal year 1999 consisted of loans originated in fiscal years 1998 and 1999. As a result, the performance of these loans will have an important effect on the overall performance of FHA's loan portfolio. However, because these loans are so new, we do not have a lot of data yet showing how well they will perform over their lifetimes, which is often 30 years. Our model is based on data on loan performance for loans originating from 1975 through 1999. As long as the influences of key predictive factors on the probabilities of foreclosure and prepayment have not changed much over time, then we can be reasonably confident that the estimates of these relationships generated by our models will apply to these recent loans. However, in recent years, FHA's competitors in the conventional mortgage market—private mortgage insurers and conventional mortgage lenders—are increasingly offering to selected homebuyers products that compete with FHA's for those homebuyers who are borrowing more than 95 percent of the value of their homes. By lowering the required down payment, conventional mortgage lenders and private mortgage insurers may have attracted some less risky borrowers who might otherwise have insured their mortgages with FHA. And this may have increased the average risk of FHA-insured loans in the late 1990s. However, because these loans are relatively new, the increased risk would not yet be observable in the data on foreclosures and prepayments. If this effect, known as adverse selection, has been substantial, the economic value of the Fund may be lower than we estimate, and it may be more difficult for the Fund to withstand worse-than-expected loan performance than our estimates suggest.
- **Changes in FHA's insurance program**—A number of changes that FHA has made or might make in the future could affect the future cash flows associated with loans in FHA's portfolio as of the end of fiscal year 1999 and, therefore, the Fund's economic value, in ways that are

not accounted for in our models. For example, if HUD reinstates paying distributive shares to borrowers when they pay their mortgages in full or voluntarily terminate their insurance, cash outflows might be higher than our estimates.<sup>3</sup> FHA's loss mitigation program might either reduce or increase cash outflows, depending on whether the program succeeds in reducing foreclosures or whether the program mainly results in delayed foreclosures that lead to larger losses for FHA in the long run. On the other hand, if FHA's financial counseling program reduces foreclosures for those homebuyers who received such counseling, then losses to the Fund will be less than we have estimated. Steps taken by HUD to improve the oversight of lenders and the disposition of properties could also reduce the level of losses to FHA below what we have estimated.

- **The impact of new loans**—Our models do not look at cash flows associated with loans that FHA would insure after fiscal year 1999. Our analysis of the ability of the Fund to withstand adverse economic conditions requires making the assumption that the adverse conditions would not also cause loans insured by FHA after fiscal year 1999 to be an economic drain on the Fund. Since the 1990 FHA reforms, the cash flows associated with each year's loans have been estimated to have a positive economic value, thereby adding to the economic value of the entire Fund. However, during adverse economic times, new loans might perform worse than loans that were insured by FHA during the 1990s. Furthermore, recent and future changes in FHA's insurance program may cause these loans to perform differently from how past experience suggests that they will. If, for example, FHA loosens underwriting standards, future loans may perform worse than past experience suggests. In addition, the recent reduction in up-front premiums could reduce cash inflows into the Fund, although it could also lower the riskiness of the loans that FHA insures. If the newly insured loans perform so poorly that they have a negative economic value, then the loss to the Fund in any of the adverse economic scenarios that we have considered would be greater than what we have estimated. Alternatively, if the newly issued loans have positive economic values, then they would contribute to further growth of the Fund.

Caution also needs to be applied in making changes to FHA's insurance program because of the current uncertainty about their impact on the Fund. In analyzing the impact of changes in FHA's programs and policies on the Fund, it is important to recognize that such changes can affect the volume and riskiness of loans that FHA insures. Although the models currently used in the annual actuarial reviews of the Fund can be used to estimate the direct impact that some policy changes may have on the Fund's economic value, these models cannot isolate indirect effects on the volume and riskiness of FHA's loans. Accordingly, in our report, we recommended that the Secretary of HUD develop better tools for assessing the impacts that these changes may have on the volume and riskiness of loans that it insures.<sup>4</sup>

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<sup>3</sup>Between 1943 and 1990, FHA rebated these so-called excess funds to borrowers as distributive shares. In 1990, however, Congress suspended the payment of these shares until the Secretary of HUD determines that the Fund is actuarially sound. HUD has announced that it will resume paying distributive shares. HUD officials said that they are developing systems to facilitate the payment of these shares and expect to be ready to resume paying them in mid-2001.

<sup>4</sup> *Mortgage Financing: FHA's Fund Has Grown, but Options for Drawing on the Fund Have Uncertain Outcomes* (GAO-01-460, Feb. 28, 2001).

## **Options for Drawing on the Fund Have Uncertain Outcomes, But Any Use of the Fund's Reserves Will Affect the Federal Budget**

Given the recent growth in the economic value of the Fund, several proposals have been made to use what some are calling excess reserves or take other actions that could result in a change in the value of the Fund. If Congress or the Secretary of HUD believes that the economic value of the Fund is higher than the amount needed to ensure actuarial soundness, several changes to the FHA single-family loan program could be adopted. The impact that these actions might have on the capital ratio and FHA borrowers is difficult to assess without using tools designed to estimate the multiple impacts that policy changes often have. However, any actions that influence the Fund's reserve levels will also affect the federal budget. In short, any proposal that seeks to use reserves, if not accompanied by a reduction in other spending or an increase in receipts, would result in either a reduction in the surplus or an increase in any existing deficit.

Several changes to the FHA single-family loan program could be adopted if Congress or the Secretary of HUD believes that the economic value of the Fund is higher than the amount needed to meet its definition of actuarial soundness. For example, actions that the Secretary could take that could reduce the value of the Fund include lowering insurance premiums, adjusting underwriting standards, and reinstating distributive shares. However, congressional action in the form of new legislation would be required to make other program changes that are not now authorized by the statute. These would include such actions as changing the maximum amount FHA-insured homebuyers may borrow relative to the price of the house they are purchasing and using the Fund's reserves for other federal programs.<sup>5</sup>

Reliably estimating the potential effect of various options on the Fund's capital ratio and FHA borrowers is difficult because the impacts of these policy changes are complex, and tools available for handling these complexities may not be adequate. Policy changes have not only immediate, straightforward impacts on the Fund and FHA's borrowers, they also have more indirect impacts that may intensify or offset the original effect. Implementing these options could affect both the volume and the average riskiness of loans made, which, in turn, could affect any future estimate of the Fund's economic value. As a result of this complexity, obtaining a reliable estimate would likely require that economic models be used to estimate the indirect effects of policy changes. At this time, however, neither the models used by HUD to assess the financial health of the Fund, nor those used by others, explicitly recognize the indirect effects of policy changes on the volume and riskiness of FHA's loans. As a result, HUD cannot reliably estimate the impact of policy changes on the Fund.

Although it is difficult to predict the overall impact of a change on the Fund's capital ratio and thus on FHA borrowers as a whole, different options would likely have different impacts on current and prospective FHA-insured borrowers. Some proposals would more likely benefit existing and future FHA-insured borrowers, while others would benefit only future borrowers, and still others would benefit neither of these groups. One interpretation of the higher premiums that borrowers paid during the period in which the economic value of the fund has

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<sup>5</sup> During the 106<sup>th</sup> Congress, legislation was introduced that proposed using the Fund's resources to fund affordable rental housing (see S. 2997).

been rising is that borrowers during the 1990s “overpaid” for their insurance. Some options for reducing the capital ratio, such as reinstating distributive shares, would be more likely to compensate these borrowers. The payment of distributive shares would benefit certain existing borrowers who voluntarily terminate their mortgages. If these policies continued into the future, they would also benefit future policyholders. Alternatively, reducing up-front premiums, reducing the number of years over which annual insurance premiums must be paid, or relaxing underwriting standards would tend to benefit only future borrowers.

Under 1990 credit reform legislation, FHA’s budget is required to reflect the subsidy cost to the government of FHA’s loan insurance activities for that year.<sup>6</sup> Credit reform was intended to ensure that the full cost of credit activities for the current budget year would be reflected in the federal budget so that Congress and the executive branch could consider these costs when making annual budget decisions. For FHA’s Mutual Mortgage Insurance Fund, the subsidy cost is negative; that is, the program is operating at a profit. Under credit reform, the negative subsidy receipts would be available for appropriation for other uses, and a balance would not be permitted to accumulate in the liquidating account. However, to accommodate the differing statutory requirements of budgeting for the subsidy cost of insuring the loans and maintaining a 2-percent reserve, the Office of Management and Budget (OMB) and FHA have allowed reserves to accumulate in the Fund in the form of interest-bearing Treasury securities. At the end of fiscal year 1999, FHA held nearly \$15 billion in Treasury securities. These securities represent a claim on the U.S. Treasury to cover future losses to the Fund. From the perspective of the U.S. Treasury, these securities represent a liability. From the standpoint of the government as a whole, the securities represent a debt owed by one part of the federal government to another. By investing in nonmarketable Treasury securities, FHA makes funds available to other federal programs. Each year that the Fund runs a surplus, the budget surplus for the federal government, as a whole, is higher than it would otherwise have been if FHA had not been insuring profitable loans. When the total federal budget was in a deficit (as it was for most of the 1990s), that deficit was lower than it would have been if the Fund had not been realizing a surplus at the same time.

Because of the difficulty in reliably measuring the effect of most actions that could be taken either by Congress or the Secretary of HUD on the Fund’s capital ratio, we cannot precisely measure the effect of these policies on the budget. However, any actions taken by Congress or the Secretary that influence the Fund’s capital ratio will have a similar effect on the federal budget. If Congress or the Secretary of HUD adopts policies, such as lowering premiums, paying distributive shares, or loosening underwriting standards, that reduce the profitability of the Fund, the negative subsidy amount reported in FHA’s budget submission and the Fund’s reserve will both be lower.<sup>7</sup> Some of these policies—lowering premiums and paying distributive shares—would affect FHA’s cash flows immediately.<sup>8</sup> Thus, the amount of money available for

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<sup>6</sup>The subsidy cost is the estimated net cost to the government, in present value terms, of FHA-insured loans over the entire period the loans are outstanding.

<sup>7</sup>If Congress were to use the Fund’s reserves to fund other programs, the reserves would be lower, but there would be no effect on the negative subsidy amount reported in FHA’s budget submissions.

<sup>8</sup> Assuming that the volume and riskiness of FHA-insured loans will not change, HUD estimates that the recent reductions in up-front premiums combined with the introduction of mortgage insurance cancellation policies will lower the estimated value of the Fund by almost \$6 billion over the next 6 years.

FHA to invest in Treasury securities would be lower. Treasury in turn would have less money available for other purposes, and the overall surplus would decline. If the amounts of cash flowing out of the Fund exceeded current receipts, FHA would be required to redeem its investments in Treasury securities to make the required payments. Assuming no changes in other spending and taxes, Treasury then would be required to either increase borrowing from the public or use general tax revenues to meet its financial obligations to FHA. In either case, the annual budget surplus would be lower.

Budgetary scoring for budget control purposes under the 1990 Budget Enforcement Act<sup>9</sup> is required only when a law is enacted; actions taken by the Secretary under existing authorities are not scored for budget control purposes, even though they may affect the budget surplus or deficit. Whether and how the proposals under discussion would be scored depend on the exact wording of the new law and are determined by OMB for Budget Enforcement Act purposes. However, any action taken by Congress or the administration to reduce FHA's reserves, if not accompanied by a similar reduction in other government spending or by an increase in receipts, will result in either a reduction in the surplus or an increase in any existing deficit.

### **Actuarial Soundness Should be Defined**

Whether actions should be taken to change the value of the Fund depends on whether the Fund's capital resources and expected revenues exceed the amount needed to meet its expected cash outflows under designated stressful conditions; that is, whether it is actuarially sound. Assessing whether this condition exists requires that the degree of risk that the Fund is expected to be able to withstand must be specified. If the Fund is expected to withstand what Price Waterhouse called reasonably adverse economic downturns, then our results could be construed to mean that the Fund is taking in more revenue than it needs. Alternatively, if the Fund is expected to never exhaust its reserves, the current Fund might not be adequate.

The 1990 reforms did not specify the amount of risk that the Fund needed to withstand. Instead, the reforms specified a minimum capital ratio and required that the Fund achieve actuarial soundness before the secretary of HUD could take certain actions that might reduce the value of the Fund. Because we believe that actuarial soundness depends on a variety of factors that could vary over time, setting a minimum or target capital ratio will not guarantee that the Fund will be actuarially sound over time. For example, if the Fund comprised primarily seasoned loans with known characteristics, a capital ratio below the current 2-percent minimum might be adequate. But under conditions such as those that prevail today, when the Fund is composed of many new loans, a 2-percent ratio might be inadequate if recent and future loans perform considerably worse than expected.

We believe that to evaluate the actuarial soundness of the Fund, one or more scenarios that the Fund is to withstand would need to be specified. Then it would be appropriate to calculate the economic value of the Fund or the capital ratio under the scenario(s). As long as the estimated economic value of the Fund is positive when the desired stress scenario(s) is used to make that

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<sup>9</sup>As part of the effort to control federal budget results, the Budget Enforcement Act of 1990, as amended, created controls over laws changing or creating mandatory spending (basically entitlements) and receipts.

estimate, the Fund could be said to be actuarially sound. However, it might be appropriate to leave a cushion to account for the factors not captured by the model and the inherent uncertainty attached to any forecast. In any event, we believe that a single, static capital ratio does not measure actuarial soundness.

### **Matters for Congressional Consideration**

For these reasons, Madam Chairwoman, Congress may wish to consider taking action to specify criteria for determining when the Fund is actuarially sound. More specifically, Congress may want to consider defining the types of economic conditions under which the Fund would be expected to meet its commitments without borrowing from the Treasury.

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

### **Contact and Acknowledgments**

For further information regarding this testimony, please contact Thomas J. McCool at (202) 512-8678. Individuals making key contributions to this testimony included Nancy Barry, Jay Cherlow, and Mathew Scire.



## **Related GAO Products**

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

*Mortgage Financing: Financial Health of the Federal Housing Administration's Mutual Mortgage Insurance Fund* (GAO/T-RCED-00-287, Sept. 12, 2000).

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

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

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

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

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

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

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

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

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

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

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

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

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

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