United States General Accounting Office

GAO

Report to Congressional Requesters

April 2004

HOME INSPECTIONS

Many Buyers Benefit from Inspections, but Mandating Their Use Is Questionable

GAO
Accountability ★ Integrity ★ Reliability

GAO-04-462

GAO Highlights

Highlights of GAO-04-462, a report to congressional requesters

April 2004

HOME INSPECTIONS

Many Homebuyers Benefit from Inspections, but Mandating Their Use is Questionable

Why GAO Did This Study

In the 1990s, the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA) dealt with a series of instances where buyers had not been notified of serious problems revealed by their appraisals. This led to several reforms, some of which allegedly may have caused some buyers to forgo home inspections, confusing that service with appraisals.

Advocates of mandating home inspections claim that FHA will benefit from fewer foreclosures, and buyers will benefit by avoiding homes with costly problems. GAO was asked to assess (1) how many recent FHA homebuyers got home inspections and what were the perceived benefits, (2) whether homebuyers understand the differences between appraisals and home inspections, (3) whether inspections are associated with loan performance, and (4) the implications of mandating home inspections.

What GAO Recommends

GAO is not making any recommendations. We observed, and HUD agreed, that there appears to be little value to making home inspections mandatory. Many buyers already get them, there is no significant link with loan performance, and the resources to enforce an inspection requirement may well outweigh the benefits.

www.gao.gov/cgi-bin/getrpt?GAO-04-462.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Thomas J. McCool at (202) 512-8678 or mccoolt@gao.gov.

What GAO Found

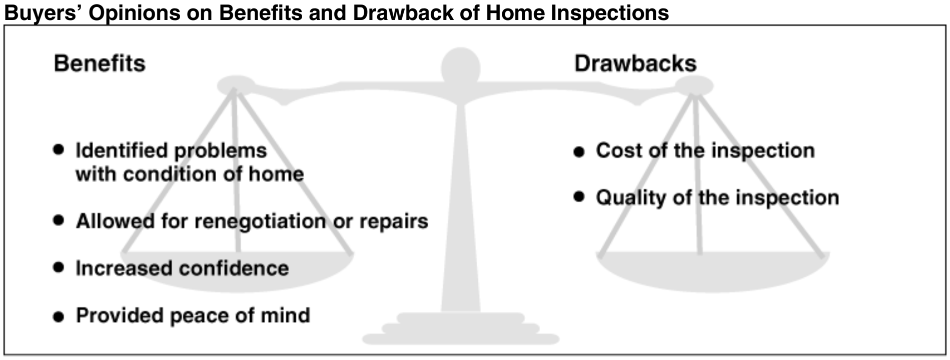
From its survey of recent homebuyers, GAO estimates 86 percent of those using FHA-insured mortgages in 2002 got home inspections. These buyers frequently reported the inspections to be positive and beneficial, but occasionally said the inspections had drawbacks, mainly related to their cost and quality. Home inspections do not appear to be associated with loan performance; other factors, such as borrowers' credit scores, are stronger predictors of how FHA-insured loans perform. Because of this, and because mandating inspections for all homebuyers could pose serious resource challenges for FHA, the marginal benefit of requiring inspections is questionable.

One of the reasons often cited for getting a home inspection was to ensure there were no serious problems with the house. Homebuyers reported that two-thirds of inspections uncovered problems with homes. As a result, they benefited by being able to renegotiate their purchases. Buyers also reported inspections were worth as much or more than they cost and increased their confidence in their decisions to buy homes.

Inspections are a more in-depth review of property condition than FHA appraisals, take longer, and more often give buyers the option to back out of a purchase. GAO estimates 36 percent of FHA homebuyers understand the differences between FHA's mandatory home appraisal and its recommended home inspection. For most of the remaining buyers, GAO was not able to determine definitively the extent to which they understood the differences.

Finally, FHA officials believe mandating home inspections would be difficult to enforce because the agency lacks the human capital and other resources to do so effectively. FHA also might see its pool of higher risk borrowers grow, as some buyers go elsewhere for non-FHA financing options available to lower income buyers. Benefits experienced by survey respondents might carry over to all homebuyers, but a mandatory inspection could put them at a disadvantage in highly competitive markets.

Buyers' Opinions on Benefits and Drawback of Home Inspections



Source: GAO analysis of survey respondent data.

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Abbreviations

FHA	Federal Housing Administration
GAO	General Accounting Office
HUD	Department of Housing and Urban Development

United States General Accounting Office
Washington, D.C. 20548

April 30, 2004

The Honorable Robert W. Ney
Chairman
Subcommittee on Housing and
Community Opportunity
Committee on Financial Services
House of Representatives

The Honorable Doug Bereuter
House of Representatives

Every year, nearly one million people buy homes—many for the first time—using mortgages that the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA) insures. FHA does not require prospective homeowners to protect their interests by, for example, getting a home inspection before committing to buying a house; however, there are requirements, such as getting an appraisal, to protect the interests of FHA and the lenders who make the loans FHA insures. Appraisals do this by confirming the home's market value so that the lender and FHA know they are not lending or insuring more than the home is worth.

FHA requires that appraisers conduct a limited review of a home's physical condition. In the 1990s, FHA dealt with a series of problems resulting from owners being unaware of costly problems appraisers identified in the homes they bought with FHA-insured mortgages. This led FHA to emphasize the importance of getting a home inspection by requiring borrowers to read and sign a form explaining the benefits of inspections. Because borrowers might not get this information until they apply for mortgages (after signing purchase contracts), and because getting an inspection usually requires making a purchase offer contingent on it, prospective buyers may have made their decisions about inspections before they get this information. FHA also began notifying buyers (just prior to closing on their homes) of any defects documented in the appraisers' physical condition reviews.

Because the property condition elements of the FHA appraisal might appear to be quite similar to a home inspection, some in the home inspection industry expressed concern that buyers were now confusing inspections and appraisals and, in some cases, forgoing home inspections because they mistakenly understood them to be the same thing. Home inspection advocates claimed that increasing the number of buyers who get home inspections would benefit FHA by reducing foreclosures resulting from costly property condition problems an inspection could have helped the buyer avoid. Assessing the validity of the industry's claims, however, proved difficult because no one knew with certainty how many buyers get home inspections and to what extent the buyers and FHA benefit from them.

To better assess whether more, or possibly all, buyers using FHA-insured mortgages should get home inspections, you asked us to develop some of the information necessary to make such a judgment. As agreed with your offices, this report answers four questions: (1) how many recent homebuyers got home inspections and what do they report as the primary benefits and drawbacks of the inspections, (2) to what extent and by what means do recent homebuyers understand the differences between appraisals and home inspections, (3) to what extent is getting a home inspection associated with the performance of FHA-insured loans, and (4) what would be the implications for FHA, homebuyers, and others if home inspections were made mandatory for FHA-insured mortgages.

We surveyed a representative sample of recent homebuyers[1] (those who purchased homes in 2002 using FHA-insured financing) to determine (1) how many got home inspections; (2) what they report as the benefits and drawbacks of inspections; and (3) the extent to which they understand the differences between appraisals and inspections. The response rate for this survey was 56 percent.[2] To assess the association home inspections may have with loan performance, we reviewed a random sample of FHA loan files from loans insured in fiscal years 1996 through 1999 to determine whether the file indicated the homebuyer had sought a home inspection; we then used an econometric model to analyze the association that home inspections and other information about properties and borrowers, such as credit scores, might have with the loans' performance. To determine the implications of making home inspections mandatory, we interviewed

[1]Throughout this report, we generally use the term "homebuyers" to mean those who bought homes using FHA-insured financing. In any instance where we include others in this description, such as those using conventional financing, we note that it includes these types of buyers.

[2]The estimates we report from the homebuyer survey are subject to sampling error. Except where noted, all percentage estimates have 95 percent confidence intervals within +/- 10 percentage points. See appendix V for more information on each survey question.

officials at FHA, the Department of Veterans Affairs, the Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac); we also consulted with industry association officials representing home inspectors, appraisers, realtors, and lenders.

Appendixes II and III provide detailed information on the scope and methodology for our homebuyer survey and loan performance file review. We present the results of our homebuyer survey in appendix V. We conducted our review between April 2003 and April 2004 in accordance with generally accepted government auditing standards.

Results in Brief

The vast majority of buyers using FHA-insured financing in 2002 got home inspections and benefited from them in ways such as getting sellers to fix minor problems before closing, but they occasionally reported certain drawbacks related to the cost and quality of the inspections. We estimate 86 percent of buyers got home inspections for the homes they purchased using FHA-insured financing in 2002. Most often, buyers got the inspections because they wanted to ensure there were no serious problems with the homes they were purchasing or because they believed FHA required an inspection. Homebuyers reported several ways in which they benefited from getting home inspections, which typically cost less than $400. Two-thirds of the inspections identified problems with homes, most of which buyers characterized as minor (costing less than $500 to address). This benefited buyers by allowing them to renegotiate the terms of their purchases so that sellers fixed these problems before closing. Some buyers also benefited from their inspections by learning about home maintenance. While most buyers characterized their experience as generally positive, some identified drawbacks. About 16 percent reported that in the first year they owned their homes, they experienced problems that they believe inspectors should have identified but did not (most commonly in the plumbing and appliances).

About 36 percent of all homebuyers using FHA-insured financing in 2002 appear to understand the differences between appraisals and home inspections,[3] but it is unclear to us to what extent most homebuyers understand the differences between the two. Home inspections and appraisals differ in substantial ways. Inspections protect buyers' interests, involve in-depth observations of a home's major systems, and can allow buyers to cancel a purchase. Appraisals protect FHA's financial interests, involve a visual observation of readily observable conditions, and give buyers fewer options for canceling a purchase. Most homebuyers, regardless of their understanding, report that they learn about home inspections and appraisals from real estate agents and lenders. We believe it is likely that buyers more often understand the differences between appraisals and inspections when they report someone has discussed these differences with them. However, the response rate for our homebuyer survey precludes us from identifying additional distinctions about the various ways homebuyers may have developed their understanding of the differences between appraisals and inspections.

We found no significant relationship between getting a home inspection and loan performance. Other factors that have long been recognized as strong predictors of loan performance explain most, if not all, of any apparent difference in how often borrowers who got inspections and those who did not defaulted on their mortgages. For example, research indicates homebuyers who have higher mean credit scores or less often use adjustable rate mortgages tend to default on their loans at lower rates than other buyers and we found this held true for the loans we analyzed. Other factors that also had measurable effects on loan performance included the age and size of the loans, the initial loan-to-value ratio,[4] and house price appreciation. A simple comparison of foreclosure rates between borrowers who did and did not get inspections can be misleading. The net effect of a variety of factors, including home inspections, is that borrower,

[3]We base this estimate on our analysis of and judgments about the respondents' answers in our survey of recent buyers, drawing on survey questions dealing with characteristics that are closely associated with either inspections or appraisals. These characteristics include things like timing (inspections usually happen soon after signing a purchase offer); who arranged for the service (lenders arrange for appraisals, buyers and/or real estate agents usually arrange inspections); and method of payment (appraisal costs can be included in the mortgage; inspections generally are not).

[4]The loan-to-value ratio is the amount of the loan as a percentage of the property's value. For example, a buyer with a $94,000 loan on a home valued at $100,000 would have a 94 percent loan-to-value ratio.

loan, and property characteristics explain the apparent difference in foreclosure rates in our sample, not the inspections. Therefore, based on our analysis, increasing the number of buyers who get inspections would likely not have a material effect on FHA's financial health.

The implications for FHA of making home inspections mandatory primarily concern setting national standards for the inspections and the resources it would need to enforce such a requirement. For other concerned parties, such as homebuyers, making home inspections mandatory would have mixed results—more might reap the benefits of home inspections, but some buyers might also find the requirement hurts their ability to compete in certain markets while driving up costs for them and, possibly, home inspectors. FHA officials consider an effective enforcement system for any home inspection requirement would be the most important and resource-intensive part of any new regulatory effort. These officials indicate FHA does not have the resources it would need to do this job well and stress that without them any such requirement would have little benefit. FHA might be able to mitigate the resource requirements by working through the states, 27 of which have in place varying degrees of regulatory structures and enforcement capacity. Doing so might require that FHA devote resources to support these 27 states' efforts. In the 23 states that do not currently regulate home inspections, FHA would face a choice between finding a way to conduct the enforcement itself or, for example, paying those states to do so. FHA might also find the requirement hurts its competitiveness as more buyers who can pursue other lending options do so, potentially exacerbating a trend of FHA serving increasing numbers of riskier borrowers. Homebuyers would likely see mixed results from such a requirement, reaping benefits similar to those recent homebuyers reported in our survey but also facing some of the same drawbacks associated with the quality of some inspections. The home inspectors could face added costs associated with any FHA requirements that exceed those they may already be meeting (such as a state continuing education requirement).

In comments on a draft of this report, HUD characterized it as a comprehensive analysis and agreed with our findings and observations.

Background

Annually, nearly 1 million people buy a home using a mortgage that HUD's Federal Housing Administration (FHA) insures. Private lenders, not FHA, make the loans to borrowers. FHA insures the lender against losses it may incur when a borrower defaults on his or her mortgage and the lender has to foreclose on the home. FHA provides this insurance through programs supported by its Mutual Mortgage Insurance Fund (the fund). It deposits into the fund the mortgage insurance premiums it collects from borrowers (when they initially get their loans and then as part of each monthly mortgage payment), as well as proceeds from the sale of foreclosed properties. FHA draws on the fund to reimburse lenders for their losses on foreclosed properties.[5]

FHA provides this insurance so that lenders will make mortgage loans with more lenient underwriting standards than "conventional" financing. FHA does this to open homeownership opportunities to households unable to meet the requirements of the private market for mortgages and mortgage insurance. For example, FHA insurance allows borrowers to make low down payments and finance closing costs as part of their loan rather than pay cash for those expenses. As a result, FHA plays a particularly important role among certain groups of potential homeowners, particularly first time buyers, minorities, and lower-income households. In fiscal year 2002, for instance, 72 percent of FHA-insured purchase mortgages went to first-time buyers.

FHA relies on lenders to underwrite the loans it insures. This means lenders accept mortgage applications, obtain borrowers' employment verifications and credit histories, and perform other tasks in the loan underwriting process, including ordering an appraisal on the property the borrower wants to purchase. FHA appraisals estimate the fair market value of the home to (1) protect the lender from loaning more than the home is probably worth (for FHA's mortgage insurance purposes) and (2) minimize FHA's losses when it has to sell foreclosed properties. According to FHA, the bulk of an appraiser's time is spent estimating the property value. However, the appraiser must also spend some time performing and documenting a limited review of the property's condition to ensure it meets the agency's minimum property requirements. For example, the appraisal might address the condition of the roof and the operation of certain mechanical systems, such as the furnace.

Consumers are responsible for protecting their own interests in the homebuying process. FHA and lenders expect buyers will gather the information they need to make informed decisions about home purchases.

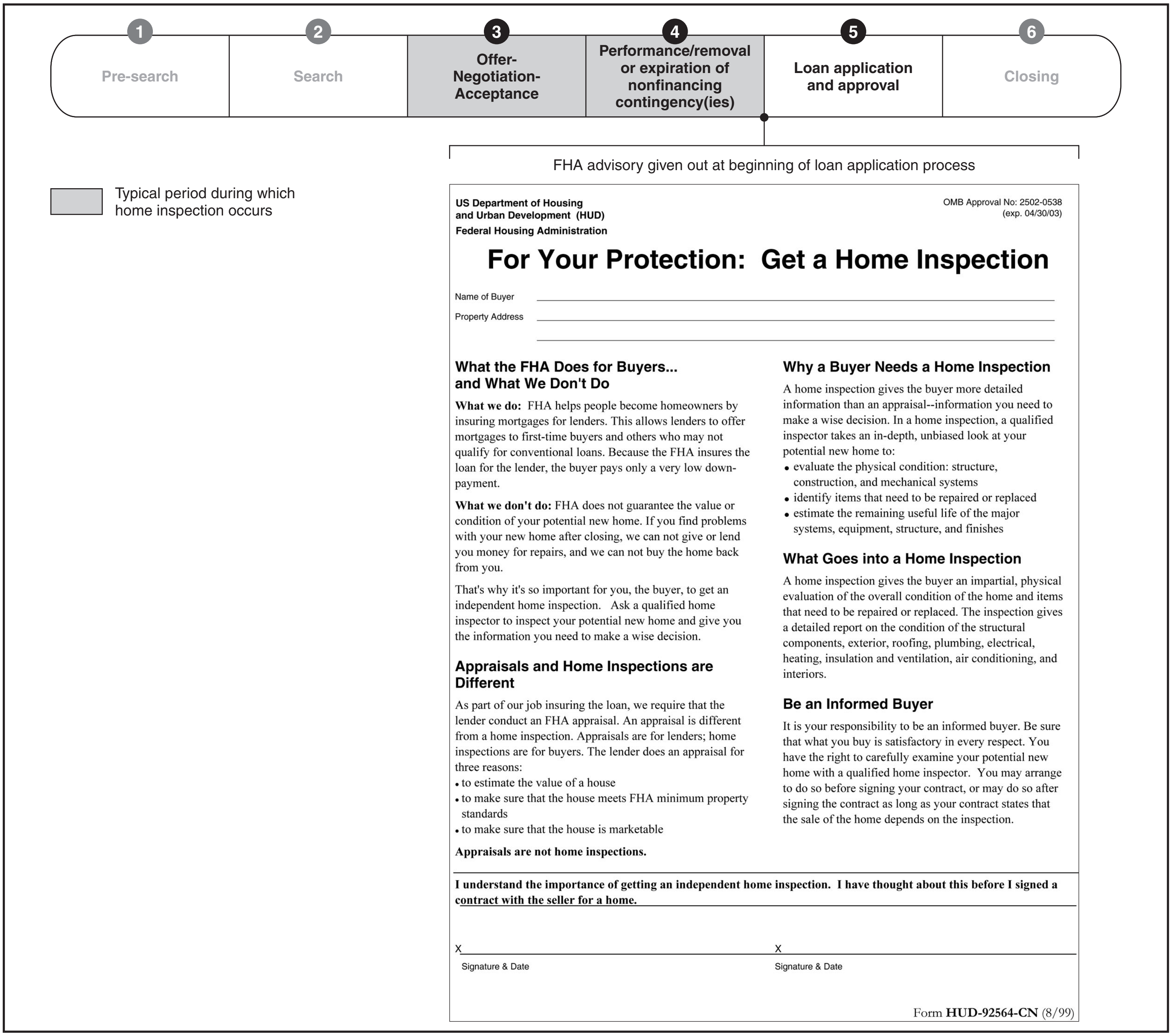
[5]FHA also uses the fund to pay refunds of up-front premiums on mortgages that buyers prepay, as well as administrative expenses for managing the program.

FHA encourages buyers to protect their interests by getting a home inspection before finalizing a contract to purchase a house, but does not require them to do so.

Homebuyers, particularly those purchasing their first homes, can face a daunting array of steps, requirements, and new terminology as they navigate the homebuying process—many of which they encounter before they might apply for a FHA-insured mortgage. For example, prior to searching for a home, a buyer may choose to work with a lender to obtain pre-approval for a mortgage, which would involve verifying employment history and checking credit, similar to what lenders require during underwriting. During their search, buyers may begin working with a real estate agent, looking at numerous homes for sale, and acquainting themselves with important information they may need to make a purchase offer, such as the need for an inspection of a particular home they may want to buy. After offering to purchase a specific home, a buyer may have to consider counteroffers from the seller, get a home inspection if they have insisted on one, and consider the results of the inspection before finalizing the purchase contract.

In figure 1, we illustrate some of the more common steps in the homebuying process. As we illustrate, buyers can be well on the road to homeownership before they encounter the FHA requirements affecting them.

Figure 1: Common Steps in the Homebuying Process



US Department of Housing and Urban Development (HUD)
Federal Housing Administration

OMB Approval No: 2502-0538 (exp. 04/30/03)

For Your Protection: Get a Home Inspection

Name of Buyer ____________________

Property Address ____________________

What the FHA Does for Buyers... and What We Don't Do

What we do: FHA helps people become homeowners by insuring mortgages for lenders. This allows lenders to offer mortgages to first-time buyers and others who may not qualify for conventional loans. Because the FHA insures the loan for the lender, the buyer pays only a very low down-payment.

What we don't do: FHA does not guarantee the value or condition of your potential new home. If you find problems with your new home after closing, we can not give or lend you money for repairs, and we can not buy the home back from you.

That's why it's so important for you, the buyer, to get an independent home inspection. Ask a qualified home inspector to inspect your potential new home and give you the information you need to make a wise decision.

Appraisals and Home Inspections are Different

As part of our job insuring the loan, we require that the lender conduct an FHA appraisal. An appraisal is different from a home inspection. Appraisals are for lenders; home inspections are for buyers. The lender does an appraisal for three reasons:

- to estimate the value of a house
- to make sure that the house meets FHA minimum property standards
- to make sure that the house is marketable

Appraisals are not home inspections.

Why a Buyer Needs a Home Inspection

A home inspection gives the buyer more detailed information than an appraisal--information you need to make a wise decision. In a home inspection, a qualified inspector takes an in-depth, unbiased look at your potential new home to:

- evaluate the physical condition: structure, construction, and mechanical systems
- identify items that need to be repaired or replaced
- estimate the remaining useful life of the major systems, equipment, structure, and finishes

What Goes into a Home Inspection

A home inspection gives the buyer an impartial, physical evaluation of the overall condition of the home and items that need to be repaired or replaced. The inspection gives a detailed report on the condition of the structural components, exterior, roofing, plumbing, electrical, heating, insulation and ventilation, air conditioning, and interiors.

Be an Informed Buyer

It is your responsibility to be an informed buyer. Be sure that what you buy is satisfactory in every respect. You have the right to carefully examine your potential new home with a qualified home inspector. You may arrange to do so before signing your contract, or may do so after signing the contract as long as your contract states that the sale of the home depends on the inspection.

I understand the importance of getting an independent home inspection. I have thought about this before I signed a contract with the seller for a home.

X____________________ X____________________

Signature & Date Signature & Date

Form **HUD-92564-CN** (8/99)

Sources: GAO and HUD.

FHA requires lenders to provide a disclosure statement to all FHA-insured mortgage applicants, which we also show in figure 1. This statement emphasizes it is the borrower's responsibility to protect his or her interest, and one way of doing that is by getting a home inspection.

As FHA's advisory describes, a home inspection provides detailed information about the overall condition of the home. Inspections generally consist of a visual examination of a home's readily accessible systems and components, such as the electrical system and the plumbing, and result in a report to the buyer describing what the inspector observed. However, because some states regulate various aspects of home inspections and others do not, the actual content of any given buyer's home inspection may vary depending on the state in which the buyer lives and the extent to which individual inspectors may be able to do more (or less) than the state prescribes.

FHA requires that lenders provide this advisory because it has contractual relationships with them and can insist that they do so. FHA does not, however, have contractual relationships with or oversight authority over various other parties who deal with potential buyers earlier in the homebuying process, such as real estate agents. Consequently, while borrowers may have seen and read the advisory prior to applying for their mortgage (e.g., because a realtor provided it), the point at which FHA requires they see it is no later than the point at which they apply for their mortgage. Because getting a home inspection usually requires that a purchase offer is contingent on the seller allowing the inspection, buyers have chosen to get (or to forgo) a home inspection before FHA requires that they read and sign a document explaining the importance of the inspection and how it differs from the FHA appraisal.

Home inspections and the limited property condition review FHA appraisers conduct can address or speak about the condition of many of the same parts in the home. Table 1 shows a side-by-side comparison of the various components that may be part of a typical home inspection and where an FHA appraiser would perform a limited property condition review in those same areas.[6]

Table 1: Home Inspection Components Addressed by FHA Appraisals

Home inspection component	Addressed by appraisers for compliance with FHA's minimum property requirements? Yes	No
Water pressure/flow	✔	
Electrical panel box	✔	
Attic	✔	
Roof	✔	
Cooling system	✔	
Heating System	✔	
Structure of home	✔	
Interior (e.g., walls, stairways)	✔	
Exterior (e.g., grading, drainage)	✔	
Fireplace/solid fuel burning appliances		✔
Garage doors	✔	

Source: FHA valuation conditions; National Association of Home Inspectors Standards of Practice and Code of Ethics, 1990-2003.7 edition, © NAHI; and The Standards of Practice and Code of Ethics of the American Society of Home Inspectors, January 1, 2000, © ASHI.

Despite their apparent overlap in addressing many of the same parts of a house, home inspections and FHA appraisals differ substantially in terms of their purpose and timing, the type and focus of each, the depth of examination of the home, and the recourse available to the buyer. Table 2 elaborates on the differences in these characteristics of inspections and appraisals.

[6]We describe the typical components of a home inspection by using the model standards of practice of two industry associations: the National Association of Home Inspectors (NAHI) and the American Society of Home Inspectors (ASHI). Both sets of standards establish, for the associations' members, the minimum standards of performance for residential home inspections including, for example, the various systems and components that should be part of a home inspection.

Table 2: Differences in Characteristics of Home Inspections and FHA Appraisals

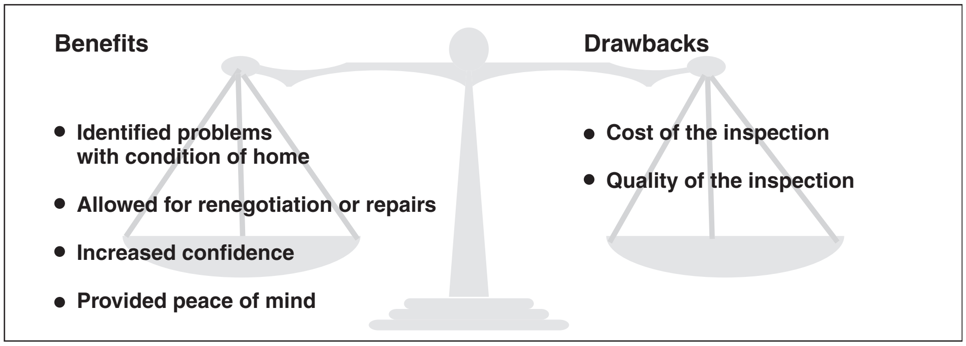
Characteristic	Home inspection	FHA appraisal
Purpose	Protects buyers' interests	Protects lenders' and FHA's financial interests; ensures compliance with FHA minimum property requirements
Timing	Usually less than 2 weeks after seller accepts a purchase offer	After loan application; may be ordered by the lender more than several weeks after seller accepts purchase offer
Type/focus	Detailed report on the structural and functional condition of the property	Market value assessment (based on conditions observable to the naked eye)
Depth	In-depth, invasive observations of readily accessible systems and components; can take 2 hours or longer	Readily observable conditions; 30 minutes to 1 hour on site
Recourse for buyer	Renegotiate or cancel purchase offer (if a contract contingency requires the inspection and allows recourse for the buyer)	Limited options—mainly applicable if (1) appraised market value is lower than purchase price or (2) property does not meet FHA's minimum property requirements

Source: GAO.

Buyers Frequently Use and Report Benefits from Home Inspections, with Some Noting Problems with Quality and Cost

A substantial majority of the homebuyers using FHA-insured financing in 2002 report getting home inspections and benefiting from them primarily by being able to renegotiate their purchases. Typically, buyers chose to get home inspections to make sure there were no serious problems with the homes they were purchasing and most say the inspection was a positive experience. Buyers reported that they benefited from the home inspections because they identified problems that buyers were often able to get sellers to address before closing. Buyers did occasionally report drawbacks to getting home inspections. These included the cost of the inspections and problems buyers believe home inspectors missed. Figure 2 summarizes the benefits and drawbacks homebuyers reported.

Figure 2: Buyers' Opinions on Benefits and Drawbacks of Home Inspections



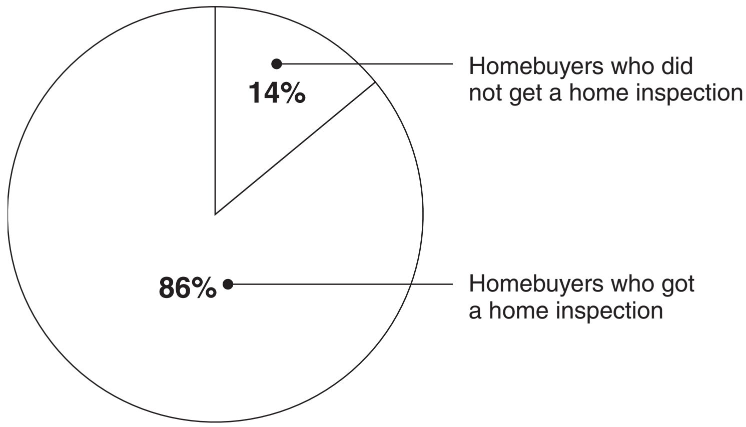
Source: GAO analysis of survey respondent data.

Many Homebuyers Get Home Inspections, Primarily to Ensure That Houses Are in Adequate Condition

A large majority of homebuyers using FHA-insured financing in 2002 report getting home inspections (see figure 3), almost always using a referral from a real estate agent, lender, friend, or relative to find an inspector. Our estimates are similar to the findings from a 2001 joint home inspectors' and realtors' industry association survey.[7] Most inspections cost buyers less than $400.

[7]That survey, by the National Association of Realtors and the American Society of Home Inspectors, found that 77 percent of all buyers (those using FHA-insured loans, conventional financing, or no loans at all) got home inspections.

Figure 3: Homeowners Using FHA-Insured Financing in 2002 Who Report Getting Home Inspections



Source: GAO analysis of survey respondent data.

Buyers of existing homes get home inspections substantially more often than do those who buy newly constructed homes. We estimate that 93 percent of buyers of existing homes get inspections, while more than one-third fewer (58 percent) of those buying newly constructed homes do so. The likelihood that buyers expect they will have to budget for costly repairs on their homes or want to make sure such repairs will not be necessary may explain why buyers of existing homes more often get them inspected. Almost none of the buyers who bought newly constructed homes cited this as a reason for getting a home inspection, but 18 percent of those purchasing existing homes did.

Overall, whether buyers purchased new or existing homes, the most common reason they cite for getting home inspections is to ensure nothing serious is wrong with the homes they are purchasing—nearly 8 in 10 cite this as one factor in their decision to get an inspection. Even though home inspections are optional, over 60 percent of all buyers (existing homes and new construction) believed FHA required them.

Buyers Are Highly Satisfied with Home Inspections, Reporting Benefits in Negotiating Purchases and Learning about Home Maintenance

Most buyers who got home inspections said they were satisfied with the service in a variety of ways and that they would almost always get an inspection for any future home purchase (see table 3).

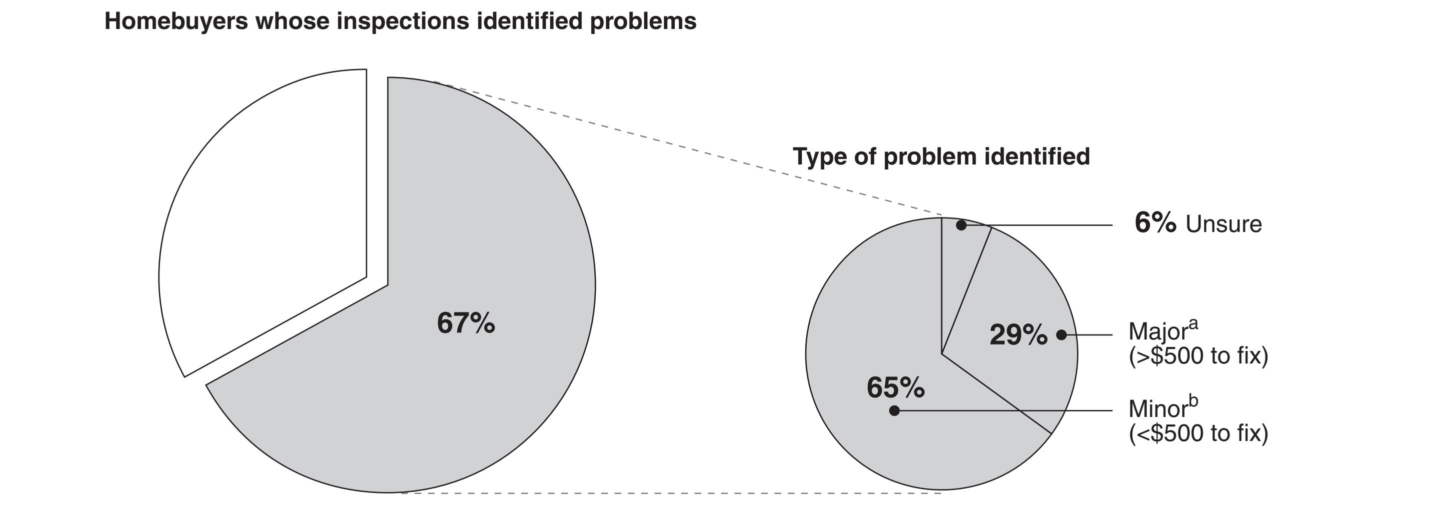
Table 3: Opinions of Buyers Who Got Home Inspections in 2002 (percent reporting certain answer choices)

Buyer is likely to get a home inspection for future purchases	94%
Inspections were worth as much or more than buyers paid for them	85%
Increased the buyer's confidence in their purchase	80%
Inspection gave buyers peace of mind that homes had no major problems	74%
Experience was somewhat or very positive	73%

Source: GAO analysis of survey respondent data.

Nearly half of homebuyers say one reason they liked their inspections is because sellers made needed repairs before the buyers moved in. As we show in figure 4, inspections often identified problems that the buyers required the sellers fix.

Figure 4: Percentage of Homebuyers Whose Inspections Identified Problems (overall and by type and cost)



Source: GAO analysis of survey respondent data.

[a]The 95 percent confidence interval exceeds +/- 10 percent of the estimate (lower and upper bounds are 53 percent and 76 percent).

[b]The 95 percent confidence interval exceeds +/- 10 percent of the estimate (lower and upper bounds are 19 percent and 41 percent).

When the inspections identified either minor or major problems, 30 percent of the time buyers were able to renegotiate one or more terms of their purchases. Most often they did so by convincing sellers to fix problems.[8] In addition, about one in five buyers report that they benefited from their home inspection because it allowed them to learn about home maintenance.[9] For buyers of existing homes, the inspections also provided benefits associated with uncertainties about the condition of the home and the operation of major systems—questions typically of greater concern with a property likely to have seen more wear and tear than a new home.

[8]The 95 percent confidence interval exceeds +/- 10 percent of the estimate (lower and upper bounds are 69 percent and 95 percent).

[9]There were instances where buyers reported using home inspections to avoid buying homes altogether. About 17 percent indicated the results of a home inspection were one reason they chose not to buy a home they considered before they found the one they currently own (95 percent confidence interval exceeds +/- 10 percent of the estimate; lower and upper bounds are 7.3 percent and 30.9 percent).

Specifically, 11 percent said it identified for them a need to set aside money for repairs the house would need.

A Small Minority of Buyers Report the Costs and Quality of Some Inspections Can Be Drawbacks

Even though most homebuyers who got inspections were generally satisfied with them, some cited concerns with the cost and quality of the inspections. Of the buyers who got home inspections, 19 percent disliked them because of the cost. In addition, 16 percent of those getting inspections report that in the first year of owning their homes, they experienced problems they believe the home inspectors should have observed. As we show in figure 5, the areas where buyers most often report these experiences are the plumbing, appliances, and air conditioning and electrical systems.

Figure 5: Areas Where Buyers Who Got Home Inspections Report Problems in Their First Year of Homeownership (percent)

Item	Percent of buyers reporting: Few problems (<$100)	Some problems ($100 to $500)	Many problems ($500 or more)	Total
Plumbing/ water pipes	24	14	9	46
Appliances	8	15	9	31
Cooling/air conditioner	11	9	6	25
Electrical	15	6	4	25
Roof	6	4	8	18
Heating system/furnace	4	6	8	17
Structure	7	4	4	15

Source: GAO analysis of survey respondent data.

Note: Row percentages may not add due to rounding.

While our survey results do not allow us to judge whether the conditions buyers cited are, in fact, ones that an inspector should have observed, they may be indications of a communications gap between the buyers and the inspectors. For example, two major home inspectors' industry associations exclude appliances from their standards of practice. This means inspectors who follow only these standards are not required to observe or report on the condition of appliances. In these instances, this may represent buyers' or inspectors' failure to clearly establish in advance what buyers should and should not expect the inspection to provide.

Over One-Third of Homebuyers Understand the Differences between Home Inspections and Appraisals

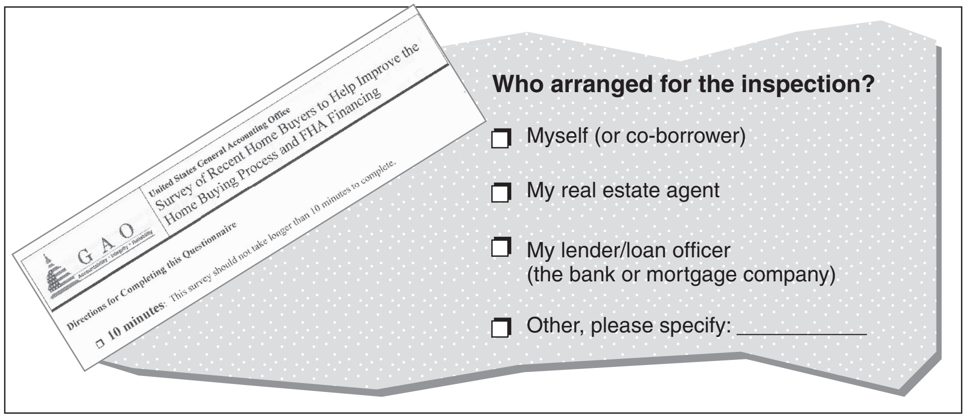
Where we could make a conclusive judgment, we determined that about 36 percent of all homebuyers using FHA-insured financing in 2002 understand the differences between home inspections and appraisals. This estimate changes very little (rising to 42 percent) when we consider only those buyers who got home inspections. For the most part, it is unclear to us whether a substantial number of buyers understand the differences between inspections and appraisals. Among those who did not get home inspections this is most pronounced—we cannot conclusively judge understanding for any of these buyers. These results should not necessarily be interpreted to mean that a substantial number of the buyers were actually unclear about these differences. The results may point as much or more to the difficulty of judging an individual's understanding with an instrument such as a survey.

More Than One-Third of Homebuyers Understand the Differences between Home Inspections and Appraisals

About 36 percent of all homebuyers appeared to understand the differences between appraisals and home inspections, according to our analysis of the answers they gave to certain questions in our survey of recent buyers. When we consider just those buyers who report they got home inspections, this figure rises to 42 percent.

To make these judgments about the buyers responding to our survey, we consulted with a variety of real estate industry experts to develop and build into our homebuyer survey questions that would collectively address unique characteristics of each of the two assessments (appraisals and inspections). For example, when a respondent said that he or she had gotten a home inspection, we asked them who arranged for the inspection (fig. 6).

Figure 6: GAO Inspection Survey Question



Source: GAO.

Industry experts told us that in most instances, borrowers and/or real estate agents typically arrange for the home inspection, and it is virtually always the lender who arranges for the appraisal. Consequently, the answers to this question (and others) allowed us to judge whether buyers who reported they had gotten a home inspection might actually be referring to the appraisal. In such a case, for a respondent who said the lender or loan officer had arranged the inspection, we judged this answer indicative that the respondent likely did not understand the differences. While we would not consider that such an answer by itself is sufficient to make such a judgment, the sum of a respondent's answers to multiple questions about the unique characteristics of appraisals and inspections does allow such a judgment. We present in appendix II the complete set of survey questions and decision rules we used to make these judgments about buyers. Figure 7 presents examples of the answer choices we used to make judgments that buyers did or did not understand the differences between appraisals and inspections.

Figure 7: Responses GAO Considered to Determine Understanding

Examples of responses GAO considered indicative buyers:	
Understand the differences between appraisals and inspections	**Do not understand the differences between appraisals and inspections**
• Buyer or real estate agent arranged for the inspection	• Buyer reports he/she does not know the purpose of a home inspection
• Inspection performed soon after the seller accepted a purchase offer	• Buyer is not sure if they were present for the inspection
• Buyer was present for the inspection	• Buyer says the cost of their home inspection was rolled into the closing costs of the loan
• Buyer paid for the inspection at or near the time of the inspection	• Buyer was told the appraisal does the same thing as a home inspection

Source: GAO.

No Conclusive Judgment Was Possible for Most Homebuyers

For 60 percent of all homebuyers, we found there was insufficient information to make a conclusive judgment about their understanding, making it unclear to us whether or to what extent they understand the differences between appraisals and home inspections. For the subset of buyers who reported they got home inspections, we could not make a judgment about 53 percent of them. For buyers who reported they did not get home inspections, we could not conclusively judge understanding for any of them.[10] These results may be a reflection of the difficulty of using a survey to measure understanding or knowledge and, as a result, cannot necessarily be interpreted to mean that most buyers are themselves unclear about the differences between inspections and appraisals.

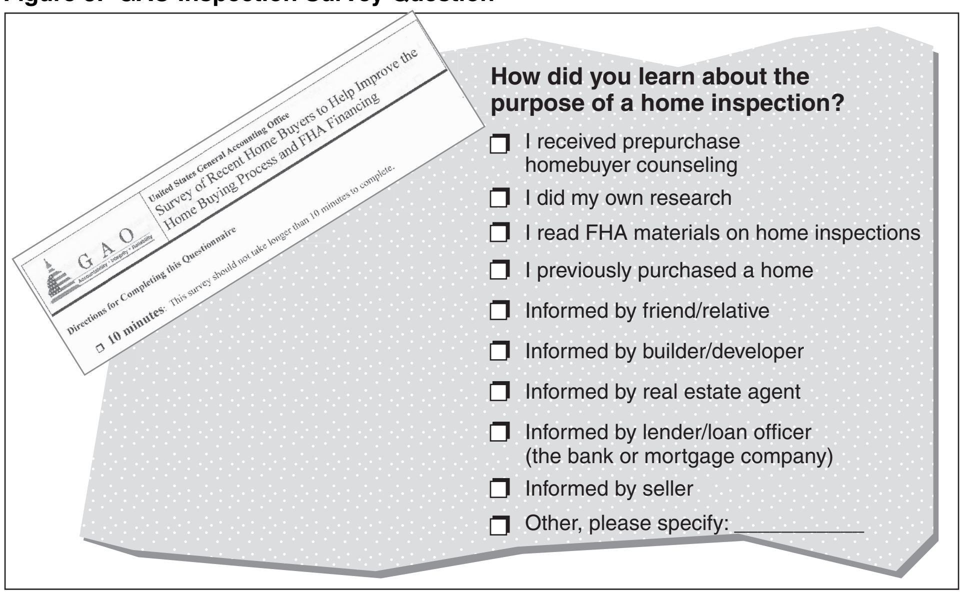
Because there were relatively few survey respondents whom we initially judged clearly do not understand the differences, we cannot use these results to estimate with a reasonable confidence interval the percentage of all homebuyers who do not understand the differences. Consequently, for analysis purposes, we combined this group of respondents with those whose understanding we are unclear about and compared just two sets of homebuyers—those we judge to understand and all others.

[10]Relatively fewer buyers report they did not get inspections, and these buyers answered fewer survey questions than did those who got the inspections (see app. V). As a result, there were fewer questions from which to attempt a judgment about these buyers' understanding, which increased the possibility that these buyers gave too few answer choices for us to make a judgment.

Those buyers whom we judge understand the differences were more likely to have discussed these differences with someone else during their homebuying process. Specifically, comparing the homebuyers who understand to all others, 77 percent of those who understand the differences report having such a discussion;[11] for all other buyers, 47 percent report having this discussion.[12]

Buyers typically learned about home inspections from several different sources, usually doing so before applying for their mortgages (the point at which they would get FHA's home inspection advisory). Most often, buyers cited real estate agents as a source for information about home inspections (see fig. 8).

Figure 8: GAO Inspection Survey Question



Source: GAO.

[11]The 95 percent confidence interval exceeds +/- 10 percent of the estimate (lower and upper bounds are 63 percent and 88 percent).

[12]The 95 percent confidence interval exceeds +/- 10 percent of the estimate (lower and upper bounds are 37 percent and 58 percent).

About 57 percent indicated real estate agents, with lenders (38 percent), friends or relatives (28 percent), and their own research (25 percent) also figuring prominently. Just under 19 percent reported they learned about home inspections by reading FHA materials. However, our survey results do not allow us to discern differences in buyers' understanding between those who rely on one source of information (e.g., real estate agents) compared to another or, for example, when they learn about inspections early in the buying process as opposed to later. This is because the confidence interval for any estimate we might make from such an analysis would be too wide to say definitively that there is some difference between two sets of homebuyers.[13]

Many homebuyers reported they learned about the purpose of home inspections before they applied for their FHA-insured mortgage—the point when FHA requires lenders give them information about the importance of home inspections. Specifically, nearly 40 percent of buyers reported they learned about inspections before they began looking for a home and 43 percent said they learned during the search process. Our survey did not define "search process" for the buyers, so we cannot rule out that some considered applying for a mortgage to be part of that process. Nonetheless, substantial numbers of buyers learn about inspections and make their choices to get or forgo them before that time, meaning FHA cannot be sure many buyers have the benefit of its advisory in time to factor it into their decisions.

[13]For example, it initially appeared that those who understand more often reported they got information about the purpose of home inspections from real estate agents than all other buyers (67 percent vs. 51 percent). However, the upper and lower bounds for this estimate at the 95 percent confidence interval overlap, making it possible that there is, in fact, no difference in this instance. For those who understand, the interval ranges from 52 to 80 percent; for all other buyers, the range is 39 to 62 percent.

Home Inspections Appear to Have No Significant Association with the Performance of FHA-Insured Loans

The differences in loan performance between buyers who did and did not get home inspections[14] are not significant when we consider the full range of factors known to predict or have some association with loan performance. A side-by-side comparison of foreclosure rates between those who did and did not get inspections initially shows fewer foreclosures among those who got inspections, but this comparison can be misleading. A large body of research evidence and past GAO work has shown some factors, such as credit scores and loan-to-value ratios, are highly predictive of loan performance. The net effect, when we considered home inspections and the fuller range of other factors predictive of loan performance, is that these other factors appear to explain the apparent differences in foreclosure rates in our sample. While foreclosures are costly to FHA's insurance fund, increasing the number of buyers who get home inspections by itself may not have a material effect on this fund.

The Net Effect of Home Inspections on Loan Performance Is Not Significant

A large body of research evidence from GAO and others has long shown factors associated with borrowers, their loans, and/or the properties they buy are highly predictive of loan performance.[15] For example, recent research[16] has shown the importance of borrowers' credit scores in assessing the likelihood of loans going to foreclosure, noting that those

[14]We determined that borrowers had gotten home inspections when we found evidence of a home inspection contingency in their purchase contracts, recognizing that, in some instances, buyers may not have exercised their rights from such contingencies or may have gotten inspections without evidence of them in the contracts. See appendix III for a complete discussion of the methodology for this analysis. Details from this analysis appear in appendix IV.

[15]For example, see U.S. General Accounting Office, *Mortgage Financing: Changes in the Performance of FHA-Insured Loans*, GAO-02-773 (Washington, D.C.: July 2002); or U.S. General Accounting Office, *Loan Policy Changes Made to Strengthen FHA's Mortgage Insurance Program*, GAO/RCED-91-61 (Washington, D.C.: March 1991); or An Actuarial Review for Fiscal Year 1998 of the Federal Housing Administration's Mutual Mortgage Insurance Fund Final Report, PriceWaterhouseCoopers LLP, March 1, 1999; or Cotterman, Robert F., "New Evidence on the Relationship Between Race and Mortgage Default: the Importance of Credit History Data", Unicon Research Corporation, May 23, 2002.

[16]Cotterman, Robert F.

with higher scores tend to have better loan performance.[17] Certain features of the loan, such as the loan-to-value ratio, interest rate (fixed or adjustable) and term (15 or 30 years) can also help predict loan performance. For example, lower loan-to-value ratios are often associated with better loan performance because the borrowers have more equity in their properties than those with higher ratios. Greater equity in the home gives a borrower more incentive to sell rather than fall behind on mortgage payments and face foreclosure. Similarly, house price appreciation is predictive of loan performance because it gives borrowers more equity in their homes and greater incentives to sell rather than default.

To consider home inspections in conjunction with the factors known to be predictive of loan performance, we reviewed a stratified random sample of 260 FHA paper loan files for evidence the borrower got a home inspection. We also collected borrower credit scores where they were present. This file review was necessary because FHA does not collect home inspection or credit score data for all the loans it insures. We selected loans FHA insured in fiscal years 1996 through 1999 because prior work by GAO and others has shown the peak foreclosure period for mortgages is 3 to 8 years after origination.[18] We then added the home inspection and credit score data as well as current information on the performance of these loans (as of June 2003) to an existing model that predicts prepayments and foreclosures (see app. IV).[19]

Because other factors have been shown to strongly predict loan performance, simply comparing the foreclosure rates of borrowers who got inspections with those who did not could be misleading. At first glance, borrowers who get home inspections go to foreclosure about 10 percent less often (2.6 percent vs. 2.9 percent for those not getting inspections). However, this comparison can be misleading in important ways. First, at

[17]Credit scores are a tool creditors can use to measure the likelihood that a borrower will repay a debt. The scores, typically three digit numbers, represent a snapshot of credit risk for a particular point in time. According to the Federal Trade Commission, the use of credit scoring allows lenders to make underwriting decisions faster and more objectively.

[18]Fiscal year 1996 began on October 1, 1995, and fiscal year 1999 ran through September 30, 1999. Because we used the loans' status as of June 2003, our analysis covers loans that may be as old as 8 years (early fiscal year 1996) or as recent as 4 years ago (late fiscal year 1999).

[19]See U.S. General Accounting Office, *Mortgage Financing: FHA's Fund Has Grown, but Options for Drawing on the Fund Have Uncertain Outcomes*, GAO-01-460 (Washington, D.C.: February 2001).

conventional levels of significance, this difference is not statistically significant. That is, the difference between the two is too small to rule out that it occurs by chance rather than because of some difference that we might otherwise link to the home inspections. Furthermore, when we performed a regression analysis,[20] we found borrowers who got inspections have a higher foreclosure rate. Again, however, the significance of this difference makes relying on such an analysis misleading—the effect when we singled out home inspections was not statistically significantly different from no effect.

Borrower Characteristics, Loan Features, and House Price Changes Are the Significant Predictors of Loan Performance

Consistent with our past work and the research of others into loan performance, we found that borrower, loan, and property characteristics explain the differences in loan performance between borrowers who did and did not get home inspections. For example, borrowers who got inspections were less likely to get adjustable rate mortgages, which could also explain why they have a lower foreclosure rate. Also, borrowers who got home inspections had average credit scores 9 points higher than those who did not get inspections.

Specifically, we estimate that the difference in mean credit scores explains about half of the difference in foreclosure rates between those who did and did not get home inspections. However, in our sample, borrowers who got inspections had higher mean loan-to-value ratios, which could increase their foreclosure rate or counteract the benefits of higher credit scores (see table 4).

[20]Regression analysis is a technique that allows us to single out the effect one factor might have in explaining an observation, such as differences in foreclosure rates (see app. IV).

Table 4: Differences in Average Borrower and Loan Characteristics between Buyers Who Did and Did Not Get Home Inspections (FHA-insured loans, fiscal years 1996-1999)

Variable (percent)	Home inspections	No home inspection
Foreclosure rate	2.64%	2.95%
Loan-to-value ratio	95.7%	93%
Adjustable rate mortgage	10%	19%
No credit score present	21%	30%

Source: GAO.

To determine the net effect of differences in a broad range of risk characteristics, we analyzed a fuller range of factors that may affect loan performance. These include measures encompassing the ages and amounts of loans, the initial loan-to-value ratios, changes in equity over time due to changes in house prices or interest rates, and the type of loan (in terms of interest rate—fixed or adjustable—and term—30 or 15 years). We created a risk measure to encompass these characteristics and then considered borrowers' credit scores (where they were present in the FHA file) and the home inspection data we collected for each loan.

We used the risk measure we created, the two credit score variables, and the home inspection data as independent variables in a regression analysis. The dependent variable was an indicator for whether the loan went to foreclosure in a given time period. Doing so allows us to isolate the effect getting a home inspection has apart from the borrower, loan, and property characteristics in the dependent variables. This analysis showed that the risk measure (loan and property characteristics) and borrower characteristics appear to explain the difference in foreclosure rates between loans in our sample with and without home inspections (see app. IV for the details of this analysis). Consequently, based on our analysis, increasing the number of buyers who get home inspections is not likely to have a material effect on FHA's insurance fund.

Enforcing Mandatory Home Inspections Would Pose Significant Challenges to FHA but Would Offer Varied Results for Homebuyers and Inspectors

The implications for FHA of mandatory home inspections mainly have to do with the need to set national standards for inspections and the resources FHA would need to enforce compliance with them. FHA believes it does not have the resources to effectively enforce a requirement for home inspections meeting an appropriate standard. Also, FHA expects that more often, capable buyers might choose to pursue other lending options rather than bear the cost of home inspections, potentially exacerbating a trend of FHA serving increasing numbers of riskier borrowers. For homebuyers, such a requirement would likely bring benefits to those who would otherwise forgo home inspections, such as having sellers make repairs on the homes. However, buyers might also find the requirement negatively affects their competitiveness in certain real estate markets or increases the costs of obtaining mortgage loans. Lastly, home inspectors might face added costs from meeting or demonstrating their compliance with new FHA requirements.

FHA Believes Mandatory Home Inspections Would Require Setting National Standards

FHA officials believe the first step in implementing a requirement for home inspections would be to establish national standards. These standards would spell out inspectors' qualifications and list all the required components of an FHA-sanctioned inspection. FHA officials believe if it requires homebuyers to get inspections, the agency has an obligation to ensure a minimum level of quality of the service. FHA officials say national standards are the way to accomplish this, because they would address variations among home inspections from state to state.

Officials from FHA, the National Association of Realtors, the Mortgage Bankers Association, and two home inspectors' industry associations agree that differences exist in the quality of home inspections as well as the qualifications of the inspectors from one location to the next. For the most part, they attribute these differences to the presence (or absence) of state regulation of home inspections and, to a certain extent, some variation in the manner in which states that regulate do so. As we show in figure 9, 27 states currently regulate home inspections in some way, but the remaining states and the District of Columbia do not.

Figure 9: States That Regulate Home Inspections

Source: GAO analysis of state data.

Note: The District of Columbia does not regulate home inspections.

We found FHA officials and others are likely correct in asserting that there can be variations in the manner in which different states regulate home inspections. For example, most of the states that regulate home inspections have standards for inspectors in areas such as experience, continuing education, and codes of ethics. However, the states' requirements in these areas can vary. For example, in states that require continuing education, the number of hours required each year ranges from 5 to 20 hours. In states with a home inspection experience requirement, the number of inspections each inspector must conduct as an apprentice in order to meet state requirements varies from 20 to 250 inspections. Also, states vary in terms of the extent to which they spell out the contents of home inspections. For example, 21 of the 27 states that regulate the home inspection industry have or plan to develop standards of practice for the various parts of a home that inspectors must address. However, 6 states have no such standards defining the content of home inspections.

Based on FHA's stated preference for national standards, past GAO work has suggested that FHA's choices would likely come down to standards that are either fixed or minimum.[21] These choices differ primarily in the way they preempt existing state regulations (see figure 10).

Figure 10: Fixed vs. Minimum Federal Standards

Fixed federal standards—	preempt all state rules, allowing no state to deviate from them by, for example, adding more requirements.
Minimum federal standards—	preempt some, but not all, state rules. States with rules less stringent than the new federal standard would have to raise them, but those that meet the new standard would not. All states are free to set additional standards as they continue to meet the federal minimum.

Source: GAO.

FHA officials indicated they would likely set minimum federal standards for home inspections rather than establish a fixed standard. The flexibility of minimum standards offers certain attractive features over fixed standards. Minimum standards would not prevent states from setting specific regional requirements, such as wind-resistance standards in hurricane-prone areas. Also, inspectors prefer an approach like this because it would allow them to distinguish their services by offering more than what FHA might require, and, in doing so, better compete for homebuyers' business.

FHA officials would expect to develop the national standards for home inspections themselves. However, they stated that another option would

[21]See U.S. General Accounting Office, *Regulatory Programs: Balancing Federal and State Responsibilities for Standard Setting and Implementation*, GAO-02-495 (Washington, D.C.: March 2002).

be to contract with a qualified organization to develop standards of practice. However, FHA would continue to have an oversight role as contract administrator and would have to assure itself that any standards developed under contract are sufficient for its purposes. FHA could then establish a requirement that inspections meet these standards or any that are substantively equivalent to them.

FHA May Lack the Resources to Effectively Enforce a National Home Inspection Requirement

FHA officials said creating and maintaining an effective enforcement system would be the most important and resource-intensive part of any effort to mandate home inspections, but currently the agency has neither the capacity nor resources to effectively carry out this task. According to FHA, past experiences with mandatory appraisals and a lack of sufficient human capital and other resources are its main concerns with effectively enforcing such a requirement.

FHA cites the difficulty of regulating the home appraisal industry as the basis for its concerns about home inspections. Recent GAO work has demonstrated various problems FHA and its partners have experienced in regulating appraisals. For example, FHA officials acknowledge that they have lacked sufficient resources to evaluate the quality of many FHA appraisals and that its procedures for monitoring appraisals were inadequate and inefficient. Consequently, according to FHA, its sanctioning of appraisers was inconsistent. To address these problems, FHA restructured its enforcement efforts to focus more on individual appraisers rather than the content or quality of the appraisals themselves. According to FHA, it did so in order to adopt a risk-based, more manageable approach to its oversight responsibilities that allows it to target only those appraisers whom various indicators show may have a pattern of poor performance. For example, FHA now tracks foreclosure rates by appraiser—that is, it links individual loans for which it has paid claims to the person who did the appraisal in support of the loan when it was originated. FHA does this in order to identify those who may be performing fraudulent, inflated appraisals, which can increase the likelihood of foreclosure.[22]

FHA officials told us they doubt FHA's ability to effectively ensure the quality of home inspections given the agency's history of struggling to do this with appraisals (prior to turning its focus to the appraisers). Because it has no experience regulating home inspections and inspectors, FHA officials expect they would have to spend some time evaluating the quality of home inspections before they could consider turning FHA's focus to individual inspectors by adopting the kind of risk-based approach it adopted for appraisals.

FHA officials said the agency currently does not have the human capital or other resources it needs to enforce a home inspection requirement. For example, FHA officials told us that they do not have enough people with the right skills to conduct basic enforcement activities, such as quality control reviews of home inspections or investigating complaints. They also indicated an effective enforcement system would require an infrastructure for approving inspectors to perform FHA-sanctioned inspections and tracking inspectors' compliance with standards. Being able to track performance is particularly important to FHA officials because lessons learned from the appraisal industry taught them the necessity of having in place at the outset an effective system to monitor performance so FHA can act quickly against poorly performing or fraudulent inspectors.

FHA might be able to reduce the resource demands of a home inspection requirement by relying on those states that have existing regulatory efforts. FHA officials indicated that they would likely defer to state standards in those states that regulate the home inspection industry. However, FHA officials say they would need to evaluate each state's standards and enforcement efforts to ensure they meet any minimum standard FHA sets. The extent to which relying on existing state regulatory structures would help FHA is unclear. GAO has reported that in situations where the federal

[22]An inflated appraisal increases the likelihood a borrower will default on the mortgage because the market value of the house is less than the buyer paid for it and/or owes on the mortgage. As a result, the buyer may have no (or negative) equity in the house because the loan amount exceeds the sales price the buyer would probably get (the actual market value, as opposed to the value the inflated appraisal determined). Buyers who encounter difficulty making loan payments may be more likely to default in such a situation because selling the home would be costly (unlike, e.g., a buyer with positive equity who would profit from selling the home).

and state governments have overlapping regulatory programs, states might curtail their efforts in response to new federal regulations.[23] This phenomenon, which some term “programmatic displacement,” could make it necessary for FHA to provide resources to these states to induce or require them to maintain the level of effort they had been putting into oversight of the home inspection industry. In those states currently without home inspection regulations, the resource implications for FHA would almost certainly be greater. FHA officials expect that in these states the agency would face a choice between finding a way to conduct the enforcement itself or, possibly, paying the states to do so. Ultimately, the extent of programmatic displacement and the resources FHA might need to deal with it would depend on the nature of a federal home inspection requirement.

FHA agrees that concerns remain about its appraisal oversight system that could carry over to any system it develops for home inspections in which it relies on the states to enforce its requirements. For example, as part of its oversight process, FHA requires appraisers to hold state licenses and relies on the states to report disciplinary actions against appraisers to the Appraisal Subcommittee.[24] GAO has reported that this kind of reliance on the states, particularly for investigating complaints, can prove problematic. Officials of some appraisal industry associations have also said that state enforcement efforts can be inconsistent, particularly where enforcement must compete with other state priorities for resources.[25]

[23] GAO-02-495.

[24] The Appraisal Subcommittee is responsible for monitoring the implementation of Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which addresses both the quality of appraisals and the qualifications of appraisers involved in federally related transactions. Subcommittee members are appointed by the federal financial institution regulators (the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration).

[25] Some states have funding mechanisms that rely on appraiser license fees rather than an appropriation in the state’s budget process. Because some states dedicate these fees to enforcement, enforcement efforts do not have to compete for resources as they may have to do in other states.

Homebuyers Might Seek Other Loan Options if FHA Requires a Home Inspection

FHA and real estate industry professionals indicated to us that adding a home inspection requirement might make FHA-insured loans less attractive to homebuyers. The demand for FHA-insured loans sometimes depends, in part, on what alternatives are available to homebuyers. In the past, buyers who did not meet conventional loan underwriting standards had few financing options other than FHA-insured loans. However, recently Fannie Mae and Freddie Mac have started offering loan products that compete with FHA's. Similarly, private mortgage insurers also are attracting homebuyers who might have used FHA-insured financing by relaxing underwriting standards for certain lower income borrowers, allowing more of them to obtain conventional financing.

None of FHA's competitors, such as the Department of Veterans Affairs, Fannie Mae, Freddie Mac, or private mortgage insurers, require a home inspection as a condition of (the lenders) making loans. FHA officials, agreeing that private mortgage insurance often costs less than FHA's, indicated that a home inspection requirement could drive away those borrowers who can choose between FHA and the affordable products offered by others. In doing so, this requirement would, FHA argues, exacerbate a trend GAO has identified toward increased risk level in the FHA-insured loan pool.[26]

More Homebuyers Might Benefit from Inspections, but More Also Might Report Drawbacks from a New Requirement

Mandatory home inspections would likely bring to some homebuyers the benefits identified by survey respondents, but they would also likely affect the buyers' costs, their competitiveness in certain markets, or their ability to become homeowners. Similar to survey respondents, homebuyers might also find that an inspection requirement has drawbacks because the inspections provide them different assurances than they expected or because inspectors may fail to observe some problems. For example, 31 percent of buyers who got inspections reported they had problems with appliances in the first year of homeownership. Because some inspectors adhere to standards that do not require them to report on the condition of appliances, the buyers who reported these problems may be getting fewer or different assurances than they expected. Also, buyers reported inspectors failed to observe certain conditions that buyers believe the inspectors should have noticed. Most often, buyers reported that such problems had to do with plumbing.

[26] GAO-02-773.

Real estate industry professionals indicated to us that buyers who must insist on home inspections would be at a disadvantage in highly competitive real estate markets, particularly when other buyers can make offers not contingent on an inspection. The industry professionals and FHA officials also said that a home inspection requirement could lengthen search times for buyers who qualify only for FHA-insured financing, restrict some to looking for homes in certain parts of the market, or delay the homebuying process.

Home Inspectors May Do More Inspections but Face Some Additional Costs

Home inspectors would likely see some increase in business because buyers who might otherwise forgo inspections would have to get them. The amount of the increase would depend on the number of homes purchased each year. According to our survey, in 2002, 14 percent of homebuyers using FHA-insured financing did not get home inspections. Consequently, the annual increase in inspectors' business if such a requirement had begun in 2002 could have been more than 100,000 inspections (assuming that no buyers opted for conventional financing or delayed their purchases).[27]

Home inspectors might also incur additional costs from an FHA requirement, but the extent to which this might be the case would depend on the standards and various related requirements that FHA might set. At a minimum, officials of one inspectors' association expect that their membership would find it costly to adapt to a standardized reporting format for home inspection reports. FHA officials confirmed that a standardized format would be necessary in order for it to manage the workload associated with requiring and enforcing standards for hundreds of thousands of home inspections each year. To a lesser extent, inspectors might also face new costs from the requirements FHA sets for the inspections. Specifically, home inspectors, particularly those in states that regulate their industry, may already be paying for licenses, continuing education, insurance, or membership in a professional association. To the extent that FHA adopts requirements more stringent than those of the

[27]FHA insured about 730,000 purchase money mortgages on single-family homes purchased in 2002 ("purchase money" means this figure excludes mortgage refinancings—this figure also excludes condominiums) and 14 percent of 730,000 is 102,200. We estimate that the increase in the number of inspections may be greater than 100,000 because the requirement could extend to more homes than those included in the scope of our homebuyer survey, such as condominiums.

states or professional associations, inspectors would face additional costs to comply with FHA's standards.

Observations

For the most part, mandating home inspections for buyers using FHA-insured mortgages would have little added value for FHA or the buyers. The most compelling case for making home inspections mandatory would be a substantial, material effect on FHA's insurance fund, but demonstrating such an effect has proven illusory. While most buyers already get inspections and say they reap a number of benefits from them, those benefits apparently have little to do with nor do they extend to FHA's insurance fund. The resources necessary to enforce the requirement could easily more than offset the small marginal benefits of such a requirement, while causing unintended consequences, such as placing a burden on homebuyers in some housing markets.

FHA's reliance on lenders to provide buyers with information about the importance of home inspections is understandable. FHA has authority to hold lenders accountable for doing so but has no such influence over most others involved in the homebuying process. However, buyers often turn to sources other than lenders to learn about home inspections, and many do so before they apply for their FHA-insured mortgages. Consequently, relying solely on lenders means FHA cannot be sure that all buyers have the benefit of its advice to get home inspections at the point when buyers typically would choose to get them. Nonetheless, the response rate to our survey precludes us from concluding that FHA's advisory has an effect on the frequency of home inspections or that providing the FHA advisory sooner would have a measurable effect on buyers' choices about inspections.

Agency Comments and Our Evaluation

We provided HUD with a draft of this report for review and comment. In a letter from the Assistant Secretary for Housing (see app. I), HUD agreed with our findings and observations. HUD also suggested several technical clarifications, which we have incorporated as appropriate.

Scope and Methodology

To determine how many homebuyers got home inspections, what they report as benefits and drawbacks of the inspections, and the extent to which they understand the differences between appraisals and inspections, we surveyed a representative sample of buyers who purchased homes in

2002. To assess the association home inspections may have with loan performance, we reviewed a representative sample of FHA loan files from loans insured in fiscal years 1996 through 1999 to determine whether the homebuyer had sought a home inspection. We used this information, combined with data on loan performance and borrower characteristics, such as credit scores, to determine the association home inspections may have with loan performance. In appendixes II and III we present in greater detail the methodologies we used for developing, administering, and analyzing the results of the homebuyer survey and the loan performance file review.

To determine the implications of making home inspections mandatory, we interviewed officials at FHA, the Department of Veterans Affairs, Fannie Mae, and Freddie Mac. We also interviewed industry association officials representing home inspectors, appraisers, real estate agents, and lenders. We reviewed reports that GAO, the HUD Inspector General, and others have issued addressing various aspects of FHA's oversight of the appraisal industry to identify implications that experience might suggest for a home inspection requirement. We also drew on work GAO has done in recent years on intergovernmental relations issues to identify and discuss with FHA and others the implications of a federal home inspection requirement in relation to the states' inspection regulations. To determine which states regulate home inspections as of the end of calendar year 2003, we verified the results of an industry association's analysis by visiting each state's web site to confirm the presence or absence of state regulations, as well as confirm the details of the regulations the states have in place. We corroborated with a home inspectors association the information on the number of states that regulate inspections.

We conducted our review between April 2003 and April 2004 in accordance with generally accepted government auditing standards.

As arranged with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after the date of this letter. At that time, we will send copies to the appropriate congressional committees and to the Secretary of Housing and Urban Development; it will also be available at no charge on GAO's Web site at http://www.gao.gov.

If you or your staff have any questions about this report, please call me at (202) 512-8678. Key contributors to this report are listed in appendix VI.

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

Comments from the U.S. Department of Housing and Urban Development

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

APR 1 5 2004

Mr. Mathew J. Scire
Assistant Director
Financial Markets and Community Investment
General Accounting Office
441 G Street NW, Room 2440-B
Washington, DC 20548

Dear Mr. Scire:

The Department of Housing and Urban Development's Federal Housing Administration (FHA) has reviewed the draft report entitled *Home Inspections: Many Buyers Benefit from Inspections, but Mandating Their Use is Questionable (GAO-04-462)*. FHA appreciates the General Accounting Office's (GAO) comprehensive analysis of the issue and concurs with the findings and conclusions outlined in the draft report.

FHA has identified a few minor errors and is recommending revisions for accuracy and clarification. The proposed edits are listed below:

Page 1: 2nd paragraph, 4th sentence, recommend the description be expanded and the sentence split into several sentences to read as follows: "Borrowers are required to read and sign "For Your Protection: Get a Home Inspection" at or before the sales contract is ratified. However, in some cases, the borrower does not receive the information from their realtor at the time the sales contract is executed. In these cases, at loan application, the lender would direct the borrower to review and sign the form and would have the sales contract re-executed. When borrowers signs the form at loan application, rather than at the time the sales contract is executed, they may have made their decisions about inspections before they read and signed the form."

Page 7: 1st paragraph, end of last sentence should read as follows: "In Fiscal Year 2002, for instance, 72 percent of FHA-insured **purchase mortgages** went to first time buyers."

Page 7: 2nd paragraph, 3rd and 4th sentences, recommend the words "confirm" and "confirming" be changed to "estimate" and "estimating," respectively.

Page 9: the For Your Protection: Get a Home Inspection form (HUD-92564-CN) was updated and made mandatory on February 22, 2004.

www.hud.gov espanol.hud.gov

2

Page 11: heading on right hand side of Table 1, recommend the phrase "minimum property standards" be changed to read "minimum property requirements."

Page 12: upper right and lower right boxes in right hand column of Table 2, recommend the phrase "minimum property standards" be changed to read "minimum property requirements."

Page 33: 3rd paragraph, 2nd sentence, recommend sentence be changed to read as follows: "In the past, HUD's procedures for monitoring appraisals were inadequate and inefficient. The Department was reviewing a random sample of 10 percent of the program's activity, rather than identifying particular appraisers or targeting riskier types of loans for review. Consequently, the sanctioning of FHA appraisers was inconsistent."

Page 36: 1st paragraph, 2nd sentence, recommend sentence be changed to read as follows: "As part of the oversight process, FHA requires appraisers to hold state licenses and relies on the states' reporting of disciplinary actions to the Appraisal Subcommittee (ASC)."

If you have any questions or comments pertaining to these suggested changes, please contact Vance T. Morris, Director of the Office of Single Family Program Development at 202-708-2121.

Sincerely,

John C. Weicher
Assistant Secretary for Housing-
Federal Housing Commissioner

Scope and Methodology for GAO Survey of Recent Homebuyers

Overview

GAO conducted a general population survey of homeowners who closed on their home purchases in calendar year 2002 to determine: (1) how many recent homebuyers got home inspections, (2) what recent buyers report as the primary benefits and drawbacks of the inspections, (3) the extent that recent homebuyers understand the differences between appraisals and inspections, and (4) by what means buyers develop their understanding of these differences. We present the survey itself in appendix V.

Scope and Methodology

The population for the homebuyer survey consisted of buyers who bought their homes in 2002 using a mortgage FHA endorsed for insurance that same year. We chose 2002, as opposed to earlier or later years, for two reasons: (1) buyers would likely still remember key aspects of their homebuying experience, such as the home inspection and (2) buyers would have experienced full heating and cooling seasons and be able to report on the condition of their homes and the major systems during their first year of homeownership.

The survey addressed the number of buyers who reported getting inspections and allowed them to indicate what they believe were the benefits and drawbacks of inspections. The survey also asked respondents about key aspects of inspections and appraisals so that we could use responses to individual questions or combinations of questions to determine whether the answers reflect an accurate understanding of the two processes. Examples of the key aspects of home inspections and appraisals include how and when the buyer paid for the inspection, when the inspection and appraisal took place, whether the buyer was present for the inspection, and who arranged for the inspection.

Survey Development

To develop areas of inquiry for the survey, we reviewed previous GAO work related to appraisals, FHA materials, and literature from industry associations related to issues about the homebuying process. We used these sources and our own analysis to develop an initial set of questions. We further developed and refined the questions by holding discussion sessions with GAO employees who had recently bought homes using FHA-insured financing.

In an effort to include the most relevant questions in a clear and concise manner, we consulted with a variety of real estate industry professional associations to discuss and improve the clarity of the questions. We also relied on these groups to confirm and/or identify for us the characteristics unique to inspections or appraisals around which we framed questions to allow us to make judgments about homebuyers' understanding of the differences between home inspections and appraisals. These groups included the American Society of Home Inspectors, the National Association of Home Inspectors, the National Association of Realtors, the National Association of Hispanic Real Estate Professionals, the Appraisal Institute, and the American Society of Appraisers.

In addition to an internal expert technical review by GAO's Survey Coordination Group, we pretested the survey with individuals who used FHA-insured financing in 2002 to verify the clarity and suitability of the questions and determine how long it would take respondents to complete the survey. We identified pretest subjects through members of the National Association of Realtors as well as personal contacts with real estate agents; we also telephoned some individuals whose names we obtained from FHA's information systems.

FHA's data indicated that 19 percent of homebuyers identified themselves as Hispanic. For this reason, we translated the survey into Spanish to improve our response rate by making it easier for those who might prefer to answer our questions in Spanish. We also pretested the survey with native Spanish speakers who used FHA-insured financing in 2002. For buyers in our sample who had indicated to FHA that they are Hispanic, as well as buyers with clearly Hispanic surnames, we sent both English and Spanish language surveys, instructing them to use the version with which they were most comfortable.

Sampling

We conducted the survey between October 2003 and February 2004 using a self-administered mail-out questionnaire to a random sample of 261 homebuyers. We drew the names of these buyers from a FHA database of all new 203(b)[1] loans insured in calendar year 2002. We stratified this sample by region (using four geographic areas of the United States) and by whether or not the state in which the buyer lives regulated home inspections as of the time we drew our sample. We did this in order to control for variations in respondents' answers that may have been related to location or state regulation. A sample size of 261 allows for estimates

[1]203(b) refers to single-family homes and excludes, for example, condominiums.

within plus or minus 5 percent about the population of all buyers using FHA-insured loans (at the 95 percent level of confidence). We performed basic tests to ensure the reliability and usefulness of the data FHA provided us. These included computer analyses to identify inconsistencies and other errors in the data set from which we drew our sample of homebuyers.

The combination of regulatory status and geographic region created a stratified random sample with eight strata in total. We drew a stratified random sample using the licensure regulatory status/regional scheme. For purposes of inclusion in the population frame, only loans for purchases made in the fifty states and the District of Columbia were included. We excluded loans for purchases of condominiums and loans for mortgage refinancing.

We mailed the survey on October 14, 2003, and, to maximize the response rate, sent three subsequent follow-up mailings of the survey in November, December, and January. After the second mailing, we also telephoned many of the nonrespondents to encourage them to complete the survey. Follow-up mailings and telephone calls went only to those who had not responded. We ended data collection on February 2, 2004.

We received 150 of the 261 surveys mailed out. We deemed 9 of these to be outside of the scope of our survey and did not include them in any analysis because the respondents indicated that they either did not buy their homes in 2002 or they did not use FHA-insured financing. Disregarding these 9 surveys, our overall response rate was 56 percent. Table 5 shows the final disposition of the sample (the 261 surveys initially mailed) by strata.

Table 5: Disposition of Sample Drawn from 2002 FHA Data

Strata ID	Population size	Sampled	In scope	Out-of-scope	Nonrespondents
1	21,863	12	5	0	7
2	42,027	23	14	1	8
3	190,775	80	43	2	35
4	64,032	49	22	3	24
5	97,252	41	24	1	16
6	20,321	10	5	1	4
7	43,028	21	12	1	8
8	70,285	25	16	0	9
Total	**549,583**	**261**	**141**	**9**	**111**

The estimates we make in this report are the result of weighting the survey responses to account for effective sampling rates in each stratum. These weights reflect both the initial sampling rate and the response rate for each stratum. As with many surveys, our estimation method assumes that nonrespondents would have answered like the respondents.

Sampling Error

For the estimates we present in this report, due to some survey nonresponse, we are 95 percent confident that the results we would have obtained had we studied the entire population are within +/- 10 or fewer percentage points of our estimates (unless otherwise noted). Because we surveyed a sample of recent homebuyers, our results are estimates of homebuyer characteristics and thus are subject to sampling errors. Our confidence in the precision of the results from this sample is expressed in 95 percent confidence intervals, which are expected to include the actual results for 95 percent of the samples of this type. We calculated confidence intervals for our results using methods appropriate for a stratified probability sample.

Nonsampling Error and Data Quality

We conducted in-depth pretesting of the questionnaire to minimize measurement error. However, the practical difficulties in conducting surveys of this type may introduce other types of errors, commonly known as nonsampling errors. For example, measurement errors can be introduced if (1) respondents have difficulty interpreting a particular question, (2) respondents have access to different amounts of information in answering a question, or (3) those entering raw survey data make keypunching errors. We took extensive steps to minimize such errors in developing the questionnaire, collecting the data, and editing and analyzing the information. For example, we edited all surveys for consistency before sending them for keypunching. All questionnaire responses were double key-entered into our database (that is, the entries were 100 percent verified), and a random sample of the questionnaires was further verified for completeness and accuracy. In addition, we performed computer analyses to identify inconsistencies and other indicators of errors.

GAO's Decision Rules for Using the Homebuyer Survey to Measure Respondents' Understanding of the Differences between Inspections and Appraisals

To make judgments about buyers' understanding of the differences between appraisals and inspections, we built into our survey questions focusing on characteristics that are closely associated with either inspections or appraisals. We consulted with industry experts and FHA officials to identify these characteristics, which included the timing, financing (method of payment), referral source (how buyers found inspectors or appraisers), and outcome of each assessment. For example, home inspections typically occur much closer to the time sellers accept purchase offers than do appraisals (survey question 28); also, the costs of appraisals are commonly rolled into the closing costs for mortgages, whereas this is rarely the case for home inspections (survey question 39). (See app. IV for the homebuyer survey and the individual questions to which this appendix refers).

Members of the audit team then reviewed the survey questions to make independent judgments about which answer choices to various survey questions were most or somewhat indicative of whether or not buyers do or do not understand the differences between inspections and appraisals. The team then developed a consensus on the answer choices we would use to make judgments about buyers. In doing so, we arrayed these answer choices according to whether or not the buyer first reported having gotten a home inspection and then divided these groups into those who likely do (or do not) understand the differences.[2]

[2]The set of questions we used to judge buyers' understanding is different depending on whether or not the buyer reported getting a home inspection (early in the survey). It was necessary to use different lists for each set of buyers because respondents answered different sets of questions via survey skip patterns, depending on whether or not each reports they got a home inspection.

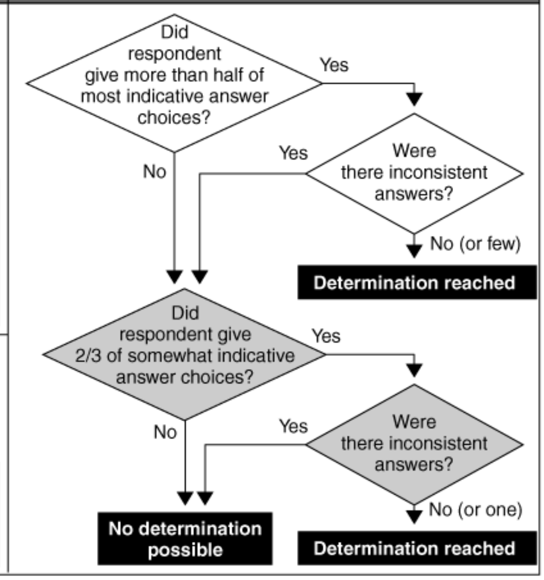
We applied the decision rules we illustrate in figure 11 to make our judgments about buyers' understanding, first considering the answer choices that indicate that the buyer understands the differences between appraisals and home inspections. Where no determination about the buyer's understanding was possible, we then considered the answer choices that indicated that the buyer did not understand. For any remaining respondents about whom we could not make a determination, we concluded there was insufficient information to make a judgment about their understanding because they had given too few answers indicative of a level of understanding and/or gave too many inconsistent answers.[3]

[3]An inconsistent answer would be, for instance, a buyer who reported contacting a professional home inspector organization to find an inspector (answer choice 29.5) who also reported the inspector did not provide a written report or binder with the results of the inspection (30.2). These answers are inconsistent because the professional inspector organizations almost always require the inspector provide a written report summarizing the results of the inspection.

Figure 11: GAO Decision Rules for Judging Buyers' Understanding of the Differences between FHA Appraisals and Home Inspections

Determination: Did buyer understand the differences between appraisals and home inspections?	GAO survey answer choices used to make determination: Buyers who got a home inspection	GAO survey answer choices used to make determination: Buyers who did not get a home inspection
Yes (most indicative)	27.1 28.1 or 28.2 29.5 30.1 32.2 (if yes) 39.1 43.5	50.11 (50.2 or 50.4 or 50.12 or 50.14) and 51.1
Yes (somewhat indicative)	(12.2 and 23.1) or (12.2 and 23.2) 26.3 27.2 29.1 or 29.3 or 29.4 or 29.6 or 29.7 44.3 51.1 and 52.2	(12.2 and 23.1) or (12.2 and 23.2) 50.3 or 50.8 50.6 50.10 51.1 and 52.2
No (most indicative)	23.4 26.5 27.3 38.3 39.3	23.4 50.7 50.9 50.13
No (somewhat indicative)	30.3 38.4 39.2 52.3	52.3

Determination process



White box: Most indicative of understanding/not understanding
Grey box: Somewhat indicative of understanding/not understanding

Source: GAO Survey of Recent Homebuyers.

Note: Survey question numbers with decimals refer to a specific answer choice for a question; for example, 29.5 refers to the fifth answer choice for question 29; see appendix V for a copy of the survey instrument.

Scope and Methodology for GAO Loan Performance Analysis: FHA-Insured Loans, Fiscal Years 1996-1999

Overview

For an earlier report,[1] we built econometric models to capture the probabilities that a borrower might default on a loan (and result in a claim on FHA's Mutual Mortgage Insurance Fund) or prepay the loan (e.g., by refinancing). For this analysis, we assessed whether there is evidence that factors not captured in our previous model—credit scores and home inspection contingencies—may exert independent effects on the credit risk of FHA-insured single-family mortgages. In this appendix, we describe how we conducted that assessment.

Our basic approach was to (1) use the results of the econometric models built for our previous report to produce a measure of the overall credit risk on a particular loan; (2) add two additional types of variables, reflecting the borrower's credit score and the presence of a home inspection contingency in the loan file; and (3) estimate a new regression to predict claim (or prepayment) as a function of our risk estimate from the previous model combined with the newly added variables.

Scope and Methodology

To determine the extent to which getting a home inspection might affect the performance of FHA-insured loans, we reviewed a random sample of loan files for FHA-insured mortgages originated in fiscal years 1996 through 1999 to (1) determine whether the buyer(s) got a home inspection and what credit score(s), if any, the lender considered in underwriting the loan and (2) assess the reliability of selected key data elements whose original source(s) are the documents in the loan file and which FHA provided us from its electronic databases. The first step (home inspection and credit scores) required original data collection; the second required verification of data FHA collected.

We selected loans that FHA insured in these years because prior work by GAO and others has shown the peak foreclosure period for mortgages to be 3 to 8 years after origination.[2] We focused on those in FHA's 203(b) program (single-family, one-to-four-unit dwelling) and excluded condominiums and mortgage refinancings because (1) for condominiums,

[1]GAO-01-460.

[2]Because we obtained from FHA the loans' status as of June 2003, their "age" relative to origination ranged from almost 8 years (loans from early fiscal year 1996 would have been originated late in calendar year 1995) to over 3 years (loans from late fiscal year 1999 would have been originated as late as September 1999).

many of the major areas and systems that home inspections cover are typically the responsibility of a homeowner's association, not the property owner and (2) refinancings are not purchases and thus would not present the owner an option to obtain an inspection as a condition of the purchase.

We drew a random sample of 300 loans from the fiscal years 1996-1999 period consisting of two strata: loans with no claim and loans with a claim (i.e., the loans had gone to foreclosure). Because relatively few mortgages end in foreclosure, we over-sampled that strata (relative to its proportion in the loan database) in order to have enough observations in each strata to determine whether there is a statistically significant relationship between getting a home inspection and loan performance. FHA provided us information on the status of these loans as of June 2003.

We reviewed 260 paper loan files for these loans to record whether a home inspection occurred by examining the purchase contracts for evidence of home inspection contingencies. Generally, if the contract contained a contingency requiring the seller to allow the buyer to have a professional home inspection, we concluded that this buyer got a home inspection.[3] We also collected from these files information on borrowers' credit scores in order to perform a secondary analysis on whether there is a relationship between credit scores and loan performance.[4] We verified 100 percent of the data we collected from these files by having a second person compare

[3]We recognize that there may be occasions where such a contingency exists and the buyer did not obtain the inspection; similarly, there may be occasions where we find no such contingency but there was, in fact, a home inspection. A realtor with whom we consulted, among others, indicated that there are likely few of these instances and agreed that it is a reasonable judgment to conclude that the presence of a home inspection contingency indicates that the buyer obtained the inspection.

[4]When files contained (1) scores for both the borrower and a coborrower, we used the scores of the borrower; (2) multiple credit reports, we used the scores from the most recent report; (3) scores from more than one source, we used the median of these scores.

the record we created during initial data collection to the original paper loan files.[5]

[5]Just under 50 percent of the loan files we reviewed contained evidence that the borrower got a home inspection, less than the 86 percent who reported getting inspections in our survey of recent buyers. A number of factors may explain this difference. For example, 76 percent of the buyers we surveyed indicated they had inspection contingencies in their purchase contracts, which means that 10 percent of borrowers surveyed said they did not include such contingencies. Also, because FHA does not require home inspections, these loan files do not have to contain evidence that one took place. For over half of the buyers responding to our survey, we could not judge whether or to what extent they understood the differences between inspections and appraisals; presumably some of these buyers may have erroneously reported getting inspections. Finally, we do not know the extent to which the purchase contracts in the FHA loan files may have been preceded by offers and counter-offers that included inspection contingencies but which did not include them after the parties had exercised all of their options and finalized the terms of the sale.

Results of GAO's FHA-Insured Loan Performance Analysis, Fiscal Years 1996-1999

We had to modify the calculation of variables we used in the prior report before applying the results to the current model. For example, the 2001 model used annual observations by fiscal year. Because the data in the present analysis was current as of June 30, 2003, which was not the end of a fiscal year, we modified the calculations to produce quarterly data and used the results of the model to predict quarterly, instead of annual, termination probabilities. Instead of using an estimate of borrower's equity at the end of the previous fiscal year, we used an estimate of equity from the four quarters prior to the current quarter. The logistic regressions estimated the conditional probability of a loan being foreclosed in each quarter.[1]

We combined the variables and coefficients from our 2001 report into a combined risk measurement variable, which we defined as the sum of the independent variables multiplied by their respective coefficients. This variable was used as a key independent variable for the logistic regression that predicted the probability of a loan resulting in a claim during a given quarter. Two independent variables related to the credit score were also used as explanatory variables in the claim regression. First, we created a 0-1 dummy variable from our review of the paper files, reflecting whether or not a home inspection contingency was found in the paper file review. Second, we created variables for the median credit score for the borrower, which was set to zero if the borrower did not have at least one score in the paper files. We also created a dummy variable reflecting whether the file contained at least one credit score. Other researchers have found credit scores to be predictive of credit risk.[2] Borrowers with no score may be at higher risk than borrowers with an average score because these may be borrowers with very little experience with credit. However, in this analysis a borrower may have no credit score either because a score could not be calculated or simply because a score was not included in the paper file.

In general, our results are consistent with the economic reasoning that underlies our models. Most important, the probability of foreclosure increases as our combined risk measurement increases, and the coefficient on this variable is very close to 0.25, which is what we would expect from applying an annual risk variable to quarterly claim probabilities. Additionally, the coefficient on the credit score variable implies that a 10

[1]These probabilities are conditional because they are subject to the condition that the loan has remained active until a given quarter.

[2]Cotterman.

point increase in credit scores results in about a 5 percent (10 times -0.00469) reduction in foreclosure probability, similar to but somewhat lower than the 9 percent reduction for a 10 point increase effect found in Cotterman's research on FHA mortgages.[3] Additionally, a borrower who has no credit score has about the same probability of foreclosure as does a borrower with a credit score somewhat less than the typical credit score in the paper files [4] As we show in table 6, these effects are statistically significant.

Table 6: Coefficients from Logistic Regression

Variable	Estimate	Standard error	P-value
Intercept	-2.3430	1.2118	0.0532
Risk	0.2511	0.0487	0.0001
Median credit score	-0.00469	0.00186	0.0116
No credit score	-2.8584	1.1812	0.0155
Inspection	0.0795	0.1839	0.6655

Source: GAO.

The coefficient on the home inspection contingency variable indicates an impact that is the opposite of our expectation. The positive coefficient of 0.0795 implies that borrowers with inspection contingencies actually have higher credit risk, after controlling for other risk characteristics. This is the only variable in the regression that is not statistically significant at conventional levels. The standard error on this variable indicates that the effect of a home inspection could be to reduce foreclosure probabilities by as much as 28 percent or raise foreclosure probabilities by as much as 44 percent.[5]

[3]Cotterman.

[4]This is calculated by dividing the coefficient on the no credit score variable, -2.8584, by -0.00469, the coefficient on the credit score variable.

[5]These impacts are for percentage changes, not percentage point changes. A claim rate of about 3 percent in this sample implies that the effect could be anywhere from a three-quarters of a percentage point reduction in claims to a one-and-a-half percentage point increase in claims.

GAO's Econometric Model for Forecasting the Performance of FHA-Insured Mortgages

The econometric models in our previous report used observations on loan years—that is, information on the characteristics and status of an insured loan during each year of its life—to estimate conditional foreclosure and prepayment probabilities. These probabilities were estimated using observed patterns of prepayments and foreclosures in a large set of FHA-insured loans. More specifically, our models used logistic equations to estimate the logarithm of the odds ratio,[6] from which the probability of a loan's payment (or a loan's prepayment) in a given year could be calculated. These equations were expressed as a function of interest and unemployment rates, the borrower's equity (computed using a home's sales price and current and contract interest rates as well as a loan's duration), the loan-to-value (LTV) ratio, the loan's size, the geographic location of the home, and the number of years that the loan had been active. The results of the logistic regressions were used to estimate the probabilities of a loan being foreclosed or prepaid in each year. Details concerning the estimation of these regressions are contained in appendix II of our 2001 report,[7] as are tables of coefficients for the independent variables.

Reliability of Data GAO's Model Uses to Estimate Foreclosures and Prepayments

To ensure that data contained in FHA's information systems were reliable, we compared seven elements of the paper loan file to the electronic file to determine if they matched. These data elements included the address of the property, the closing date, loan amount, appraised market value, sales price, interest rate, and whether the loan's interest rate was fixed or variable. We selected these elements because of their importance in ensuring that our model (to predict loan performance) is using accurate data. Specifically, we assessed a random sample of 30 files for data reliability and found no significant or material errors; we also reviewed several years' worth of FHA financial statements audits and found no known or suspected problems with the relevant FHA information systems. From these steps, we concluded these data are sufficiently reliable for our analyses in this review.

[6] If P is the probability that an event will occur, the "odds ratio" is defined as P/(1-P). The logistic transformation is the natural logarithm of the odds ratio. See G.S. Maddala, *Limited Dependent Variables and Quantitative Variables in Econometrics* (Cambridge: Cambridge University Press, 1983).

[7] GAO-01-460.

GAO Survey of Recent Home Buyers

United States General Accounting Office

Survey of Recent Home Buyers to Help Improve the Home Buying Process and FHA Financing

Directions for Completing this Questionnaire

- **10 minutes:** This survey should not take longer than 10 minutes to complete.
- **Your answers are important:** They're what we'll use to figure out ways to improve the home buying process for people like yourself. Your "lessons learned" will benefit future buyers, but for that to happen, we need *everyone* who gets this survey to fill it out and return it.
- **Go to question 1:** That's it—please begin! There is some important information below—mainly where to send this and whom to call if you have a question—so you may want to refer back to this when you're done.

Thank you!

Please return your completed survey in the enclosed self-addressed, stamped envelope **within 10 days**. If you should lose or misplace the envelope, please send the completed survey to:

United States General Accounting Office
Attn: Julianne Stephens
200 West Adams Street, Suite 700
Chicago, IL 60606

Or, you may fax a copy of your completed survey to 202-512-2502 or 202-512-2514.

If you have any questions, please call either of the following people ***toll free*** at 1-877-211-6513:

Ben Federlein (*Hablo español*)
E-mail: FederleinB@gao.gov
or,

Bill MacBlane
E-mail: MacBlaneW@gao.gov

Please do not remove the label at the top of this survey—it helps us take your name off our mailing list so we know you've helped us (and so we don't send reminders thinking we've not heard from you).

NOTES: [a]95% confidence interval exceeds ±10% of estimate; [b]95% confidence interval exceeds ±30% of estimate.

BACKGROUND

1. Did you buy your home (go to settlement) in 2002?

100% Yes
0% No

2. Did you use FHA financing?

100% Yes
0% No
0% Unsure/Don't recall

If you answered "No" to question #1 or question #2, please do not continue. Place the survey in the return envelope and mail it back to us so we'll know this survey does not apply to you.

Otherwise, continue with Question #3.

3. Is the address where we mailed this survey the address of the home you bought in 2002?

99% Yes
1% No ➔ *(Skip to question #5)*

4. Do you still live at this address?

99% Yes
1% No

5. What month in 2002 did you go to closing?

YOUR SEARCH FOR YOUR HOME

6. Approximately how many homes did you look at before deciding on this one?

7. Besides the one you bought, did you make a written offer on any others?

33% Yes
68% No ➔ *(Skip to question #12)*

8. How many?

9. Which of the following reasons were factors in why you didn't buy that house(s)? (*Mark all that apply* ☒)

12%[a] Problem with financing
5%[a] Could not sell the home I owned at the time
19%[a] Seller backed out
16%[a] Changed my mind
35%[a] My contract was not accepted
17%[a] Had a home inspection done on the house and found problems
25%[a] Other (specify): _______________

10. Did you have a home inspection done on any of the house(s) that you did not buy?

27%[a] Yes
73%[a] No ➔ *(Skip to question #12)*

11. Did you try to negotiate with the seller further before choosing not to purchase that house(s)?

67%[b] Yes
33%[b] No

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About Your Home

12. Have you (or your co-borrower) ever purchased a home before?

28% Yes
72% No

13. What kind of home did you end up purchasing in 2002?

1% Condo/Co-op
5% Townhouse/Row house
90% Single Family detached house
4% Duplex or Multiplex

14. Was your home newly constructed (you were the first to live there) or an existing home?

20% Newly Constructed
81% Existing

15. Approximately what year was your home built?

Financing your Home

16. When did you decide to use FHA financing?

14% I only considered FHA financing
48% When I pre-qualified for my loan
8% Before I began looking for a home
15% During the search process
6% After I signed the sales contract
6% Other, please specify: __________
3% (MULTIPLE ANSWERS)

17. Why did you choose to use FHA financing? (*Mark all that apply* ☒)

64% Low down payment
36% Closing costs could be financed
13% Better protections/warranty
19% I could use gift funds for the down payment
38% Better interest rate
4% Builder offered incentives tied to FHA
5% Recommended by builder/developer
29% Recommended by real estate agent
59% Recommended by lender/loan officer (the bank or mortgage company)
20% It was the only type of loan I qualified for
2% Other, please specify: ___________

18. When you applied to your lender for a mortgage loan to buy your house, did that <u>lender</u> provide information on home inspections or home appraisals? (*Mark all that apply* ☒)

57% Information on home inspections
52% Information on appraisals
11% No information on either
27% Unsure/Don't recall

19. At any time in the process of buying your home did anyone give to you and require you to <u>read and sign</u> a document about home inspections?

53% Yes
10% No ➔ (*Skip to question #22*)
37% Unsure/Don't recall ➔ (*Skip to question #22*)

20. Who?

36%[a] Lender/Loan Officer (the bank or mortgage company)
36%[a] Real Estate Agent
4% Builder/Developer
2% Seller
3% Other, please specify: __________
18%[a] (MULTIPLE RESPONSES)

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21. When did you receive this document?

- 6% Before I began looking for my current home
- 25%[a] When I applied for the loan
- 45%[a] When I wrote a contract offer for the home
- 13%[a] At closing
- 9% Other, please specify: __________
- 3% MULTIPLE RESPONSES

MAKING AN OFFER ON YOUR HOME

22. Often, purchase offers or sales contracts require that certain conditions or "contingencies" must be met before the purchase of the home is final. Which of the following types of contingencies, if any, were included in your sales contract? (*Mark all that apply* ☒)

- 76% Home Inspection
- 22% Lead Inspection
- 11% Radon Inspection
- 58% Termite Inspection
- 6% Selling another property
- 9% Other, please specify: ___________

HOME INSPECTION

23. When, if applicable, did you learn about the purpose of a home inspection?

- 40% Before I began looking for my current home
- 43% During the search process for my current home
- 9% After I closed on my current home
- 8% I do not know the purpose of a home inspection ➔ (*Skip to #25*)
- 1% MULTIPLE RESPONSES

24. How did you learn about the purpose of a home inspection? (*Mark all that apply* ☒)

- 10% I received prepurchase homebuyer counseling
- 25% I did my own research
- 19% I read FHA materials on home inspections
- 15% I previously purchased a home
- 28% Informed by friend/relative
- 5% Informed by builder/developer
- 57% Informed by real estate agent
- 38% Informed by lender/loan officer (the bank or mortgage company)
- 2% Informed by seller
- 3% Other, please specify: __________

25. Did you get a home inspection?

- 86% Yes
- 14% No➔ (*Skip to question #47*)

26. Why did you choose to get a home inspection? (*Mark all that apply* ☒)

- 79% Make sure nothing serious was wrong with the house
- 4% Previously had a good experience with a home inspection
- 5% The appraisal made me want an inspection
- 28% Someone recommended it
- 61% FHA required me to get an inspection in order to get the loan
- 16% Make sure I knew to budget for costly repairs the house will need
- 4% Other, please specify: __________

27. Who arranged for the inspection?

- 25% Myself (or co-borrower)
- 40% My real estate agent
- 24% My lender/loan officer(the bank or mortgage company)
- 7% Other, please specify: ___________
- 4% MULTIPLE RESPONSES

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28. From the time the seller or builder accepted your offer to buy the house, how long was it before you had the home inspection done?

21% Within 3 days
27% 4 to 6 days
32% 7 to 13 days
20% 14 days or longer

29. How did you find the inspector you hired?

49% A referral from the real estate agent
24% A referral from the lender/loan officer (the bank or mortgage company)
3% A referral from a friend/relative
2% Telephone book or Internet
2% Contacted a professional home inspector organization
1% I performed the inspection myself
1% A friend/relative performed the inspection
11% Other (specify): _______________
8% Unsure

DURING THE HOME INSPECTION

30. Were you present for the home inspection?

54% Yes
45% No ➔ (*Skip to question #32*)
1% Unsure/Don't recall ➔ (*Skip to question #32*)

31. Did you observe the inspector checking any of the following components?

	Yes	No	Not Applicable
a) Main water shut-off valve	83%[a]	15%[a]	3%
b) Electrical panel box	92%	8%	0%
c) Attic	78%[a]	15%[a]	7%
d) Roof	90%[a]	10%[a]	0%
e) Cooling system	68%[a]	13%[a]	19%[a]
f) Heating System	89%[a]	11%[a]	0%
g) Structure of home	92%	8%	0%
h) Interior (e.g, walls, stairways)	92%	7%	0%
i) Exterior (e.g., deck, siding)	90%[a]	6%	4%
j) Fireplace/solid fuel burning appliances	51%[a]	3%	46%[a]
k) Attached garage/ carport	54%[a]	12%[a]	35%[a]
l) Appliances	71%[a]	18%[a]	11%[a]

32. Did the inspector provide you with any of the following materials?

	Yes	No	Don't Know
a) checklist of items observed	83%	12%	5%
b) a written report or binder with information about the inspection	79%	14%	7%
c) his/her business card	66%	24%	10%
d) copy of credentials	38%	37%	25%

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RESULTS OF THE HOME INSPECTION

33. Did the home inspection identify any problems with the home?

67% Yes
33% No ➔ *(Skip to question #35)*

34. Were the problems major or minor?

29%[a] Major (total cost $500 or more)
65%[a] Minor (less than $500)
6% Unsure

35. Did you renegotiate the sale as a result of the home inspection?

30% Yes
70% No ➔ *(Skip to question #37)*

36. What happened? (*Mark all that apply* ☒)

14%[a] Renegotiated a lower price
85%[a] Seller agreed to fix problems the inspector identified
12%[a] Seller added a home warranty
3%[a] Seller added a warranty on certain items (such as an appliance)
3%[a] Seller had to place money in escrow to pay for repairs at a later date
6%[a] Nothing
0% Other, please specify: ______________

VALUE AND PRICE OF THE HOME INSPECTION

37. How much did your home inspection cost?

15% Less than $200
30% $200 to $299
17% $300 to $399
6% $400 to $499
2% $500 or more
30% Unsure/Don't recall
1% MULTIPLE RESPONSES

38. Who paid for the home inspection?

73% Myself (or co-borrower)
14% Seller
5% My lender/loan officer (the bank or mortgage company)
7% Unsure/Don't recall
2% (MULTIPLE RESPONSES)

39. How did you pay for the home inspection?

66% Cash/Check or credit card at or near the time of inspection
4% Paid at closing separately
20% Paid at closing as part of closing costs
10% Other, please specify: ____________

40. Was your experience with a home inspection generally positive or generally negative?

47% Very positive
26% Somewhat positive
20% Neither positive nor negative
2% Somewhat negative
6% Very negative

41. When you consider the price, would you say the home inspection was:

17% Worth more than the price I paid for it
68% Worth the price I paid for it
15% NOT worth the price I paid for it

42. Do you feel having a home inspection increased or decreased your confidence in this purchase?

47% Definitely increased
33% Somewhat increased
11% Neither increased nor decreased
5% Somewhat decreased
4% Definitely decreased
1% MULTIPLE RESPONSES

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43. What things about getting a home inspection did you like? (*Mark all that apply* ☒)

3% Got a better deal on the house
48% Seller made repairs before I moved in
74% Gave me peace of mind that the house had no major problems
10% Knew to set aside money for repairs the house will need
21% Learned about home maintenance and systems
4% I liked nothing about it
3% Other, please specify: ____________

44. What things about getting a home inspection did you NOT like? (*Mark all that apply* ☒)

19% The cost
15% Inspector failed to identify problems he or she should have found
6% Hard to find a good inspector
10% No problems with the house—did not need to spend the money
54% There was not anything that I disliked
3% Other, please specify: ______________

45. In the future, if you ever buy another home, how likely will you be to get a home inspection?

78% Very likely
16% Somewhat likely
4% As likely as unlikely
1% Somewhat unlikely
1% Very unlikely

46. How likely is it that you would choose the same home inspector if you bought another home in this geographic area?

39% Very likely
23% Somewhat likely
23% As likely as unlikely
3% Somewhat unlikely
12% Very unlikely

Living in the Home You Own

47. In the first 12 months after you first moved in, what problems, if any, have you had with the following items? (*Mark one box in each row* ☒)

Item	None ($0)	Few (< $100)	Some ($100 to $500)	Much ($500 or more)	Not Applicable
Plumbing/Water Pipes	49%	24%	14%	9%	5%
Electrical	71%	16%	6%	4%	4%
Roof	79%	6%	4%	8%	3%
Cooling system/Air-Conditioner	62%	11%	9%	6%	13%
Heating System/Furnace	79%	4%	6%	8%	4%
Structure of the home	81%	7%	4%	4%	4%
Appliances	62%	8%	15%	9%	7%

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48. Were any of the problems listed in question #47 problems that you think the home inspector should have observed but did not?

16% Yes
61% No ➔ (*Skip to Question #51)*
10% Unsure ➔ (*Skip to Question #51)*
12% I did not get a home inspection ➔ (*Skip to Question #50)*
1% (MULTIPLE RESPONSES)

49. Please explain (*then skip to Question #51*):

____

____

NOT GETTING A HOME INSPECTION

50. ANSWER THIS QUESTION ONLY IF YOU DID NOT GET A HOME INSPECTION. Why did you NOT get a home inspection? (*Mark all that apply* ☒)

13%[a] There was not enough time
33%[a] Bought new home with warranty
32%[a] Cost/Wanted to save money
33%[a] Brand new home, not necessary
21%[a] Didn't think there was any risk
33%[b] Inspected home myself
0%[a] Didn't know home inspections existed
20%[a] Couldn't afford a home inspection
7%[a] Never thought about it
0%[a] Believed seller would not accept a contract with an inspection contingency
0%[a] I already lost out on a home because seller refused to allow inspection contingencies
6%[a] Seller offered a warranty on the house
13%[a] Told the appraisal does the same thing as a home inspection

APPRAISAL

51. Was an appraisal done on your home?

88% Yes
3% No
9% Unsure

52. Were you present for the appraisal?

12% Yes
82% No
6% Unsure

53. During your home buying experience, did anyone discuss with you the differences between a home inspection and the appraisal?

58% Yes
32% No➔ (*Skip to Question #55)*
11% Unsure➔ (*Skip to Question #55)*

54. Who? (*Mark all that apply* ☒)

45% Real Estate Agent
38% Lender/loan officer (the bank or mortgage company)
2% Builder/Developer
2% Unsure
1% Not Applicable

OTHER COMMENTS

55. If you have any comments relating to any of the items discussed in this questionnaire, please write them here.

____

____

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