



September 2013

FEDERAL HOUSING ADMINISTRATION

Analysis of Options for Modifying Its Products, Market Presence, and Powers

GAO Highlights

Highlights of [GAO-13-682](#), a report to congressional requesters

Why GAO Did This Study

FHA has historically provided mortgage guarantees for home buyers, particularly first-time, minority, and lower-income borrowers. In 2012, FHA insured about \$227 billion in single-family mortgages, and its overall insurance portfolio was about \$1.1 trillion. Its market presence expanded during the recent housing crisis as the conventional market contracted and Congress increased the limit on the size of loans FHA may insure. But FHA's financial condition has weakened, and FHA has not met its 2 percent statutory minimum capital ratio since 2009. In its most recent budget, the agency stated that its capital reserve account might require an infusion of federal funds.

FHA, industry participants, and researchers have suggested a number of options for improving FHA's long-term viability or for limiting FHA's market presence. These options have potential implications for taxpayers, borrowers, and others. This report discusses the options—which fall into three broad categories: (1) changes to product terms and conditions, (2) changes that would restrict FHA's market presence, and (3) changes to FHA's operations and powers—and their implications. It also describes the possible effects of broader housing finance reform on FHA.

GAO interviewed a variety of industry stakeholders and researchers and reviewed studies and other documents to identify options for reforming FHA and their implications.

View [GAO-13-682](#). For more information, contact Mathew J. Scire` at (202) 512-8678 or sciremj@gao.gov.




FEDERAL HOUSING ADMINISTRATION

Analysis of Options for Modifying Its Products, Market Presence, and Powers

What GAO Found

GAO identified a number of proposed options for adjusting product terms and conditions to help improve the Federal Housing Administration's (FHA) long-term viability (see fig. below). FHA has raised the premiums that it charges borrowers several times in recent years and has taken steps to tighten its underwriting standards—for example, by setting a minimum required credit score. Some mortgage market observers have argued that further changes such as revising underwriting standards to focus on borrowers' residual income, requiring higher down payments, or reducing seller concessions (that is, funds sellers provide to buyers to help pay for closing costs) could help FHA better manage credit risk. However, such changes would entail trade-offs. For instance, some said that raising down-payment requirements would improve loan performance, but others said that this move would delay homeownership for many borrowers. Similarly, raising premiums could potentially increase revenue, but this potential would be constrained if it caused volume to decline. Further, low-risk borrowers with fewer down-payment constraints could choose less costly loans from other sources, leaving FHA with more high-risk borrowers. These changes could have a direct effect on the availability of credit for borrowers.

Options to Improve FHA's Long-Term Viability or Reduce Its Market Presence

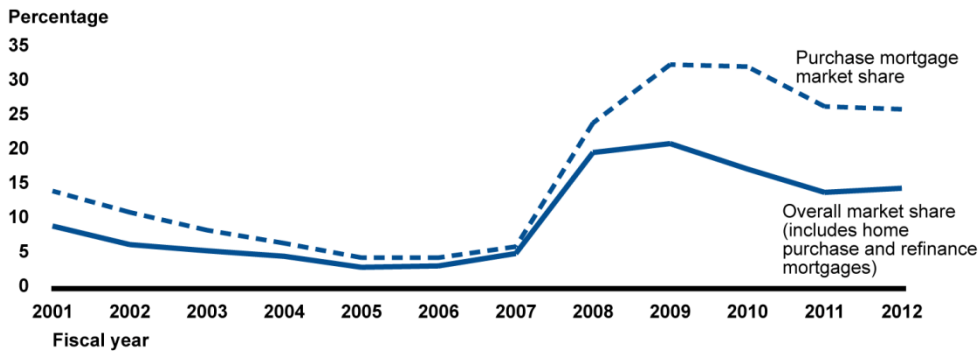
 Changes to product terms and conditions	 Changes that restrict FHA's market presence	 Changes to FHA's operations and powers
<ul style="list-style-type: none"> • Changing underwriting requirements • Increasing down payments and reducing seller concessions • Raising premiums and using risk-based pricing 	<ul style="list-style-type: none"> • Reducing loan limits • Determining eligibility based on income • Reducing insurance coverage to less than 100 percent of the loan amount • Risk sharing with private partners 	<ul style="list-style-type: none"> • Making FHA an independent government corporation • Enhancing its enforcement powers • Increasing its ability to make program changes • Increasing funding for information technology changes • Paying employees outside of federal pay scales • Giving it greater authority to pilot new programs

Source: GAO.

GAO also identified options that could either directly or indirectly change FHA's market presence, which increased after the housing crisis, or address its financial viability (see fig. below). Among the proposals that would have a direct effect are those limiting FHA insurance to loans below a lowered ceiling or to borrowers who met new income guidelines. Many stakeholders and FHA itself view FHA's current loan limits, which range from \$271,050 to \$729,750 for one-unit properties in the contiguous United States, as too high. Some note that the agency may insure larger loans than the housing enterprises Fannie Mae and Freddie Mac. The current FHA limits were put in place in response to declines in mortgage lending during the housing crisis, when the private sector's role in financing mortgages shrank. However, as the market has improved, some have noted that lowering loan limits would allow private capital to return to the market

and focus FHA on low- and moderate-income and first-time home buyers, a shift that many observers consider appropriate. Other proposed changes, such as reducing insurance coverage to less than 100 percent of the loan amount or entering into risk-sharing agreements with private partners, may indirectly reduce FHA's market presence. However, applying a partial coverage model would limit availability of credit to some borrowers. For some lenders, the additional exposure might prompt the purchase of additional insurance coverage from third parties, the cost of which would be passed on to borrowers. Some argue that under a risk-sharing structure private partners would assume and better manage credit risk. But creating such a structure would require careful consideration of how risks are borne, how pricing is determined, how incentives are aligned between FHA and its partners, and how FHA's role in stabilizing mortgage markets would be impacted. Others point to the additional counterparty risk posed by risk-sharing arrangements, which would necessitate greater federal oversight. Finally, these options might also affect FHA's ability to respond to changing market conditions.

FHA's Share of Loan Originations, 2001-2012



Source: GAO analysis of HUD data.

FHA and industry observers have also suggested changes to FHA's structure and powers that could enhance its flexibility and capacity to manage risk. Some of these changes would bring FHA's corporate powers more in line with those of other government corporations and increase its autonomy, providing it with enhanced enforcement powers and greater authority to change program requirements and invest in staff and technology. FHA has already requested additional enforcement authority. FHA and other observers have also argued that FHA needs greater power to change loan products or loan features without a lengthy rulemaking process and additional information technology resources—resources for which FHA must currently compete within HUD. Expanding FHA's operational and managerial powers would give the agency more flexibility, and increasing its enforcement powers would allow it to more effectively oversee lenders. But any expansion of FHA's authority may need to be limited and transparency requirements heightened, including for the rulemaking process. Even with no changes to its existing organizational structure and authorities, FHA can do more to enhance program efficiency and effectiveness and protect taxpayers. GAO has made a number of recommendations aimed at improving FHA's loss mitigation efforts, management of real-estate owned inventories, risk assessment, human capital management, and information technology systems. In response to these recommendations, FHA has taken steps, such as developing a plan for conducting an inaugural risk assessment and a workforce analysis and succession plan.

Finally, efforts to further regulate housing finance and the continuing uncertainty over resolution of Fannie Mae and Freddie Mac present challenges to any efforts to reform FHA. Following the collapse of the mortgage market, Congress passed a number of mortgage reforms that could impact FHA's market share and role because they could affect the price at which the conventional market will be able to serve future home buyers of varying credit risk profiles. Similarly, the administration has put forth several options for reforming the federal role in the mortgage market, including reform of Fannie Mae and Freddie Mac. Each of these options could have an impact on FHA's role in the mortgage market. Partly for this reason, GAO identified modernization of the federal role in housing finance as a high-risk area in early 2013. Any changes to the federal tools that support housing finance should be made in concert and with full recognition of the interdependence among FHA, the enterprises, and federal regulation.

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Abbreviations

APA	Administrative Procedure Act
APOR	average prime offer rate
APR	annual percentage rate
CFPB	Bureau of Consumer Financial Protection
DTI	debt service-to-income
FCRA	Federal Credit Reform Act of 1990
FHA	Federal Housing Administration
FHFA	Federal Housing Finance Agency
HECM	Home Equity Conversion Mortgages for Seniors
HERA	Housing and Economic Recovery Act of 2008
HPML	higher-priced mortgage loan
HUD	Department of Housing and Urban Development
IT	information technology
LTV	loan-to-value
MBA	Mortgage Bankers Association
MBS	mortgage-backed securities
NPRM	notice of proposed rulemaking
OMB	Office of Management and Budget
PTI	payment-to-income
QM	qualified mortgage
QRM	qualified residential mortgage
RHS	Rural Housing Service
TOTAL	Technology Open to Approved Lenders
USDA	Department of Agriculture
VA	Department of Veterans Affairs

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September 9, 2013

The Honorable Jeb Hensarling
Chairman
Committee on Financial Services
House of Representatives

The Honorable Randy Neugebauer
Chairman
Subcommittee on Housing and Insurance
Committee on Financial Services
House of Representatives

The Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA) has helped millions of families purchase homes through its single-family mortgage insurance programs, which insure private lenders against losses on mortgages that finance purchases of properties or that refinance existing FHA mortgages. In 2012, FHA insured about \$227 billion in single-family mortgages, and its overall insurance portfolio was about \$1.1 trillion. In recent years, FHA has experienced a dramatic increase in its market share, partly because the conventional mortgage market contracted during the 2007-2009 financial crisis. At the same time, FHA has faced fiscal challenges. Since 2009, its Mutual Mortgage Insurance Fund (the Fund) has not met statutory reserve requirements, as measured by the Fund's estimated capital ratio.¹ The Fund is required to maintain a capital ratio of at least 2 percent. Also, declining balances in the fund's capital reserve account and significant underestimates of program costs have heightened the possibility that FHA will require additional funds to pay all future insurance claims on its existing portfolio.

FHA has made a number of changes to address its fiscal challenges. However, mortgage market observers have stated that further actions are needed and have proposed options that could improve FHA's long-term viability or reduce its market presence. These suggestions range from changes to its product features to broad changes to its organizational structure. You asked us to examine these options and their implications.

¹The capital ratio is the economic value divided by the insurance-in-force. The economic value of the Fund is the sum of existing capital resources plus the net present value of future cash flows.

This report discusses the implications of options related to (1) changing FHA's product terms and conditions for single-family mortgage insurance, (2) restricting FHA's presence in the single-family housing market, and (3) altering FHA's operations and powers within its single-family program.² It also discusses the possible effects of broader housing finance reform on FHA. Options that included changes to FHA's capital reserve requirements were not within the scope of our review. However, we previously recommended that in place of FHA's 2-percent capital requirement, Congress or FHA specify the economic conditions the Fund would be expected to withstand without drawing on the U.S. Treasury.³ Additionally, in another report issued today, we compare the reserving practices and capital requirements of FHA to those of private mortgage insurers.⁴

To examine the options that have been proposed for improving FHA's long-term viability or limiting its market presence, we identified relevant academic and industry studies from our previous products and ongoing work and from a literature search of databases. We reviewed these studies and other documents—including from FHA and HUD—to summarize and categorize options for FHA reform. The categories we identified were potential changes to product terms and conditions, changes that affect FHA's mortgage market presence, and changes to FHA's operational powers and structure. We also reviewed studies and other documents to identify the potential implications of these options, including how the options affect cost and risk to the taxpayer, borrowers' access to credit, FHA's role and the market it serves, and other mortgage market participants. We conducted interviews with mortgage industry observers from industry, academic, government, and consumer organizations to obtain their views on the options and related implications that we identified and to obtain any additional relevant studies or papers. Appendix I contains additional information on our scope and methodology.

²FHA insures both forward and reverse single-family mortgages. Reverse mortgages permit borrowers to convert their home equity into cash advances. This report primarily focuses on FHA's forward single-family insurance program.

³GAO, *Mortgage Financing: FHA's Fund Has Grown, but Options for Drawing on the Fund Have Uncertain Outcomes*, [GAO-01-460](#) (Washington, D.C.: Feb. 28, 2001).

⁴GAO, *FHA Mortgage Insurance: Applicability of Industry Requirements Is Limited, but Certain Features Could Enhance Oversight*, [GAO-13-722](#) (Washington, D.C.: Sept. 9, 2013).

We conducted this performance audit from April 2013 to September 2013 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

FHA is a wholly owned government corporation within HUD.⁵ It was established in 1934 under the National Housing Act to broaden homeownership, shore up and protect lending institutions, and stimulate employment in the building industry.⁶

FHA's Single-Family Mortgage Insurance

FHA's single-family programs insure private lenders against losses from borrower defaults on mortgages that meet FHA criteria for properties with one to four housing units. FHA primarily insures forward mortgages for initial home purchases and refinancing, but also insures reverse mortgages that permit persons 62 years and older to convert their home equity into cash advances through its Home Equity Conversion Mortgages for Seniors (HECM) program.⁷ FHA provides most of its single-family mortgage insurance through programs supported by the Fund.⁸ FHA's single-family insurance programs are administered by the Deputy Assistant Secretary for Single Family Housing, who reports to the Assistant Secretary for Housing-Federal Housing Commissioner.

⁵A government corporation is generally a federally chartered entity created to serve a public function of a predominantly business nature.

⁶FHA was created as a separate entity by the National Housing Act on June 27, 1934. It was later abolished as a separate entity and made an entity within HUD by the Department of Housing and Urban Development Act on September 9, 1965.

⁷With forward mortgages, the borrower's monthly loan payments to the lender add to the borrower's home equity and decrease the loan balance. With reverse mortgages, the borrower receives payments from the lender. The lender adds the principal and interest to the loan balance, reducing the homeowner's equity.

⁸FHA also administers mortgage insurance programs that help to finance multifamily properties, health care facilities, hospitals, and manufactured homes under a separate insurance fund.

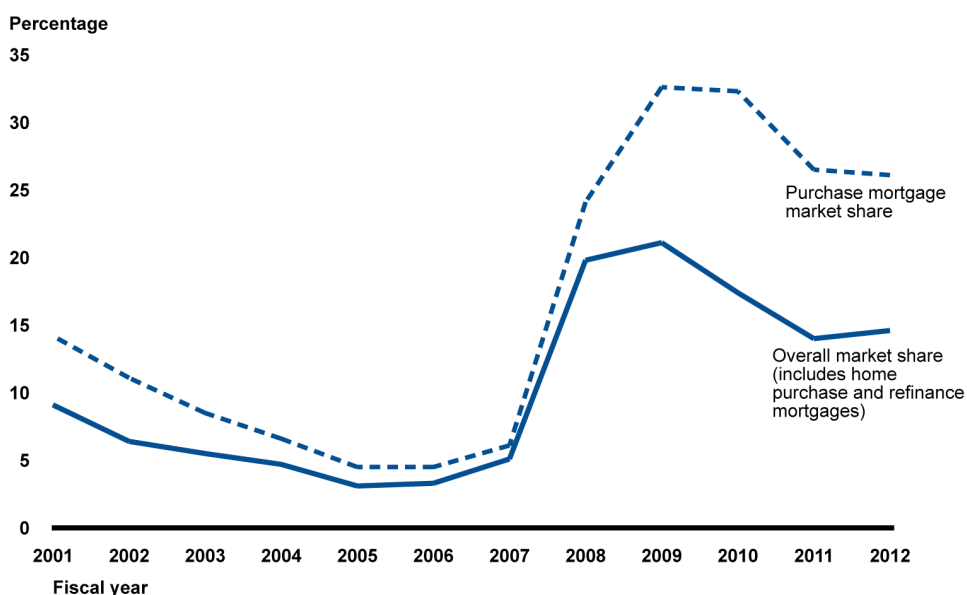
FHA is a government mortgage insurer in a market that also includes private mortgage insurers. Private mortgage insurance policies provide lenders coverage on a portion (generally 20 to 30 percent) of the mortgage balance. However, borrowers who have difficulty meeting down-payment and credit score requirements for conventional loans may find it easier to qualify for a loan with FHA insurance, which covers 100 percent of the principal balance of the loan involved in a claim and other eligible costs. Generally, borrowers are required to purchase mortgage insurance when the loan-to-value (LTV) ratio (the amount of the mortgage loan divided by the value of the home multiplied by 100) exceeds 80 percent. FHA-insured borrowers are required to make minimum cash investments of 3.5 percent, which may come from the borrowers' own funds or from certain third-party sources. Borrowers are also permitted to finance their mortgage insurance premiums, a practice that can create an effective LTV ratio of close to 100 percent. Congress has set limits on the size of the forward mortgages FHA may insure, which can vary by county. For the period from January 1, 2013, through December 31, 2013, the limits range from \$271,050 to \$729,750 for one-unit properties in the contiguous United States.

FHA's Role in Mortgage Financing

FHA's single-family mortgage programs have played a prominent role in mortgage financing in the wake of the 2007-2009 financial crisis and housing downturn. In 2012, FHA insured about \$227 billion in single-family mortgages, and its overall insurance portfolio was about \$1.1 trillion. The agency has played a particularly large role among minority, lower-income, and first-time homebuyers. In 2012, about 78 percent of FHA-insured loans went to first-time homebuyers, about 32 percent of whom were minorities. FHA is generally thought to promote stability in the market by ensuring the availability of mortgage credit in areas that may be underserved by the private sector or that are experiencing economic downturns. As the recent housing crisis and economic recession set in, the contraction of other segments of the mortgage market and legislated increases in the loan amounts eligible for FHA insurance resulted in higher demand for FHA-insured mortgages. FHA officials also noted that even if their volume had not increased, the agency's share of the market would have increased because other segments of the market declined or were completely eliminated. According to HUD's *Housing Market Conditions*, FHA's share of the market for home purchase mortgages (in terms of loan originations) grew sharply, rising from approximately 4.5

percent in 2006 to approximately 26.1 percent in 2012.⁹ Looking at the entire mortgage market (including refinance activity), FHA's share of the market also rose dramatically, and stood at 14.6 percent in 2012 (see fig. 1).

Figure 1: FHA's Share of Loan Originations, 2001-2012



Source: GAO analysis of HUD data.

A number of other private-sector and government institutions participate in the mortgage market.

- Private lenders offer home purchase and refinance mortgages and often work with mortgage brokers, independent contractors that originate the loan products of multiple lenders.¹⁰

⁹U.S. Department of Housing and Urban Development, Office of Policy Development and Research, *U.S. Housing Market Conditions 4th Quarter 2012* (Washington, D.C.: February 2013).

¹⁰Mortgage origination involves such functions as accepting loan applications and obtaining employment verifications and credit reports on the borrowers. It is distinct from mortgage underwriting, which refers to a risk analysis that uses information collected during the origination process to decide whether to approve a loan.

-
- The Department of Veterans Affairs' (VA) Loan Guaranty Service and the Department of Agriculture's (USDA) Rural Housing Service (RHS) administer federal programs that insure or guarantee single-family mortgages made by private lenders.
 - Private mortgage insurance companies offer mortgage insurance that protects private lenders against losses in the event the borrower defaults on the mortgage. Fannie Mae and Freddie Mac, two government-sponsored enterprises (the enterprises), purchase mortgages from lenders across the country, financing their purchases through borrowing or by issuing securities backed by the mortgages (mortgage-backed securities or MBS). The enterprises are currently under conservatorship.¹¹
 - Ginnie Mae is another wholly owned government corporation in HUD. It guarantees the timely payment of principal and interest of MBS backed by pools of federally insured or guaranteed mortgage loans, such as FHA, VA, or RHS.

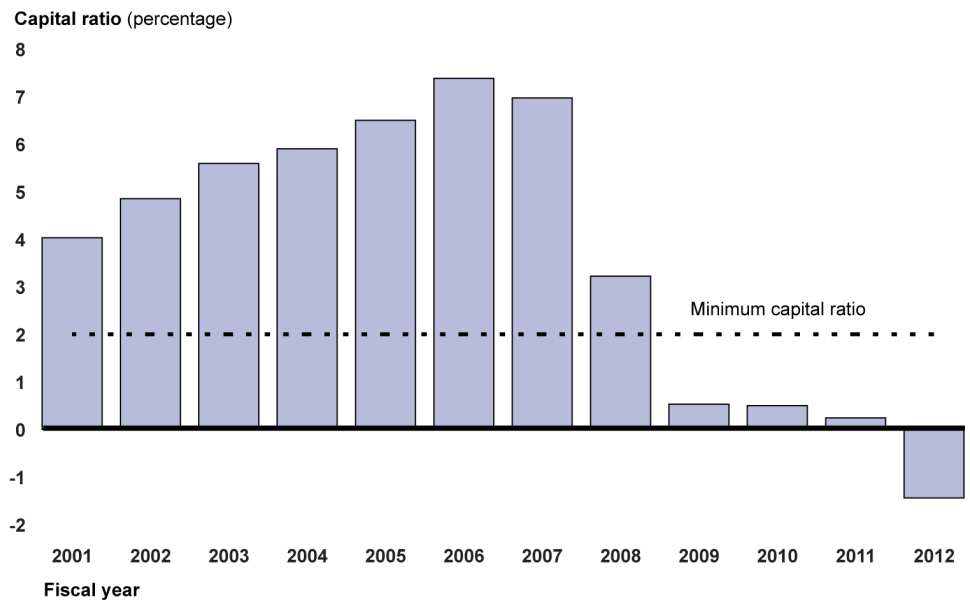
FHA's Mutual Mortgage Insurance Fund

The Omnibus Budget Reconciliation Act of 1990 required HUD to take steps to ensure that the Fund attained a capital ratio of at least 2 percent by November 2000 and maintained at least that level thereafter.¹² The capital ratio is the Fund's economic value divided by the insurance-in-force (outstanding insurance obligations). The act also required an annual independent actuarial review of the Fund's economic net worth and soundness. This actuarial review is now a requirement in the Housing and Economic Recovery Act of 2008, which also requires an annual report to Congress on the results of the review. The Fund's capital ratio dropped sharply in 2008 and fell below the statutory minimum in 2009, when economic and market developments created conditions that simultaneously reduced the Fund's economic value (the numerator of the ratio) and increased the insurance-in-force (the denominator of the ratio). According to annual actuarial reviews of the Fund, the capital ratio fell from about 7 percent in 2006 to 3 percent in 2008 and dropped to below 2 percent in 2009 (see fig. 2). In 2012, the ratio fell below zero to negative 1.44 percent.

¹¹On September 6, 2008, the enterprises' regulator—the Federal Housing Finance Agency (FHFA)—placed them into conservatorship out of concern that their deteriorating financial condition threatened the stability of the financial markets.

¹²Pub. L. No. 101-508.

Figure 2: Estimates of the Fund's Capital Ratio, 2001-2012



Source: GAO analysis of FHA data.

Under the Federal Credit Reform Act of 1990 (FCRA), FHA and other federal agencies must estimate the net lifetime costs—known as credit subsidy costs—of their loan insurance or guarantee programs and include the estimated costs to the government in their annual budgets. Credit subsidy costs represent the net present value of expected lifetime cash flows, excluding administrative costs.¹³ When estimated cash inflows (such as borrower insurance premiums) exceed expected cash outflows (such as insurance claims), a program is said to have a negative credit subsidy rate and generates offsetting receipts that reduce the federal budget deficit. When the opposite occurs, the program is said to have a positive credit subsidy rate and therefore requires appropriations. Generally, agencies must produce annual updates of their subsidy estimates—reestimates—on the basis of information about actual performance and estimated changes in future loan performance. FCRA recognized the difficulty of making credit subsidy estimates that mirrored

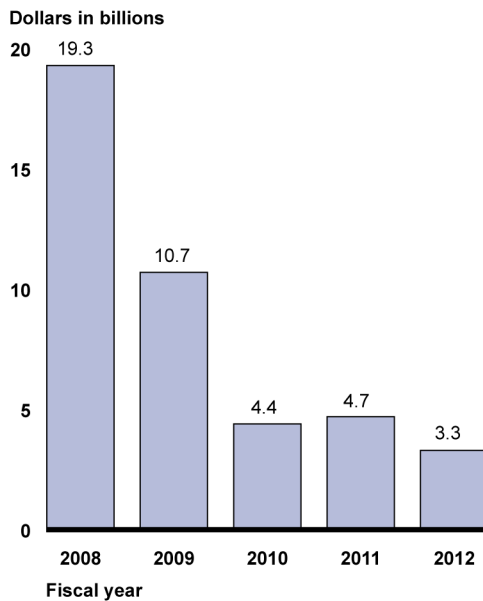
¹³For a mortgage insurance program, cash inflows consist primarily of fees and premiums charged to insured borrowers and proceeds from sales of foreclosed properties, and cash outflows consist mostly of payments to lenders to cover the cost of claims.

actual loan performance and thus provided permanent and indefinite budget authority for reestimates that reflected increased program costs.¹⁴ Upward reestimates increase the federal budget deficit unless accompanied by reductions in other government spending or an increase in receipts.

As the capital ratio declined, the Fund's condition also worsened from the federal budgetary perspective. FHA annually estimates the subsidy costs of new activity for its loan insurance program and also reestimates, or annually updates, prior subsidy cost estimates. Historically, FHA estimated that its loan insurance program had a negative subsidy cost. On the basis of these estimates, FHA accumulated substantial balances in a capital reserve account, which represents amounts in excess of those needed for estimated claims or other costs and was used to cover reestimates reflecting unanticipated increases to those costs (such as higher-than-expected claims). In recent years, FHA has transferred billions of dollars annually from the capital reserve account to cover increases in estimated credit subsidy costs of the Fund (upward subsidy reestimates). As a result, balances in the capital reserve account fell dramatically, from \$19.3 billion at the end of 2008 to an estimated \$3.3 billion at the end of 2012 (see fig. 3).

¹⁴Budget authority is the authority federal law provides to enter into financial obligations that will result in immediate or future outlays involving federal funds. Permanent budget authority is available as the result of previously enacted legislation and is available without further legislative action. Indefinite budget authority is budget authority that, at time of enactment, is for an unspecified amount.

Figure 3: End-of-Year Balances in the Fund's Capital Reserve Account, 2008-2012



Source: GAO analysis of FHA data.

If the reserve account were to be depleted, FHA could draw on permanent and indefinite budget authority to cover reestimates indicating additional increases in estimated credit subsidy costs. The President's budget for 2014 contained a \$22.4 billion upward reestimate in FHA's credit subsidy costs for the Fund. The budget indicated that the reestimate would be funded by depleting FHA's capital reserve account in 2013, using premiums collected in 2013 from new endorsements, and potentially drawing on \$943 million in permanent and indefinite budget authority. However, to the extent that such premiums collected in 2013 are different than FHA estimated, FHA may need to draw on more or less permanent and indefinite budget authority.

Changes to Product Terms and Conditions Could Help Mitigate Risk and Increase Financial Viability but Could Also Limit Borrowers' Access to Credit

Mortgage industry observers have suggested changes to FHA's product terms and conditions to lower its exposure to risk and improve its capital position. These proposed changes include tightening its underwriting standards and increasing down payments and premiums charged. However, implementing one or a combination of these options could affect borrowers' access to credit, create an adverse selection problem for FHA, or affect the agency's role in terms of the types of borrowers it serves.¹⁵

Proposed Changes to FHA's Underwriting Standards Would Involve Trade-offs That Could Affect Target Populations

Lenders must comply with FHA's underwriting criteria when making FHA-insured loans. Underwriting is a risk analysis that uses information—such as a borrower's credit history and cash assets, among other things—collected during the origination process to decide whether to approve a loan. In order to qualify for an FHA-insured loan, a borrower must have a decision credit score of at least 500.¹⁶ In addition, a borrower's payment-to-income (PTI) ratio may exceed 31 percent and debt service-to-income (DTI) ratio may exceed 43 percent only if compensating factors are documented.¹⁷

With some exceptions, lenders are required to use FHA's Technology Open to Approved Lenders (TOTAL)—a mortgage scorecard—to

¹⁵In an insurance context, adverse selection occurs when individual insurance buyers may differ in their underlying risk factors in ways that are not fully observed by the insurer. If an insurer offers policy terms and rates designed to cover its costs based on the average risks of a group of potential buyers, the result may be that those buyers who are riskier than average purchase the insurance, and impose larger than average claims on the insurer, while those buyers who are less risky than average do not purchase the insurance.

¹⁶FHA implemented this minimum required credit score in October 2010. A credit score is a numeric summary of the information in an individual's credit reports that represents his or her potential credit risk. Three national credit bureaus calculate credit scores, which range from a low of 300 to a high of 850. A decision credit score is based on the middle of the three national credit bureau scores, or the lower of the two scores when all three are not available.

¹⁷The PTI ratio is the total monthly mortgage payment divided by gross income. The DTI ratio is the total mortgage payment plus recurring obligations divided by gross income.

underwrite loans.¹⁸ TOTAL evaluates the overall creditworthiness of an applicant based on a number of credit variables and determines the associated risk level for an FHA-insured loan. FHA requires lenders to manually underwrite loans that are not accepted by TOTAL to determine if the loan should be accepted or rejected.¹⁹ Among other things, manual underwriting involves evaluating compensating factors to justify the approval of an FHA-insured mortgage. Table 1 describes the compensating factors lenders may consider when manually underwriting an FHA-insured loan for a borrower whose PTI ratio exceeds 31 percent or DTI ratio exceeds 43 percent.

Table 1: Descriptions of Compensating Factors

Compensating factor	Description
Housing expense payments	The borrower has successfully demonstrated the ability to pay housing expenses greater than or equal to the proposed monthly housing expenses for the new mortgage over the past 12-24 months.
Down payment	The borrower makes a large down payment of 10 percent or higher toward the purchase of the property.
Accumulated savings	The borrower has demonstrated an ability to accumulate savings and a conservative attitude toward using credit.
Previous credit history	A borrower's previous credit history shows that he/she has the ability to devote a greater portion of income to housing expenses.
Compensation or income not reflected in effective income	The borrower receives documented compensation or income that is not reflected in effective income, but directly affects his/her ability to pay the mortgage. This type of income includes food stamps and similar public benefits.
Minimal housing expense increase	There is only a minimal increase in the borrower's housing expense.
Substantial cash reserves	The borrower has substantial documented cash reserves (at least 3 months worth) after closing. The lender must judge if the substantial cash reserve asset is liquid or readily convertible to cash, and can be done so absent retirement or job termination, when determining if the asset can be included as cash reserves, or cash to close.
Substantial nontaxable income	The borrower has substantial nontaxable income.
Potential for increased earnings	The borrower has a potential for increased earnings, as indicated by job training or education in his/her profession.

¹⁸Lenders use TOTAL in conjunction with automated underwriting systems.

¹⁹On July 15, 2010, FHA issued a proposed rule that would impose stricter reserve and DTI ratio requirements for loans that TOTAL refers for manual underwriting as well as for loans that need to be manually underwritten because the borrowers have no credit scores. As of August 30, 2013, the rule had not been finalized.

Compensating factor	Description
Primary wage-earner relocation	The home is being purchased because the primary wage earner is relocating, and the secondary earner has an established employment history, is expected to return to work, and has reasonable prospects for securing employment in a similar occupation in the new area.

Source: FHA.

FHA recently revised TOTAL to tighten its underwriting standards. For example, according to FHA officials, the agency revised the cut points—the points of separation within a population of mortgage scores that divide applications that are accepted in TOTAL from those that are not—in order to set the lifetime claim rate of its highest-risk loans at about 13 percent. In addition, some mortgage industry observers we spoke to said that lenders may apply additional, more stringent underwriting requirements, known as credit overlays. For example, a lender could require that borrowers have a minimum credit score of 620 in order to qualify for an FHA-insured loan.

Some of the literature we reviewed and those we spoke to suggested that FHA could further tighten its underwriting standards in order to reduce the risk to the Fund, as well as the agency’s high market share. However, as described in the following examples, tightening of FHA’s underwriting requirements may affect certain borrowers’ ability to obtain mortgage credit and FHA’s ability to serve families that are able to sustain a mortgage, but do not qualify for conventional financing.

Increasing FHA’s Minimum Credit Score Requirement

Some mortgage industry observers have suggested raising FHA’s minimum credit score requirement to, for example, 580 or 620. We previously found that lower credit scores were associated with a higher likelihood of default.²⁰ FHA officials also told us that lower credit scores increase the likelihood of delinquency and default among borrowers. Accordingly, increasing the credit score requirement, all else being equal, could make FHA less subject to adverse selection based on its credit policy and help to reduce the level of risk in the overall portfolio.

²⁰See GAO, *Home Mortgages: Provisions in a 2007 Mortgage Reform Bill (H.R. 3915) Would Strengthen Borrower Protections, but Views on Their Long-term Impact Differ*, [GAO-09-741](#) (Washington, D.C.: July 31, 2009) and *Mortgage Financing: Additional Action Needed to Manage Risks of FHA-Insured Loans with Down Payment Assistance*, [GAO-06-24](#) (Washington, D.C.: Nov. 9, 2005).

Implementing a Residual Income Requirement

However, FHA data also show that the percentage of borrowers with FHA-guaranteed loans and credit scores below 620 was relatively small in 2009—approximately 10 percent of loans endorsed by FHA. Thus, implementing a credit score floor of 620—the conventional mortgage standard—likely would not significantly reduce FHA’s market share, absent any other changes to FHA’s underwriting standards, other program requirements, or the current lending volume.

Some mortgage industry observers noted that increasing FHA’s credit score requirement would decrease access to mortgage credit and delay or prevent homeownership for borrowers with lower credit scores. One paper we reviewed noted that more restrictive credit score requirements excluded a larger share of borrowers from the market in relation to the percentage of defaults they prevented.²¹ One mortgage industry observer also said that a higher minimum credit score requirement likely would have a disparate impact on minority borrowers. In addition, in a 2007 paper, the Federal Reserve found that different demographic groups had substantially different credit scores.²² The study found that on average blacks and Hispanics have lower credit scores than non-Hispanic whites and Asians.

Some mortgage industry observers also suggested that FHA implement a residual income requirement. Residual income is the amount of net income remaining after the deduction of payments for debts and obligations (including the mortgage), and is thus a measure of a borrower’s ability to make such payments without creating a substantial financial burden on the household. These observers pointed to VA’s

²¹Roberto G. Quercia, Lei Ding, and Carolina Reid, *Balancing Risk and Access: Underwriting Standards and Qualified Residential Mortgages* (Center for Community Capital and Center for Responsible Lending: January 2012). This study examined the way different qualified residential mortgage guidelines could affect access to mortgage credit and loan performance. It estimated the additional impacts on defaults and access resulting from setting qualified residential mortgage underwriting guidelines over and above the proposed product restrictions for qualified mortgages, which exclude loans with features associated with higher default rates such as lack of income documentation, hybrid adjustable-rate mortgages with teaser payments, interest only and balloon payments, and negative amortization. The authors used a nationally representative database on loan performance that included information on loan characteristics and borrower characteristics to conduct this analysis. Later in this report we discuss qualified residential mortgage and qualified mortgage rules in more detail.

²²See Board of Governors of the Federal Reserve System, *Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit* (Washington, D.C.: August 2007).

mortgage insurance program, which requires that lenders calculate the balance available for family support and compare that figure to the residual income guidelines that are based on family size, loan amount, and geographic location. For example, the guideline for a family of two living in the midwest with a loan of \$80,000 or more is a minimum of \$738 in residual income. For the same family in the west, it is a minimum of \$823. Lenders also consider the borrower's DTI ratio, but according to VA, that is a secondary underwriting factor to the residual income.²³

One industry observer we spoke to said that implementing a residual income test could be difficult, though not impossible, because determining whether borrowers were capable of paying for other expenses presented practical challenges. One paper we reviewed noted the lack of adequate empirical data and models documenting the relationship between residual income, DTI ratios, and loan performance.²⁴ This paper concluded that without such information, it would be difficult to determine the residual income thresholds that would most effectively produce high-quality mortgages without excluding lower-income borrowers from access to credit.

²³VA program guidance notes that a DTI ratio of greater than 41 percent requires close scrutiny unless the residual income exceeds the relevant residual income guideline by at least 20 percent.

²⁴Quercia, Ding, and Reid, *Balancing Risk and Access*.

Increasing FHA's Down-Payment Requirement and Reducing Seller Concessions Could Increase Borrowers' Cash Contributions

In addition to meeting the underwriting requirements outlined earlier, a borrower generally must make a cash investment (down payment) in the property to obtain an FHA-insured mortgage.²⁵ The amount of the down payment required depends on the borrower's credit score (see table 2). Down payment funds may come from the borrower's own savings or from certain third-party sources.²⁶

Table 2: FHA Down-Payment Requirements and Related LTV Ratios

Credit score	Minimum down payment	Related LTV ratio/maximum FHA-insured financing ^a
500-579 credit score	10%	90%
580 and above credit score ^b	3.5	96.5

Source: FHA.

^aLTV ratio is calculated on the base loan amount, excluding up-front premiums. According to FHA, nearly all insured borrowers finance the up-front premium, which today is 1 percent of the base mortgage amount. For a loan with a minimum down payment of 3.5 percent, the resulting LTV ratio with the financed premium would be higher than 96.5. We discuss up-front premiums below. Borrowers must still provide cash for the down payment, or obtain those funds from an approved third-party source.

^bHUD has proposed setting a 95 percent LTV maximum (5 percent down payment) on loans of \$625,500 or more.

In addition, borrowers also must pay for related closing costs. Currently, FHA permits a seller to pay up to 6 percent of the lesser of the purchase price or the appraised value of a home on behalf of a buyer to help fund these closing costs. Such payments are referred to as "seller concessions." In July 2010, FHA proposed reducing allowable seller

²⁵Down payment is considered equity in the property, and thus affects a borrower's LTV ratio. For example, if a borrower makes a 5 percent down payment, the LTV ratio at origination would be 95 percent, assuming no other investments.

²⁶In 2009, Congress eliminated seller-funded down-payment assistance (that is, assistance from nonprofit organizations that received at least part of their funding from property sellers). In a report and subsequent testimony, we discussed the risks associated with seller-funded down-payment assistance, including the higher delinquency and insurance claim rates and the fact that FHA-insured homes bought with seller-funded nonprofit assistance typically appraised at and sold for about 2 to 3 percent more than comparable homes bought without such assistance. See GAO, *Seller-Funded Down-Payment Assistance Changes the Structure of the Purchase Transaction and Negatively Affects Loan Performance*, [GAO-07-1033T](#) (Washington, D.C.: June 22, 2007) and [GAO-06-24](#).

Increasing FHA's Down-Payment Requirement

concessions to 3 percent of the lesser of the purchase price or the appraised value of a home in order to align its policy with conventional mortgage lenders and reduce the risk exposure to the Fund. In announcing the change, FHA noted that the then current level exposed FHA to excess risk by creating incentives to inflate the appraised value of homes.²⁷ In February 2012, FHA amended this plan in a proposed rule that permitted seller concessions in the amount of the lesser of 3 percent of the purchase price or the appraised value of a home, or \$6,000, whichever was greater.²⁸ According to FHA officials, the agency is in the process of addressing comments on the proposed rule. The officials said that they did not know when the rule would be finalized.

Some of the literature we reviewed and mortgage industry observers we interviewed suggested increasing FHA's requirement from 3.5 percent to, for example, 5 percent. Some said that increasing FHA's down-payment requirements would help to decrease risk in its portfolio. A substantial amount of the research we reviewed for a 2005 report on risks associated with FHA products indicated that LTV ratios and credit scores were among the most important factors in estimating the risk level associated with individual mortgages.²⁹ Our own analysis corroborated these findings. We found that, in general, mortgages with higher LTV ratios (smaller down payments) and lower credit scores were riskier than mortgages with lower LTV ratios and higher credit scores.

Others noted that increases to FHA's down-payment requirements would delay or prevent homeownership for many borrowers who often lack sufficient funds to make a large down payment. Supporting this argument, in 2011 FHA found that over 40 percent of all borrowers would not have had the additional funds to make a 5 percent down payment, based on

²⁷75 Fed. Reg. 41217 (July 15, 2010).

²⁸77 Fed. Reg. 10695 (Feb. 23, 2012).

²⁹See GAO, *Mortgage Financing: Actions Needed to Help FHA Manage Risks from New Mortgage Loan Products*, [GAO-05-194](#) (Washington, D.C.: Feb. 11, 2005).

information collected from loan applications.³⁰ In addition, one mortgage industry observer said that increased down-payment requirements could have a disparate impact on minorities.

Reducing Seller Concessions

Some of those we spoke to and the literature we reviewed said that FHA should reduce seller concessions. According to FHA, about 21 percent of loan originations in 2009 and 2010 had seller concessions of more than 3 percent of the property value.³¹ Allowing higher seller concessions makes FHA-insured loans more accessible than conventional loans because borrowers do not have to invest as much cash at closing. For example, according to FHA, under current policy, concessions on higher-priced homes can reach almost \$44,000. FHA and one mortgage industry observer suggested that reducing seller concessions could reduce the risk of exposure to the Fund from incentives that inflated the appraised value of homes. Our work on seller-funded down-payment assistance demonstrated that funds provided by seller-funded nonprofits had the effect of increasing the selling price of the home, leaving the borrower with less equity and FHA with more risk than they would have otherwise.³² This suggests that transactions involving seller concessions could result in higher sales prices than would occur without seller concessions.

Conversely, some have highlighted the importance of providing assistance to those borrowers who have difficulty accumulating sufficient funds to become homeowners. For example, one mortgage industry observer we spoke with said that reducing allowable seller concessions would be like increasing the down-payment requirement. In commenting on FHA's proposed rule, representatives of this group said that FHA must

³⁰FHA based its analysis on information lenders collected from borrowers' loan applications between August 2010 and July 2011. Specifically, lenders are required to verify the amount of liquid assets each borrower has available to close the loan. They report to HUD both that amount and the assets remaining after closing. The difference between these two numbers is the required cash payment to close the loan. That cash requirement includes not only the down payment, but also any loan origination fees, prepaid items, and initial escrows required of the borrower and not paid by other sources. Thus, the total cash paid at closing can be much higher than just the down-payment requirement. From this information, HUD derived the number of borrowers with LTV ratios above 95 percent that would not have had sufficient funds to pay down the loan to a 95 percent LTV (or make a 5 percent down payment).

³¹Property value is the lesser of the purchase price and the appraisal amount.

³²See [GAO-06-24](#).

strike a balance between managing risks and ensuring that its product is offered as widely as possible to qualified borrowers. They said that the proposed changes in seller concessions would adversely impact homebuyers seeking FHA-insured mortgages. Because of similar concerns, FHA revised its original proposal for reducing seller concessions. In its revised proposed rule, FHA noted that an across-the-board reduction to 3 percent would have had a disproportionately negative impact on borrowers with low and moderate incomes who were purchasing modestly priced homes. Therefore, the agency revised its proposal to allow concessions of the greater of 3 percent or \$6,000, so that borrowers purchasing homes valued at less than \$200,000 could receive seller concessions of more than 3 percent.

Pricing Changes Could Raise the Cost of Credit for Some Borrowers

FHA has raised premiums several times in recent years, but such increases have not been risk-based. Most recently, FHA increased the annual insurance premiums most borrowers pay between 0.05 and 0.10 percentage points. FHA now charges the maximum allowable premium for loans of \$625,500 or more, and although FHA also increased premiums for smaller-value loans, these premiums still remain below the maximum FHA is permitted to charge (see table 3). FHA can continue to raise up-front and annual premiums to the statutory maximums (generally 3 percent of the original insured principal mortgage amount for up-front premiums and between 1.5 and 1.55 percent of the remaining insured principal amount for annual premiums). In addition, since June 3, 2013, FHA has required most new borrowers to continue paying annual premiums, regardless of the value of their loans.³³ Previously, premiums could be canceled after the first 5 years once the principal amount declined to 78 percent of the original value. According to FHA, the reversal of the premium cancellation policy and the increase in premiums would generate approximately \$3 billion for the Fund for every \$100 billion in new endorsements.

³³For any mortgage involving an original principal obligation (excluding financed up-front premiums) less than or equal to 90 percent LTV, the annual premium will be assessed until the end of the mortgage term or for the first 11 years of the mortgage term, whichever occurs first. For any mortgage involving an original principal obligation (excluding financed up-front premiums) with an LTV greater than 90 percent, FHA will assess the annual premium until the end of the mortgage term or for the first 30 years of the term, whichever occurs first. See HUD Mortgagee Letter 2013-04.

Table 3: Increases to FHA Annual Premiums Effective April 1, 2013

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

Source: FHA.

Further Increases to Premiums

Some mortgage industry observers said that FHA could raise its up-front and annual premiums. For example, FHA could raise premiums to the statutory maximums, as outlined in table 3 above. One mortgage industry observer we spoke to and some of the literature we reviewed indicated that increases in FHA's premiums could result in more revenue for the

Fund, provided that the increases did not reduce the volume of new FHA-insured mortgages enough to offset the increased revenue.

However, we and others have noted that increases in the cost of mortgage insurance could increase the likelihood of adverse selection for FHA if its pricing were far different from its competitors.³⁴ That is, low-risk borrowers with fewer down-payment constraints could choose less costly loans from other sources, effectively making private mortgage insurance more competitive with FHA insurance. This shift in borrowers potentially could result in an increase in the overall risk of FHA's portfolio because FHA would be insuring relatively more high-risk borrowers. In this case, an increase in premiums can result in both lower premium revenue as low-risk borrowers no longer purchase FHA insurance, and an increased claim rate among the remaining higher-risk borrowers.

Further, others have noted that increased premiums could price some borrowers out of the market. As previously discussed, some mortgage industry observers have noted that many FHA borrowers have limited cash assets to pay for down-payment and closing costs. According to FHA, nearly all FHA-insured borrowers finance the up-front premium, so the net effect of increasing it would likely be to raise the borrowers' mortgage payments.

FHA officials said that the agency was unlikely to implement further increases in annual premiums in the near future. They said that FHA loans could become unaffordable to some borrowers when interest rates increase. We also found that FHA's recently announced policy lengthening the duration of premium assessments might have an adverse impact on borrowers. Mortgagee Letter 2013-04, implemented on June 3, 2013, mandates that the monthly mortgage insurance premium on FHA loans with LTV ratios exceeding 90 percent apply for the life of the loan, rather than terminating after the first 5 years once the principal amount declines to 78 percent LTV. FHA has acknowledged that this policy change will increase the annual percentage rate (APR) on FHA mortgages and may result in mortgages whose interest rates qualify them

³⁴See GAO, *Federal Housing Administration: Modernization Proposals Would Have Program and Budget Implications and Require Continued Improvements in Risk Management*, [GAO-07-708](#) (Washington, D.C.: June 29, 2007).

Implementing Risk-Based Pricing

as higher-priced mortgage loans (HPML).³⁵ Under Regulation Z, HPMLs must meet certain requirements, including those related to repayment ability, prepayment penalties, and escrows.³⁶ After consulting with the Bureau of Consumer Financial Protection (also known as CFPB), FHA issued guidance to lenders that explained their responsibilities for meeting both HPML and FHA requirements.

Some of the literature we reviewed and mortgage industry observers we spoke to suggested that FHA assess premiums using “risk-based pricing.” Risk-based pricing takes into account borrowers’ risk attributes such as credit score, DTI ratio, product type, and LTV ratio. As described earlier, FHA’s current premiums are based on the size and term of the loan and the LTV ratio and do not consider credit score and other risk factors, a practice FHA refers to as “average pricing.” Using this method, low-risk borrowers pay the same actual price for insurance coverage as high-risk borrowers. For example, all FHA borrowers with loans at or below \$625,500, LTV ratios less than or equal to 95 percent, and terms of greater than 15 years pay the same premiums, even though other measures of risk, such as credit scores, indicate that they represent a variety of risks. Risk-based pricing could address the adverse selection problem that is a possibility under average pricing (that is, when premiums charged do not align with the actual risks of borrowers so that low-risk borrowers are charged too much for insurance and thus seek it elsewhere). One mortgage industry observer also noted that it would more accurately align FHA’s revenues with its potential claims.

Conversely, others have argued that risk-based pricing would place FHA in the position of having to raise the mortgage financing costs of borrowers with weaker credit. To the extent that relatively low-risk borrowers might face lower premiums, they likely would not leave FHA. But other borrowers could face higher premiums, and those who could not qualify either for an FHA or conventional mortgage could be priced out of the market. For example, in 2007 we found that an FHA proposal to implement risk-based pricing would have affected the availability of FHA

³⁵Regulation Z generally defines an HPML as a loan secured by the consumer’s home with an APR that exceeds the average prime offer rate (APOR) for a comparable transaction by 1.5 or more percentage points for loans secured by a first lien, or by 3.5 or more percentage points for loans secured by a subordinate lien. An APOR means an annual percentage rate that is derived from average interest rates and other loan pricing terms of low-risk mortgages. 12 C.F.R. § 1026.35(a).

³⁶See 12 C.F.R. § 1026.35(b), (e).

insurance for about 20 percent of the home purchase borrowers that FHA insured in 2005.³⁷ This group would not have qualified for mortgage insurance under the parameters of the proposal because of high LTV ratios and low credit scores. FHA officials said that they are aware that the agency risks losing some lower-risk borrowers under its current pricing scheme. Therefore, they said that the agency has set pricing so that it covers the expected losses of the highest risk loans that its underwriting permits, with the idea that if FHA were to face increasing competition for its lower-risk borrowers, it would be charging a sufficiently high premium to cover expected losses on all newly insured loans.

Proposed Changes That Restrict the Borrowers FHA Serves Would Affect the Agency's Role in the Mortgage Market

As noted earlier, FHA's share of loan originations has increased in recent years. During 2006, FHA insured approximately 4.5 percent of purchase mortgages. At its peak in 2009, it insured 32.6 percent of purchase mortgages, and in 2012 still insured 26.1 percent of purchase mortgages originated that year. Mortgage industry observers have proposed options that would limit FHA's market presence as a way of either reducing FHA's liability or better ensuring that it serves a certain market—that is, low- or moderate-income borrowers and first-time homebuyers. These options include changes that would have a direct effect on FHA's market share, such as reducing loan limits from current levels and determining borrower eligibility based on income. Options that could have an indirect effect on FHA's market presence include reducing FHA's insurance coverage to less than 100 percent of the value of the loan and entering into risk-sharing agreements with private partners. Concerns have been raised that options affecting FHA's market presence might also affect its ability to serve its traditional countercyclical role to stabilize the housing market during times of increased stress or credit contraction.

³⁷See [GAO-07-708](#). In addition, in May 2008, HUD announced that it would implement risk-based premiums based on credit scores and LTV ratios for most of its single-family mortgage programs. 73 Fed. Reg. 27704 (May 13, 2008); HUD Mortgagee Letter 2008-16. However, in July of the same year, the Housing and Economic Recovery Act of 2008 placed a 1-year moratorium on FHA's implementation of the new pricing structure. Pub. L. No. 110-289, § 2133. In its notice implementing the moratorium, HUD stated that it would issue another notice when the moratorium concluded. 73 Fed. Reg. 51505 (Sept. 3, 2008); HUD Mortgagee Letter 2008-22. HUD has not, to date, announced an end to the moratorium.

Reducing Loan Limits Could Focus FHA on Low- to Moderate-Income Borrowers and Reduce Its Market Share

Congress raised the loan limits on FHA-backed forward mortgages following the recent housing crisis and has continued to extend the higher limits. Currently, the loan limits vary by county, ranging from \$271,050 to \$729,750 for one-unit properties in the contiguous United States. These limits are set to expire on December 31, 2013. Mortgage industry observers have recommended that FHA's loan limits be lowered to reduce FHA's market share. Some recommend reducing the loan limits to what they were prior to the crisis, while others propose reducing them further.³⁸ FHA data show that large loans are a small portion of FHA's loan pool. Loans that exceeded \$450,000 (somewhat higher than the national conforming loan limit) comprised only 4 percent of active FHA loans as of October 31, 2011.³⁹ As of this date, 82 percent of FHA's active pool included loans with a balance of \$271,050 or less. Because of the small number of high-value loans that FHA has endorsed, a reduction in loan limits might not have a large effect on its overall market share. However, for certain high-cost markets, a reduction in FHA's loan limits would have a greater impact. For example, according to FHA, in fiscal year 2012 about 24 percent of the loans FHA insured in Hawaii and about 10 percent of those it insured in California exceeded \$450,000. Further, more than half of the loans over \$450,000 endorsed during this time period were for properties located in California. We previously found that a possible reduction in the conforming loan limit could result in certain homebuyers in high-cost markets such as California needing to either provide a larger down payment or seek alternate financing.⁴⁰

³⁸In January 2007, FHA single-family loan limits ranged from \$200,160 to \$362,790 for one-unit properties.

³⁹Fannie Mae and Freddie Mac are restricted by law to purchasing single-family mortgages with origination balances below a specific amount known as the "conforming loan limit." Loans above this limit are known as jumbo loans. A permanent formula for the annual establishment of the conforming loan limit was established under the Housing and Economic Recovery Act of 2008 (HERA). The 2013 national conforming loan limit for one-unit properties is \$417,000. In certain high-cost areas designated by statute (Alaska, Hawaii, Guam, and the U.S. Virgin Islands) or by the Federal Housing Finance Agency, the conforming loan limit for one-unit properties extends to \$721,050 depending on geographic area.

⁴⁰GAO, *Housing Finance: Implications of Alternative Methods of Adjusting the Conforming Loan Limit*, [GAO/RCED-95-6](#) (Washington, D.C.: Oct. 5, 1994).

Industry observers have proposed approaches to reducing the current loan limits.⁴¹ For example, one researcher suggests limiting loans to no more than 100 percent of county median house price. The Mortgage Bankers Association (MBA) testified that Congress should allow the current limits to expire at the end of 2013 and reduce the loan ceiling to match the enterprises' conforming loan limits. FHA officials said that at the end of 2013 the loan limits would return to the levels established in HERA—limits that FHA has determined are appropriate for 2014.⁴²

Further, a reduction in loan limits would allow FHA to focus on low- to moderate-income borrowers and first-time homebuyers, the groups that many industry observers see as FHA's traditional market. In a February 2013 report, the Bipartisan Policy Center Housing Commission stated that a key objective for FHA should be to return to what it sees as FHA's traditional mission of serving primarily first-time homebuyers—something that could be achieved in part through a gradual reduction in loan limits.⁴³ A number of observers suggest that FHA is serving a population of borrowers far beyond those targeted by its traditional mission. For example, one observer noted that reducing FHA's loan limits by approximately 50 percent would still enable the agency to reach its intended population of first-time, minority, and low-income borrowers. Observers also noted that loan limits act as a proxy for income, with lower limits focusing FHA's efforts on low-wealth borrowers. As noted above, about 78 percent of FHA-insured loans went to first-time homebuyers in 2012.

A reduction in loan limits may have implications for FHA's financial condition, however. According to some industry observers, high-value loans improve the performance of the Fund and provide additional revenue beyond what a population of only low- and moderate-income borrowers would provide. FHA data show lower delinquency rates and

⁴¹See, for example, Bipartisan Policy Center Housing Commission, *Housing America's Future: New Directions for National Policy* (Washington, D.C.: February 2013); Jason Gold and Andrew Winkler, *Guidelines for Federal Housing Administration Reform* (Washington, D.C.: Progressive Policy Institute, March 2013); Robert Van Order and Anthony Yezer, *FHA Assessment Report: The Role of the Federal Housing Administration in a Recovering U.S. Housing Market* (Washington, D.C.: George Washington University School of Business, June 2011); and Edward J. Pinto, *How FHA Hurts Working-Class Families and Communities* (Washington, D.C.: American Enterprise Institute, December 2012).

⁴²Pub. L. No. 110-289, § 2112(a)(1).

⁴³Bipartisan Policy Center Housing Commission, *Housing America's Future*.

serious delinquency rates among loans with the highest balances (6 percent and 4 percent, respectively, of all active loans over \$625,000 as of October 31, 2011). In contrast, loans under \$271,000 had a delinquency rate of 17 percent and a serious delinquency rate of 9 percent. Factors other than loan size could contribute to these delinquency rates. For example, FHA officials noted that many high-value loans were endorsed following the housing crisis when the economy had improved and may perform better as a result. FHA officials could not point to analysis that would support the argument that high-value loans, all else being equal, perform any differently than smaller loans in terms of default, or the severity of the resulting losses. Nonetheless, FHA officials stated that a broader pool of insurable loans helps to better manage portfolio risk.

According to a number of industry observers, by reducing loan limits the agency would effectively step back from the high-wealth market, allowing private lenders to step back into the market during the recovery. Some industry observers have raised concerns about FHA crowding out private capital. They note that lower loan limits would not have a significant effect on FHA lending but would allow high-wealth buyers to be served in the conventional market, a shift they consider appropriate at this time. However, some industry observers have noted that the higher loan limits, which have been in effect since 2008, have allowed FHA to fulfill its countercyclical role of providing credit to borrowers when the private market was generally frozen. One organization stressed that the housing recovery was not complete, that lending remained constrained in many markets, and that Congress should be cautious about lowering loan limits. Industry observers also note that the elevated loan limit was particularly important in high-cost markets and that FHA continues to serve a significant role in these markets today. One observer argued that the relatively low FHA loan limits in effect prior to the crisis limited FHA's presence in high-value areas that suffered a more severe contraction during the housing crisis, which helped mitigate FHA's losses. Some said that FHA loan limits should be relatively constrained during most years, but raised when needed to provide stability in housing finance. Others noted that whatever loan limit FHA might use, it should be adjusted to allow for the variability in home prices across the country. FHA told us that it needs to have the flexibility to alter market-limiting policies—for example, by reinstating high loan limits quickly—to properly execute its countercyclical role.

Eligibility Limits Based on Income Rather Than Loan Amount Would Target Lower-Income Borrowers, but Could Also Restrict Access to Credit

Some mortgage industry observers have suggested that eligibility should be based on borrowers' income in order to refocus FHA on its traditional role of providing mortgage credit to low- and moderate-income borrowers.⁴⁴ FHA data show that 64 percent of its purchase loans and 47 percent of its refinance loans in fiscal year 2012 were made to low- and moderate-income borrowers. As shown in figure 4, the income levels of borrowers approved for purchase loans have varied over time. During the recent housing crisis, the proportion of FHA-insured mortgages made to low-income borrowers dropped substantially just as the proportion to high-income borrowers increased. Between 2005 and 2008, the share of FHA borrowers that had low incomes dropped about 16 percent, while the share that had high incomes increased about 14 percent. FHA has continued to endorse a larger proportion of high-income loans through 2012. These shifts are consistent with the increased loan limits in effect during the period. That is, loan limit increases expanded FHA's portion of the market that would be sought after by households with relatively higher income.

⁴⁴See, for example, Gold and Winkler, *Guidelines for Reform*; and Pinto, *How FHA Hurts Working-Class Families*.

Figure 4: Percentage of FHA Purchase Loans by Borrower Income, 2000-2013

Fiscal year	Number of endorsements	Percentage of loans made to:		
		Low-income borrowers (up to 80 percent of area median income)	Moderate- and middle-income borrowers (81-120 percent of area median income)	High-income borrowers (More than 120 percent of area median income)
2000	614,193	46.71%	33.86%	17.04%
2001	806,818	47.37	33.52	17.03
2002	862,898	50.27	32.22	15.60
2003	658,640	52.35	31.18	14.85
2004	586,110	53.68	30.75	14.57
2005	353,844	52.52	31.24	15.33
2006	313,998	48.37	32.98	18.28
2007	278,395	41.05	35.16	23.79
2008	631,655	36.33	34.38	29.29
2009	995,550	42.85	30.18	26.95
2010	1,118,759	48.52	27.63	23.83
2011	788,194	46.77	27.29	25.93
2012	743,532	47.97	27.36	24.66
2013	401,596	46.55	27.88	25.56

Source: FHA data.

Note: Data for fiscal year 2013 are from October 2012 through April 2013.

According to some of the literature, income limits would affect the market that FHA serves, targeting FHA's guaranty to low- and moderate-income borrowers. In recent congressional hearings, industry observers encouraged a system of assessing borrowers according to area median income targets to determine program eligibility.⁴⁵ In a 2011 white paper on reforming the housing finance market that was developed by the U.S. Department of the Treasury (Treasury) and HUD, the administration presented one option for reform that would strictly limit FHA eligibility to

⁴⁵Congress recently held multiple hearings on options for FHA reform, including before the Committee on Financial Services, U.S. House of Representatives, on February 6, 2013; before the Subcommittee on Housing and Insurance, Committee on Banking, Housing, and Urban Affairs, United States Senate, on February 28, 2013; and before the Committee on Financial Services, U.S. House of Representatives, on April 10, 2013.

low- and moderate-income borrowers, leaving the risk for high-income borrowers to the private market.⁴⁶

A change to income-based eligibility could restrict certain borrowers' access to credit. In its white paper, the administration cautioned that some borrowers, who may be ineligible when their income exceeds a threshold, may find it difficult to afford the cost of a conventional 30-year fixed-rate mortgage. Observers point to the additional costs, such as higher premiums and interest rates, that some borrowers might face if they must seek conventional mortgage insurance. Multiple observers have noted that even borrowers with relatively strong incomes have difficulty accumulating sufficient savings for a down payment, especially in high-cost areas.

Several industry observers and FHA said that a system of income verification to determine FHA eligibility would also be difficult to implement. For example, one observer we interviewed noted that FHA's current loan application process required prospective borrowers to provide documentation of qualifying income, but said that additional sources of income were not considered. According to this observer, if maximum income levels were in place, lenders would have to gather documentation for all income sources and assess the borrower's income against all liabilities and expenses, which could give borrowers an incentive to under report income. FHA officials told us that basing eligibility on income would create compliance risks for lenders and would be time consuming. Yet another industry observer added that income verification could also affect lenders' behavior, making them fearful of increased liability under indemnification agreements if they failed to correctly identify all borrower income to verify a borrower's eligibility.⁴⁷ The FHA Commissioner noted that income verification was difficult to implement in other programs, such as the Low-Income Housing Tax

⁴⁶The Department of the Treasury and the Department of Housing and Urban Development, *Reforming America's Housing Finance Market: A Report to Congress* (Washington, D.C.: February 2011).

⁴⁷FHA is authorized to require certain lenders to sign indemnification agreements under which the lender is to repay FHA for any losses that it incurs after a loan defaults and the property has been sold.

Credit Program.⁴⁸ FHA officials told us that loan limits, rather than income limits, could help FHA focus the market it served.

Further, while income limits could be structured to vary by geographic area, as loan limits now do, implementation could be difficult. Some observers described to us the complexity of implementing and monitoring income limits that vary by geographic area, and one suggested that a national income ceiling rather than income limits set by area median income might be a more expedient policy. FHA officials and industry observers told us that determining program eligibility based on appropriate loan limits is an effective substitute for income limits in order to target the program to low- and moderate-income borrowers.

Some observers have further argued that limiting eligibility based on income could affect FHA's ability to manage credit risk. Some argue that FHA-insured loans made to borrowers with higher income perform better than loans to lower-income borrowers. However, we have not seen analysis that would support the argument that income alone is a predictor of credit risk. Limiting eligibility based on income may reduce the number of insured loans, which could constrain FHA's ability to manage risk. An industry observer noted that FHA was intended to be more universally available than a program for only the lowest-risk borrowers might be. FHA officials noted the importance of maintaining a broad-based insurance pool. FHA officials also stated that they were not aware of studies concluding that serving only low-income borrowers would improve the agency's financial condition.

Finally, this option could limit FHA from serving its countercyclical role in the future. In its white paper, the administration warned that reducing FHA's market share too much—for example, by serving only low- and moderate-income borrowers—could affect its ability to ensure access to capital during a crisis.⁴⁹ The paper emphasized that without sufficient

⁴⁸Enacted in 1986, the Low-Income Housing Tax Credit Program provides an incentive for developers and investors to provide affordable rental housing for households whose income is at or below specified income levels. 26 U.S.C. § 42. The program is jointly administered by the Internal Revenue Service and housing finance agencies, state-chartered authorities established to help meet the affordable housing needs of the residents of their states. The program is an indirect financing source and resembles a grant program in that housing finance agencies are responsible for allocating the credit on a competitive basis to owners of qualified low-income rental projects.

⁴⁹Treasury and HUD, *Reforming America's Housing Finance Market*.

government support to mitigate a credit crisis, downturns could be more severe, increasing costs to the taxpayer.

Reducing FHA's Insurance Coverage Would Reduce Losses, but Might Not Protect Taxpayers and Could Increase Costs for Borrowers

Currently, FHA insures 100 percent of the principal balance of the loan involved in a claim and other eligible costs. Some mortgage industry observers have suggested that FHA's loan coverage be reduced in order to limit FHA's risk and market share. VA's guaranty program is often cited as a model, as it insures only 25 to 50 percent of the original principal in the case of a default. Various levels of reduced loan coverage have been suggested for FHA, ranging from 90 percent coverage, which some observers say would have little impact, down to 25 percent coverage.

Industry observers proposing this change point to a reduction in taxpayer risk as a key benefit.⁵⁰ They argue that a lower level of insurance coverage would reduce FHA's liability for defaulted loans by reducing the severity of the agency's loss. We have also found that a reduction in insurance coverage could have a beneficial effect on the Fund. In May 1997, we examined the potential effects of reducing FHA's insurance coverage and found that lower coverage would reduce both the volume of FHA-insured loans and income from premiums but would also reduce FHA's losses and ultimately have a beneficial effect on the Fund.⁵¹ Others have noted that a reduction in loan coverage could provide lenders an incentive to improve underwriting quality, thus reducing the risk of default. Some have cited the relatively superior delinquency and default rates in the VA program as evidence of careful origination by lenders that must assume some credit risk for VA-guaranteed loans.⁵² Nonetheless, it is important to note that VA limits its eligibility to veterans who have served in a branch of the armed services and received an honorable discharge, certain currently serving members of the Reserves or National Guard, and spouses of veterans under certain circumstances. It therefore starts with a universe of eligible borrowers that are different from the population that might seek an FHA-insured mortgage. Also, as mentioned in the previous section, VA underwriting differs somewhat from that of FHA, with

⁵⁰See, for example, Mark Calabria, *Fixing Mortgage Finance: What to Do with the Federal Housing Administration*, no. 123 (Washington, D.C.: Cato Institute, February 2012).

⁵¹See GAO, *Homeownership: Potential Effects of Reducing FHA's Insurance Coverage for Home Mortgages*, [GAO/RCED-97-93](#) (Washington, D.C.: May 1, 1997).

⁵²See, for example, Calabria, *Fixing Mortgage Finance*, and Pinto, *How FHA Hurts Working-Class Families*.

greater attention given to the veteran's residual income. Further, the VA program provides supplemental servicing to borrowers that face difficulty making mortgage payments. These and other differences need to be considered before it can be concluded that differences in insurance coverage explain the differences between VA and FHA default rates.

Industry observers also discussed the impact of a reduction in insurance coverage on borrowers' access to credit. Because lenders would be exposed to additional risk, they could increase fees and interest rates, which some industry observers noted in testimonies to Congress. Also, for some lenders the additional exposure might prompt the purchase of additional insurance coverage from third parties, the cost of which could be passed on to borrowers. We have reported that without the guaranty for FHA-endorsed mortgages, lenders would likely make fewer and more costly loans, making homeownership more expensive, limiting borrowers' access to credit, and reducing FHA's presence in underserved communities.⁵³ Our analysis showed that if lenders imposed stricter underwriting criteria or increased fees and interest rates, high-risk borrowers would be disproportionately unable to access FHA-endorsed mortgages. We found that reducing insurance coverage would limit FHA's ability to stabilize distressed communities and housing markets during regional economic downturns.

Further, some industry observers testified to Congress or told us that reduced FHA insurance coverage could simply transfer taxpayer risk from FHA to Ginnie Mae.⁵⁴ That is, any additional risk borne by the lender would pose additional risk to Ginnie Mae as the guarantor of the securities issued by that lender. This risk would require Ginnie Mae to provide more intense monitoring of its counterparties' financial condition, potentially increasing the fees it required to provide its guarantee. FHA officials agreed that Ginnie Mae would assume additional counterparty

⁵³See [GAO/RCED-97-93](#).

⁵⁴Ginnie Mae guarantees the timely payment of principal and interest on securities issued by financial institutions and backed by pools of federally insured or guaranteed mortgage loans. Ginnie Mae is a wholly owned government corporation and defines its mission as expanding affordable housing by linking capital markets to the nation's housing markets. Ginnie Mae relies on approved issuers to issue and service their mortgage-backed securities, and on agencies, such as FHA and VA, to guarantee the underlying mortgages against borrower default. Ginnie Mae faces counterparty risk when an issuer fails or defaults, which would require Ginnie Mae to ensure that investors receive monthly principal and interest payments and service the underlying loans.

risk with a reduction in coverage. Ginnie Mae officials noted that issuers would likely seek additional third-party assurance, most likely through additional mortgage insurance, to manage the additional risks they might face. As a result, borrowers could face further costs. Issuers could also take other steps, such as limiting the amount of FHA-insured lending they would permit or overlaying additional credit requirements, which would limit their participation in the program. In addition, MBA testified that this option would limit the ability of independent mortgage bankers and other small lenders to manage risk. It noted that small mortgage lenders were not structured to take on large amounts of credit risk and might restrict credit to borrowers, or leave the mortgage industry.

Other observers note that reducing FHA's loan coverage would facilitate the return of private capital. For example, one stated that the 100 percent coverage that FHA provides combined with its expanded market share created a barrier to the reentry of private capital to U.S. residential mortgage finance. The same observer noted that capital regulations and other requirements strongly favor obligations with a government guarantee over those supported by private capital.

Proposals for Entering into Risk-Sharing Agreements with Private Partners Vary

FHA does not currently engage in single-family risk sharing. To protect the taxpayer by sharing risk with the private market, various industry observers have suggested that the agency explore this option. In 2002, the Millennial Housing Commission recommended that Congress authorize FHA to initiate single-family risk-sharing demonstration programs, stating that FHA should have broader authority to choose its partners, loss position, and types of credit enhancements (including reinsurance as well as insurance or reinsurance on pooled loans).⁵⁵ The report also stated that while FHA could absorb risk better than private lenders, potential partners could have superior risk assessment and management systems and might be able to provide access to new products and delivery systems targeting communities with underserved borrowers that FHA did not yet reach. In 2007, we found that a public-private risk-sharing arrangement would recognize the government's ability

⁵⁵The Millennial Housing Commission was established by Congress in 2000 to study the federal role in meeting the nation's housing challenges. It issued a report in 2002, which includes recommendations for a variety of reforms to federal housing programs. See *Meeting Our Nation's Housing Challenges: Report of the Bipartisan Millennial Housing Commission* (Washington, D.C.: May 2002).

to spread risk.⁵⁶ We also found that private mortgage industry participants generally were more flexible and responsive to market pressures and better able to innovate and adopt new technologies quickly. Industry observers have continued to promote various forms of risk sharing to improve FHA's financial condition.⁵⁷

Two main approaches for risk sharing have been proposed by industry observers:

- *Coinsurance.* This approach would create agreements between FHA and private mortgage insurers. The private mortgage insurer would conduct an independent underwriting of the borrower and the mortgage being sought. If the borrower and the mortgage underwriting terms met the conditions that both FHA and the private insurer agreed on, the private insurer would take the first loss on the loan, and FHA would cover the remaining loss. One industry observer suggested that the agency should reduce taxpayer risk by assuming losses only after private partners absorbed first losses of 25 to 35 percent. Another risk-sharing arrangement between FHA and other partners could be a model similar to FHA's Multifamily Risk-Sharing Programs through which the agency shares proportional risk at varying levels between 10 and 90 percent with Fannie Mae, Freddie Mac, and housing finance agencies among others.
- *Reinsurance.* Large portfolio lenders and the enterprises will at times enter into reinsurance contracts with approved counterparties to sell portions of credit risk in their loan portfolios. According to a private mortgage insurer testifying before a congressional committee, this approach has the benefit of minimizing impacts on lenders and the potential to be implemented more quickly than a coinsurance arrangement. The representative noted that FHA should have the flexibility to selectively test such arrangements.

Risk sharing could affect taxpayers' risk, according to industry observers. It could protect the taxpayer, not only because private partners would assume some of the risk but also because the quality of the underwriting might improve because private partners would want to minimize the

⁵⁶See [GAO-07-708](#).

⁵⁷Industry observers have proposed multiple methods of sharing risk. We discuss some of these proposals.

likelihood of loss. However, to the extent that FHA would offer both full mortgage insurance and engage in risk sharing, it could be subject to adverse selection. That is, private partners could seek relatively low-risk borrowers for the shared-risk product, leaving FHA with the riskiest borrowers. One report notes that under risk-sharing agreements, private partners may act in other ways that are contrary to FHA's interest.⁵⁸ For example, according to this report, if FHA takes only a catastrophic loss position, the partner may have little incentive to minimize FHA's losses once the partner's maximum exposure level has been reached. Sharing risk on a pro rata basis, starting with the first dollar of loss and ending with the last dollar of loss, creates stronger incentives for FHA's risk-sharing partners to use sound underwriting terms and service their loans diligently. We have found that this is particularly true when there is a more equal division of risk.⁵⁹ If FHA agrees to assume the first portion of loss on default, the partner may not feel the need to protect against a high incidence of claims as long as the loss severity is not expected to reach its maximum level of exposure. The partner would also need to be sufficiently capitalized or otherwise protected to withstand its portion of the loss. Also, one observer warned that FHA would be at risk because it lacked the capacity to analyze risk-sharing proposals, which could place it in a weak position with partners. Consistent with this, FHA officials told us that FHA would need to increase its staff and analytic capacity to safely implement risk-sharing agreements.

Risk sharing would also affect the role that Ginnie Mae plays in guaranteeing timely payment of principal and interest on mortgage-backed securities. That is, like reducing FHA's loan guarantee coverage below 100 percent, risk sharing changes the nature of Ginnie Mae's exposure to counterparty risk, according to observers. Ginnie Mae would need to undertake assessment of a new class of counterparties—the private partner providing the insurance coverage—while continuing to assess the counterparty risk of its issuers, one observer noted. Ginnie Mae officials confirmed that any FHA risk-sharing agreements would increase the agency's counterparty risk and noted that they would probably require issuers to hold more capital to mitigate this risk. One

⁵⁸Sarah Rosen Wartell, *Single-Family Risksharing: An Evaluation of its Potential as a Tool for FHA*, prepared for the Millennial Housing Commission, June 2002.

⁵⁹See GAO, *Housing Finance: FHA's Risk-Sharing Programs Offer Alternatives for Financing Affordable Multifamily Housing*, [GAO/RCED-98-117](#) (Washington, D.C.: Apr. 23, 1998).

paper emphasized that risk sharing would also require FHA to monitor counterparty risk and provided a number of approaches for doing so.⁶⁰

Ultimately, any risk-sharing arrangement would need to carefully consider the structure of premiums and the way they were shared between parties. Identifying the type and level of premium needed by the federal government requires considering not only expected losses from loans that default and losses exceeding a predetermined level, but also unexpected losses from infrequent but costly adverse market conditions on both the national and regional level. Some argue that the federal government would still absorb catastrophic risk regardless of how risk sharing and premiums are structured. In this case, FHA would need to receive premiums across a broad spectrum of the market.

In addition, like other options for improving FHA's viability, risk sharing could impact other mortgage market participants and reduce borrowers' access to credit, according to observers. Depending on how FHA structured risk sharing, including how widely it would be applied to FHA's future endorsements, this option could reduce participation by smaller mortgage lenders, particularly community banks, which might have difficulty meeting the eligibility criteria for such a program, according to some industry observers. Others have expressed concern that risk sharing could raise the cost of the mortgage credit, as private investors would demand a market rate of return. While this trade-off might be viewed as acceptable in terms of improved underwriting, in times of market contraction risk sharing could significantly raise the cost and limit the availability of credit to borrowers, according to one observer. That is, FHA's role in stabilizing mortgage markets could be affected by its partners' willingness to continue underwriting during market contractions. This may limit FHA's ability to serve as a countercyclical force during such national or regional housing downturns.

⁶⁰Rosen Wartell, *Single-Family Risksharing*. According to the author, counterparty risk management in risk sharing might involve: (1) monitoring carefully the performance of the product for which the parties share risk, understanding not only your own revenue expectations and risk exposure, but that of the counterparty; (2) understanding the other business lines of the risk-sharing partner and monitoring carefully their performance; (3) monitoring the financial health of the risk-sharing partner and its ability to meet its obligations, especially in economic stress conditions; (4) requiring appropriate segregation of revenues from the risk-sharing product; (5) mandating that the partner maintain certain reserves, levels of liquidity, and capital ratios; and (6) mandating that the partner maintain certain ratings from independent ratings agencies.

Some of the literature we read stressed the importance of FHA serving a countercyclical role, as it has in the past, including by mitigating the effect of the 2007-2009 financial crisis on the housing market. One observer cautioned that broad changes, such as risk sharing, applied to FHA's entire portfolio, or too quickly implemented without a full understanding of the potential effects of the change, could reduce its flexibility to adjust to larger housing market shifts. Others have stated that risk sharing might constrain the agency's countercyclical flexibility because FHA and its private partners might not have the same incentives. During a downturn, private partners in risk-sharing arrangements would likely lack the incentive to serve deteriorating markets. Further, if FHA could endorse only loans that involved a private partner, a contraction of private credit could prevent it from expanding when such action was needed most. Another observer encouraged a small, discretionary or piloted approach to any risk-sharing program, suggesting that it was not necessary to make this option mandatory for each new endorsement. FHA officials cautioned that risk sharing should only be considered in the context of broad mortgage market reform, which has yet to be resolved.

Greater Operational and Managerial Powers Could Give FHA Greater Flexibility but Could Limit Congressional Direction

Although FHA is a wholly owned government corporation within HUD, it does not have the corporate powers other government corporations have. Some mortgage industry observers have suggested that making FHA an independent government corporation—more autonomous from HUD—could give it greater operational and managerial flexibility and the ability to be nimble when faced with changes in the housing market or problems in its programs. For example, FHA could have enhanced enforcement powers, greater authority to make changes to program requirements, and additional authorities to invest in technology and staff. Some of these authorities would bring FHA's corporate powers more in line with other government corporations. However, FHA and others said that these flexibilities could be implemented within FHA's existing organizational structure. But even within the existing structure, many of these options would require congressional action to implement. Further, these reform options are not mutually exclusive—that is, one or more options could be implemented—and implementation of these options would involve trade-offs between, for example, congressional direction and agency flexibility, or between efforts to minimize costs to borrowers and to make the program self-sustaining.

Making FHA an Independent Government Corporation Could Provide It with More Flexibility

Some mortgage industry observers have suggested that making FHA an independent government corporation could increase its flexibility to respond to changing market conditions and mitigate risks. FHA is a wholly owned government corporation within HUD but does not have some of the powers that other government corporations have.⁶¹ Specifically, Congress sometimes exempts government corporations from key management laws to provide them with greater flexibility than federal departments and agencies typically have in hiring employees, paying these employees competitive salaries/benefits, disclosing information publicly, and procuring goods and services. In 1995, we assessed the extent to which FHA and other government corporations had to comply with 15 selected federal statutes.⁶² FHA reported that it had to comply with 14 of the 15 federal statutes, while other government corporations reported greater flexibility.⁶³ For example, Amtrak reported full adherence to two statutes. In addition, when FHA was moved within HUD in 1965, Congress assigned the corporate powers of FHA to the Secretary of HUD, who has delegated them to the Assistant Secretary for Housing/FHA Commissioner.

Some observers have suggested that one way to give FHA increased flexibility would be to increase its corporate powers. For example, a 1994 National Academy of Public Administration study stated that FHA's

⁶¹FHA was created as a separate entity by the National Housing Act on June 27, 1934. It was later abolished as a separate entity and made an entity within HUD by the Department of Housing and Urban Development Act on September 9, 1965.

⁶²The 15 federal statutes we considered were the Privacy Act of 1974 (5 U.S.C. 552a), Freedom of Information Act of 1966 (5 U.S.C. 552), Government in the Sunshine Act (5 U.S.C. 552b), Title 5: Employee Classification (5 U.S.C. 5101-5115), Title 5: Pay Rates and Rate Systems (5 U.S.C. 5331-5338 and 5341-5349), Federal Property and Administrative Services Act of 1949 (41 U.S.C. 251-260), Federal Tort Claims Act (28 U.S.C. 2671, et seq.), Federal Managers Financial Integrity Act of 1982 (31 U.S.C. 3512 (b), (c)), Anti-Deficiency Act (31 U.S.C. 1341), Government Corporation Control Act of 1945 (31 U.S.C. 9101, et seq.), Government Performance and Results Act of 1993 (Pub. L. No. 103-62, Aug. 3, 1993), Chief Financial Officers Act of 1990 (Pub. L. No. 101-576, Nov. 15, 1990, as amended), Inspector General Act of 1978 (5 U.S.C. app.), Federal Credit Reform Act of 1990 (2 U.S.C. 661-661f), and Ethics in Government Act of 1978 (Pub. L. No. 95-521, Oct. 26, 1978, as amended). See GAO, *Government Corporations: Profiles of Existing Government Corporations*, [GAO/GGD-96-14](#) (Washington, D.C.: Dec. 13, 1995).

⁶³At that time, FHA told us that it was not subject to the Federal Property and Administrative Services Act of 1949 but had administratively adopted the statute's requirements. Ginnie Mae, another corporation within HUD, reported full adherence to 12 of the 15 statutes.

commissioner did not have the flexibility to adjust FHA products to respond to changing market conditions, such as fluctuating interest rates, and that the commissioner had to operate within the budgeting and administrative parameters of a traditional federal agency.⁶⁴ The report recommended that Congress transfer the corporate powers of FHA from the HUD secretary to the corporation, permitting it to function with greater operational autonomy within HUD. It also recommended that Congress vest management of FHA in a single administrator appointed by the President, with Senate confirmation for a 6-year term of office. Under this proposal, the administrator would be compensated at the same level as the chief executive officer of comparable government corporations. In 2002, the Millennial Housing Commission made a similar proposal, but its proposal would combine FHA and Ginnie Mae and establish a corporate board of directors.⁶⁵ Recently, some observers have suggested similar structures.

Other observers have suggested moving FHA outside of HUD. For example, one paper suggested organizing FHA as an independent government agency, a government-sponsored enterprise, or even a privatized entity structured as an assigned risk pool that would spread risk for otherwise uninsurable borrowers across insurance carriers in proportion to the size of their portfolios.⁶⁶ According to the author, any of these structures could make underwriting, pricing, and administration more efficient while achieving what he viewed as the agency's social objectives of providing credit enhancements through insurance to serve otherwise marginal low-income, first-time, and often minority homebuyers. He further stated that the FHA commissioner should have an appointment independent of HUD and for a term that would extend beyond a single administration term. Another observer testified that setting up FHA outside of HUD would reduce incentives for future administrations to impose policies on FHA that limited its flexibility and increased risks. However, two observers we interviewed said that making FHA an independent corporation outside of HUD would make it more difficult for

⁶⁴See National Academy of Public Administration, *Renewing HUD: A Long-Term Agenda for Effective Performance*, report prepared for HUD (Washington, D.C.: July 1994). Because FHA's organizational structure has changed little since 1994, we determined that this report was still relevant.

⁶⁵Millennial Housing Commission, *Meeting Our Nation's Housing Challenges*.

⁶⁶Kerry D. Vandell, "FHA Restructuring Proposals: Alternatives and Implications," *Housing Policy Debate*, vol. 6, issue 2 (1995).

Congress to hold it accountable. FHA, which was created in 1934, operated outside of a cabinet department for decades before becoming part of HUD, which was created in 1965. In addition, some people we interviewed said that FHA should remain affiliated with HUD so that it could collaborate closely with other department offices on housing policy and remain part of a cabinet-level agency.

According to the literature, making FHA more autonomous could provide it the flexibility to determine the best way to meet policy goals set by Congress or HUD and mitigate risk. For example, in a congressional testimony an observer suggested that FHA be provided the authority, without further congressional action, to create or alter specific insurance programs. Such authority, the observer argued, would enable FHA to react promptly to changes in market and other conditions. In addition, the observer stated that hiring, salaries, personnel management, and procurement could be freed from federal government constraints in order to be more consistent and competitive with the private sector. Some of the literature we reviewed noted that FHA had exercised greater control over its resources when it was independent of HUD.

However in June 2007, we found that making FHA an independent government corporation could have budgetary and oversight implications that would need to be considered.⁶⁷ For example, Congress would have to determine the extent to which (1) the corporation's earnings in excess of those needed for operations and reserves would be available for other government activities and (2) the corporation would be subject to federal budget requirements. Also, if the corporation were created outside of HUD, Congress would have to consider whether oversight of the corporation would require a new institution or could be done by an existing organization. In addition, an observer said that making FHA an independent government corporation or providing it with certain flexibilities, such as powers to change its products, could make FHA loans more attractive to borrowers who should be served by the private sector. Although such autonomy would also permit FHA greater capacity to manage risk, two observers we interviewed suggested that any additional autonomy or flexibility should be accompanied by clear direction on FHA's mission to serve borrowers not otherwise served by the private sector.

⁶⁷[GAO-07-708](#).

FHA Could Gain Greater Flexibility without Changing Its Organizational Structure

FHA and others have said that although making the agency an independent government corporation could increase the agency's flexibility, the agency could be given increased flexibility without such changes. For example, mortgage industry observers have suggested giving FHA enhanced enforcement powers, greater authority to make changes to program requirements, and additional authorities to invest in technology and staff. Many of these options would require congressional action to implement. Notwithstanding the potential benefit and costs of these options, there are a number of steps that FHA could undertake under its existing authority, including actions we have previously recommended.

Giving FHA Enhanced Enforcement Powers

In order to originate FHA-insured loans, lenders must be approved by FHA to participate in its mortgage insurance programs. Virtually all of the lending institutions approved to participate in FHA's single-family mortgage insurance programs have direct endorsement authority, meaning that they can underwrite loans and determine their eligibility for FHA mortgage insurance without HUD's prior review. Direct endorsement lenders can apply to participate in the Lender Insurance Program, which enables high-performing lenders to approve mortgages for FHA insurance without a pre-endorsement review by HUD. To hold lenders accountable for program violations or poor performance, FHA may (1) suspend their direct endorsement authority, (2) terminate their loan origination or underwriting authority through its Credit Watch program, or (3) take enforcement action through the Mortgage Review Board.⁶⁸

⁶⁸Under the Credit Watch Program, FHA has the authority to address deficiencies in a lender's performance by terminating a lender's approval to originate or underwrite FHA-insured loans in an area where its default and claim rate exceeds the established thresholds. The termination of a lender's approval using the Credit Watch default and claim analyses is separate and apart from any action taken by the Mortgage Review Board. The Mortgage Review Board is empowered to take administrative action against FHA-approved lenders that are not in compliance with FHA lending requirements such as entering into settlement agreements with lenders to bring them into compliance or withdrawing a lender's FHA approval so the lender cannot participate in FHA programs. The Board can also impose civil money penalties, probation, and suspension and issue letters of reprimand.

In its proposed budget for fiscal year 2014, FHA requested a number of additional enforcement powers. Specifically:

- Since 2010, FHA has asked for enhanced indemnification authority for direct endorsement lenders.⁶⁹ Currently, FHA has authority to require indemnification only for lenders that participate in FHA's Lender Insurance Program. According to FHA, granting the agency this authority would enable it to obtain indemnification from all of its approved lenders for loans that do not comply with its guidelines. Legislation proposed in March 2013 includes a provision intended to address this issue.⁷⁰
- HUD may terminate a lender's approval to originate or underwrite FHA-insured loans in a specific geographical area if a lender's branch office default and claim rate exceeds the established Credit Watch Termination thresholds.⁷¹ However, FHA is also seeking authority to terminate origination and underwriting approval on a broader geographic basis, stating that such authority would enhance its ability to review lender performance. If a lender was found to have an excessive rate of early defaults or claims, FHA would have greater flexibility in terminating the lender's ability to originate or underwrite single-family mortgages for FHA insurance. FHA has been seeking this authority since 2010. Again, the 2013 proposed legislation includes such a provision.
- To help make loss mitigation more effective, FHA is seeking authority to, on a case-by-case basis, transfer servicing of loans to institutions

⁶⁹Indemnification agreements require lenders to repay FHA for any losses that it incurs after a loan defaults and the property has been sold.

⁷⁰The FHA Emergency Fiscal Solvency Act, H.R. 1145 (2013).

⁷¹Under Credit Watch, FHA considers terminating a lender's authority to originate loans in a specific geographical area if a lender's branch office default and claim rate exceeded the national average and also exceeded the average local HUD field office default and claim rate by 200 percent. If a lender had more than one branch office facing Credit Watch termination action in a particular period, FHA can decide to evaluate the overall performance of the lender in the field office jurisdiction and, if unacceptable, terminate a lender's ability to originate and underwrite loans in the entire jurisdiction.

better equipped to reduce losses.⁷² Specifically, this authority would allow FHA to require any of the following actions when a servicer underutilized FHA's loss-mitigation tools or the agency deemed the action necessary to protect the interests of the Fund: (1) transfer servicing from the current servicer to a specialty servicer designated by FHA; (2) require a servicer to enter into a subservicing arrangement with an entity identified by FHA; or (3) require a servicer to engage a third-party contractor to assist in some aspect of loss mitigation such as borrower outreach. According to FHA, such authority would permit the agency to better avoid losses from poor servicing of FHA-insured loans, yielding better results for borrowers and FHA.

- Finally, FHA is seeking greater flexibility in establishing the metrics it uses to compare lender performance so that it can more effectively assess lender performance during all market conditions. As discussed previously, FHA is currently required by statute to compare lenders' default and claim rates by geographic area. With enhanced authority to set alternative performance metrics, FHA said it would be able to compare a lender's rate of early defaults and claims (for insured single-family mortgage loans) with the rates of other lenders on any basis determined appropriate. Examples of metrics include geographic area, varying underwriting standards, or populations served.

The majority of the observers we interviewed said that FHA needed authority for enhanced enforcement actions. For example, some said that FHA needed these additional powers to more effectively manage risk and avoid unnecessary losses. Others suggested additional options—for example, requiring lenders to take back loans that defaulted within the first 6 months. However, one observer said that the prospect of tough administrative and legal actions already provided strong incentives for lenders to carefully follow FHA program guidelines. Two stakeholders we interviewed stated that increased scrutiny of lenders by FHA and others had increased concern among lenders about the risks of litigation. As a result, lenders have moved to further restrict credit in recent years. Many

⁷²When home buyers fall behind on their mortgage obligations, FHA instructs mortgage servicers (typically large financial institutions) to assist the home buyers in bringing their mortgage payments current, because foreclosure proceedings can impose high costs on financial institutions and homeowners. These and other efforts are referred to as "loss mitigation."

Giving FHA Greater Authority
to Change Program
Requirements, Including
Emergency Powers

FHA lenders have taken the step of imposing additional requirements (known as credit overlays) on FHA loans, potentially making it more difficult for borrowers to obtain FHA loans.

FHA and some mortgage industry observers have suggested that the agency should have more authority to make changes to program requirements, including emergency powers. Currently, FHA must go through the rulemaking process or seek legislative authority to make major changes to its programs. For example, after problems with loans with seller-funded down-payment assistance were identified, it was several years before these loans were disallowed. HUD's latest annual report on the Fund noted that the effect of loans with seller-funded down-payment assistance on the Fund was expected to be more than \$15 billion in losses.⁷³ Problems associated with these loans are well documented. A March 2005 HUD contractor study found that property sellers who provided down-payment assistance through nonprofits often raised sale prices of the homes involved to recover the required payments that went to the organizations.⁷⁴ As noted previously, in November 2005, we also found that loans with this type of assistance had inflated prices and defaulted more often than loans without such assistance.⁷⁵ In October 2007, FHA published a rule that prohibited seller-funded down-payment assistance. Subsequently, the rule was struck down by the courts on procedural grounds. Congress ultimately prohibited the use of this assistance in January 2009.

FHA is currently trying to address losses from its HECM program (reverse mortgages that permit persons 62 years and older to convert their home equity into cash advances), but has not been able to make programmatic changes that it has determined might stem them. In a testimony on HUD's fiscal year 2014 proposed budget, the Secretary attributed the potential need for \$943 million in permanent and indefinite budget authority for the

⁷³HUD, *Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance Fund, Fiscal Year 2012* (Washington, D.C.: Nov. 16, 2012).

⁷⁴Concurrence Consulting Group, *An Examination of Downpayment Gift Programs Administered by Nonprofit Organizations*, prepared for the U.S. Department of Housing and Urban Development (Washington, D.C.: March 2005).

⁷⁵See [GAO-06-24](#).

Fund in fiscal year 2013 to losses in the HECM program.⁷⁶ FHA has proposed a number of changes to the HECM program, such as mandating the use of escrow accounts to ensure continued and timely payment of property charges, including taxes and insurance. However, FHA officials said that the average time for a rulemaking of this type was about 18 months—a length of time that exposed the agency and the Fund to risks that could be avoided if, for example, it could make changes through a mortgagee letter. Recently, FHA was provided authority to establish through mortgagee letters any requirements that HUD “determines are necessary to improve the fiscal safety and soundness” of the HECM program.⁷⁷ FHA officials told us that a mortgagee letter could be issued within 30 to 60 days. Another approach to dealing with the issue would be to limit the ability of borrowers to withdraw up-front the maximum amount allowable under the program. HUD noted that the vast majority of borrowers in the HECM program take out 80 percent or more of the maximum amount possible in one initial cash draw, and that this increases the likelihood that they have insufficient funds to pay items such as property taxes. In its November 2012 annual report to Congress, FHA announced that it would take immediate action to reduce the amount borrowers are permitted to draw out at the time of origination of their HECM loan. The report notes that the change would protect FHA from losses and reduce the likelihood of borrower default due to nonpayment of taxes and insurance. Although FHA points to other actions that will be needed to reform the HECM program, this example demonstrates the importance of FHA exercising the authority it already has.

Several proposals have been put forward that would increase FHA’s ability to make changes to its programs. One observer has recommended that Congress give the HUD secretary special emergency powers to suspend FHA insurance programs or make emergency modifications to a program when the HUD secretary finds that current program terms expose the taxpayers to an elevated risk of loss and fail to serve the public interest. In addition, a paper that lays out the current administration’s plan to reform the nation’s housing finance market stated that the administration should work with Congress to give FHA more

⁷⁶Shaun Donovan, Secretary of the U.S. Department of Housing and Urban Development, *FY 2014 Budget Request for the Department of Housing and Urban Development*, testimony before the Senate Committee on Appropriations Subcommittee on Transportation, Housing and Urban Development, and Related Agencies, 113th Cong., 1st sess., April 11, 2013.

⁷⁷Pub. L. No. 113-29 (enacted August 9, 2013).

flexibility to respond to stress in the housing market and manage its risk more effectively.⁷⁸ It added that doing so would mean giving FHA flexibility to adjust fees and programmatic parameters more quickly than it can today. Regardless, two observers pointed to the need for offsetting any additional flexibility that might be afforded to FHA with clear limits to this authority, such as limits on the duration of such changes absent a formal rulemaking process.

Two observers we interviewed expressed concern about giving FHA greater authority to make significant program changes, stating that such authority should be reserved for Congress. One noted that during the recent housing crisis Congress showed that it was able to act quickly to change FHA program requirements when needed by increasing the loan limit requirements. Also, he told us that FHA did not need congressional action to change its programs. For instance, FHA could create an interim rule to quickly handle a problem while going through the official rulemaking process to make a permanent change.⁷⁹ Similarly, the other observer said that FHA could make some changes through mortgagee letters and the rulemaking process. However, according to FHA, HUD's Office of General Counsel has advised that not all procedures or policies may be changed by interim rule and interim rules can be particularly sensitive to litigation and a legal stay. Thus it is the General Counsel's opinion that statutory authority is often the safest and fastest route to make changes.

Providing FHA with Additional Funding to Upgrade Information Technology

FHA has reported that the more than 40 information systems its single-family programs use are outdated, unable to sustain the increasing volume of insurance applications, and costly to maintain. In addition,

⁷⁸Treasury and HUD, *Reforming America's Housing Finance Market*.

⁷⁹The basic process by which agencies develop and issue regulations is spelled out in the Administrative Procedures Act (APA) (5 U.S.C. §§ 551–570a). APA generally requires agencies to (1) publish a notice of proposed rulemaking (NPRM) in the *Federal Register*; (2) allow interested persons an opportunity to comment on the rulemaking process by providing “written data, views, or arguments;” (3) issue a final rule accompanied by a statement of its basis and purpose; and (4) publish the final rule at least 30 days before it becomes effective. However, prior notice and public comment is not always required. APA allows agencies to issue final rules without the use of an NPRM in certain cases, including when the agency determines for “good cause” that notice and comment procedures are “impracticable, unnecessary, or contrary to the public interest” (5 U.S.C. § 553(b)(B)). One common type of rule often issued without an NPRM is the interim final rule, which generally is effective immediately but provides an opportunity for public comment after the rule's issuance.

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

Moreover, the audit of FHA's 2011 and 2012 financial statements identified a significant deficiency related to IT systems and stated that FHA management and the HUD Office of the Chief Information Officer should mitigate persistent IT control deficiencies.⁸⁰ The audit report noted that expensive and manual compensating controls, including monthly reconciliations of data among the interfaced systems, were needed to manage the numerous systems and that security and access controls had weaknesses. We found in November 2011 that the large number of systems resulted in hundreds of interfaces, which meant that changing one system required extensive effort to maintain the interfaces across systems.⁸¹ The multiple systems and interfaces also presented challenges for maintaining appropriate accessibility levels, security controls, and privacy standards.

To address system constraints, FHA has initiated the FHA Transformation Initiative to improve FHA's management of insurance programs through the development and implementation of a modern financial services information technology environment that is expected to improve loan endorsement processes, collateral risk capabilities, and fraud prevention.⁸² For fiscal years 2010 and 2011, HUD reported that the

⁸⁰A significant deficiency is one or a combination of deficiencies in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

⁸¹GAO, *Federal Housing Administration: Improvements Needed in Risk Assessment and Human Capital Management*, [GAO-12-15](#) (Washington, D.C.: Nov. 7, 2011).

⁸²This environment is expected to provide case management for the life cycle of a loan and capture data from the loan origination and underwriting processes.

Transformation Initiative funding made available was \$58.5 million.⁸³ According to FHA, the agency maintains an aggressive, robust, and varied project management and applications development portfolio aimed at deploying new and modernizing existing mortgage insurance capabilities and business processes. In June 2013, we found that HUD had not yet fully implemented key project management practices in executing and managing the IT projects associated with the FHA Transformation Initiative.⁸⁴ Specifically, while the department had developed project management documents such as charters and requirements management plans, none of these documents included all of the key details that could facilitate effective management of its projects such as full descriptions of the work necessary to complete the projects, cost and schedule baselines, or prioritized requirements, among other things. A lack of project management expertise along with HUD's inadequate development and use of a project management framework and governance structure contributed to these deficiencies. Therefore, we recommended that HUD establish a plan of action to fully implement best practices, provide needed project management expertise, and improve the development and use of its project management framework and governance structure. HUD agreed with our recommendations to improve its framework and governance, but did not agree with the entirety of the recommendation to develop a plan of action or the need for providing project management expertise. The department described actions it would take to improve its project management practices in order to address the deficiencies identified.

However, some mortgage industry observers said FHA should be provided with additional funding to enhance its information technology. The congressionally appointed Millennial Housing Commission found that FHA's dependence on the appropriations process for budgetary resources and competition for funds within HUD had led to underinvestment in technology, increasing the agency's operational risk and making it difficult for FHA to work efficiently with lenders and other industry partners.⁸⁵ Some observers we spoke with also cited competition for funds within HUD, and most supported providing FHA additional

⁸³HUD, *HUD Transformation Initiatives Information Technology Fiscal Year 2011 Expenditure Plan* (Washington, D.C.: December 2011).

⁸⁴GAO, *Information Technology: HUD Needs to Improve Key Project Management Practices for Its Modernization Efforts*, [GAO-13-455](#) (Washington, D.C.: June 12, 2013).

⁸⁵Millennial Housing Commission, *Meeting Our Nation's Housing Challenges*.

funding for these enhancements. One benefit of this option is that the technology enhancements could improve FHA's operations. For example, an observer said that it supported the recent efforts that FHA had taken to improve its risk management and protect the safety and soundness of the agency, but added that these efforts could not be sustained without, among other things, state-of-the-art technology.

FHA officials also told us that the agency's limited resources meant implementing technology improvements using a piecemeal approach, although it would be better if FHA could upgrade and integrate all of its systems at the same time. Specifically, the agency stated that sustained and timely funding through using receipts or direct appropriation would enable FHA to budget and procure support and services more strategically, systematically, and consistently.

In the current budget environment, funding for technology enhancement is limited. FHA technology investments must compete with other HUD technology investments. Some observers argue that FHA should be granted the authority to use a portion of its insurance premiums for technology enhancement.⁸⁶ In a June 2007 report on FHA modernization, we found that Congress could grant FHA specific authority to invest a portion of the Fund's current resources—that is, negative subsidies that accrue in the Fund's reserves—in technology enhancement.⁸⁷ However, FHA has not met its statutory capital ratio requirement since 2009 and using premium income for technology enhancement would further reduce the ratio. Even in more prosperous times, using the Fund's current resources would have implications. Specifically, in our June 2007 report we found that using the Fund's current resources for information technology would diminish its ability to withstand severe economic conditions and would also increase the federal government's budget deficit, all other things being equal. Further, requiring FHA to use program revenue to pay for administrative costs could require it to increase the premiums charged to borrowers. To the extent that having greater control

⁸⁶Currently, FHA does accumulate reserves to cover the costs associated with insurance claims but may not use them for administrative expenses, such as salaries and technology. Rather, these expenses are paid from direct federal appropriations. The administrative expenses of other federal credit programs such as RHS' single-family guaranteed loan program are also paid through direct appropriations rather than through program revenue. On the other hand, another federal credit program, the Export-Import Bank, is required to pay for administrative expenses out of fees it collects.

⁸⁷[GAO-07-708](#).

Allowing FHA to Pay Its Employees Outside of Federal Pay Scales

over resources might improve agency efficiency and effectiveness, FHA may limit any potential premium increases needed to cover administrative expenses.

Congress also could consider allowing FHA to compensate its employees outside of federal pay scales. In November 2011, we reported that from 2006 to 2010, Single Family Housing field staffing levels remained relatively constant, while key workload items, such as volume-driven loan reviews and the management of foreclosed homes, grew considerably.⁸⁸ As a result, it may be difficult for FHA staff to mitigate risk. Some federal agencies, such as the Securities and Exchange Commission, the Federal Deposit Insurance Corporation, and FHFA, are permitted to pay salaries above normal federal pay scales in recognition of the special skills demanded by sophisticated financial market operations.⁸⁹ FHA and some mortgage industry observers have suggested that FHA be given similar authority. FHA officials told us that in order to appropriately manage the Fund, FHA needs a mix of staff with industry expertise, including those with strong operations management, and that flexibility in compensation would help FHA accomplish the right balance. An observer suggested that giving the HUD secretary authority to hire risk management, analytic, and technological system staff on a more generous pay scale could close some of the gap between private market participants and those charged with protecting taxpayers from economic harm. In addition, another observer recommended that FHA have the ability to more broadly use retention allowances and recruitment bonuses. This option could help FHA to recruit experienced staff to help the agency adapt to changes. Some suggest that, as with investments in technological enhancements, enhancements in compensation could be funded with the Fund's premium income. The effect would be to provide FHA greater flexibility, but also would require program participants to absorb administrative costs that are currently borne by direct federal appropriation or would reduce resources available to pay claims and reduce the capital ratio.

⁸⁸[GAO-12-15](#).

⁸⁹In 1989, the Financial Institutions Reform, Recovery and Enforcement Act (Pub. L. No. 101-73) authorized certain financial regulators to determine their own compensation and benefits so that they could more effectively compete in the marketplace for qualified applicants. In 2002, the Investor and Capital Markets Fee Relief Act (Pub. L. No. 107-123) and in 2008, the Housing and Economic Recovery Act of 2008 gave the Securities and Exchange Commission and FHFA, respectively, similar authority as those federal banking regulatory agencies. These agencies are permitted by statute to pay salaries in excess of the Title 5 ceilings.

Giving FHA Greater Authority to Pilot New Products

Some mortgage industry observers have suggested that Congress give FHA authority to implement pilot programs. For example, one noted that too often the statutory and regulatory environment for FHA leads to “all or nothing” policy changes, although private mortgage industry participants frequently tested new strategies before applying them to an entire portfolio. She recommended that FHA be given authority to implement pilot programs quickly with the goal of better understanding, measuring, and mitigating risk. In addition, the Millennial Housing Commission found that the statutes and regulations to which FHA was subject dramatically increased the time necessary to develop and implement new products. It recommended that Congress expressly authorize FHA to introduce new products without requiring a new statute for each. In a June 2007 report, we found that such authority would offer FHA greater flexibility to keep pace with the rapidly changing mortgage market.⁹⁰ However, we determined that Congress would have less control over FHA’s product offerings and that in some cases it might take years before a new product’s risks were well understood.

In a February 2005 report, we recommended that FHA consider using pilots for new products and for any planned significant changes to its existing products.⁹¹ Because FHA officials had questioned the circumstances under which they could use pilots when not required to do so by Congress, we also recommended that FHA seek the authority to offer new products on a limited basis, such as through pilots, if the agency determined that it lacked sufficient authority. In comments on the report, HUD did not specifically state whether it agreed with the recommendations. Rather, it stated that it was in basic agreement with GAO that all policy options, implications, and implementation methods should be evaluated when considering or proposing a new FHA product. For this review, however, FHA officials told us that FHA had the appropriate level of authority to pilot programs and had successfully piloted several. For example, FHA piloted a program that allowed lenders to sell foreclosure properties securing nonperforming FHA-insured loans to third parties at a reserve price slightly below the property value without conveying the properties to FHA. According to FHA, the agency plans to expand the program after finding that this method of disposing of properties yields lower losses for the Fund than FHA’s normal disposition process.

⁹⁰See [GAO-07-708](#).

⁹¹See [GAO-05-194](#).

Managing within Existing Authority

Even with no changes to its existing organizational structure and authorities, FHA can do more to enhance program efficiency and effectiveness and protect taxpayers. We have made a number of recommendations aimed at improving FHA's information technology, loss mitigation efforts, management of real-estate owned inventories, risk assessment, and human capital management.⁹² As previously mentioned, we recommended in June 2013 that HUD establish a plan of action to fully implement best practices in management of information technology, provide needed project management expertise, and improve the development and use of its project management framework and governance structure.⁹³ In addition, in June 2012 we recommended that FHA periodically analyze the effectiveness and the long-term costs and benefits of its loss mitigation strategies and actions to more fully understand their strengths and risks and protect taxpayers from absorbing avoidable losses to the maximum extent possible.⁹⁴ This report found that several agencies, including FHA, were not conducting analyses to determine the effectiveness of their loss mitigation actions. The experiences of Treasury, the enterprises, and our econometric analysis strongly suggested that such analyses could improve outcomes and cut program costs. In November 2012, FHA announced revisions that were designed to reduce the number of full claims against the Fund. Specifically, FHA changed the steps that loan servicers must take to assist home buyers in bringing their mortgage payments current. We requested and plan to assess the analysis HUD completed as the basis for this change in FHA's loss mitigation strategies to determine whether it fully responds to our recommendation. And as noted previously, FHA has proposed additional revisions to its loss mitigation and foreclosure processes that would require congressional action.

FHA could also mitigate losses on mortgages that it insures by improving its recovery rate for foreclosures by, for example, improving the foreclosure process itself and the process for selling its inventory of foreclosed properties. In 2002, we found that FHA's existing procedures could delay the start of critical steps necessary to preserve the value of

⁹²See, for example, [GAO-13-455](#) and [GAO-12-15](#).

⁹³[GAO-13-455](#).

⁹⁴GAO, *Foreclosure Mitigation: Agencies Could Improve Effectiveness of Federal Efforts with Additional Data Collection and Analysis*, [GAO-12-296](#) (Washington, D.C.: June 28, 2012).

foreclosed properties and sell them quickly.⁹⁵ We pointed to the fact that FHA divided custody of foreclosed properties between servicers and contractors, which could prevent the initiation of critical maintenance necessary to make properties attractive to potential buyers. We recommended that HUD make establishing unified property custody a priority. In 2012, FHA announced that it was expanding a pilot that would permit such unified custody. Under the expanded pilot, FHA permitted loan servicers to maintain custody of properties from foreclosure sales through final disposition, relieving FHA of the responsibility for managing and selling these properties. Because this program is a pilot, FHA continues to take into its inventory foreclosed properties. According to FHA, it has taken steps to improve recovery through techniques such as using best execution modeling to ensure an optimal asset disposition approach. In June 2013, we recommended a number of ways that FHA could improve on the performance of these properties—for instance, by ensuring that price reductions were based on an evaluation of market conditions rather than on standardized schedules.⁹⁶ FHA agreed with these recommendations and identified actions that it had taken or planned to take in response to them.

In a November 2011 report, we recommended specific improvements that FHA could make to its risk assessment processes and human capital management.⁹⁷ We recommended that FHA (1) integrate two ongoing efforts to assess risk, (2) conduct an annual risk assessment, and (3) establish ongoing mechanisms to anticipate and address risks that might be caused by changing conditions. To improve human capital management, we recommended that FHA develop workforce and succession plans for the Office of Single Family Housing. Since our report, FHA has taken several actions, including developing a plan for conducting an inaugural risk assessment and a workforce analysis and succession plan.

Finally, we previously reported on opportunities to increase collaboration among the agencies responsible for overlapping and fragmented housing

⁹⁵GAO, *Single-Family Housing: Opportunities to Improve Federal Foreclosure and Property Sale Processes*, [GAO-02-305](#) (Washington, D.C.: Apr. 17, 2002).

⁹⁶See GAO, *Federal Housing Administration: Improving Disposition and Oversight Practices May Increase Returns on Foreclosed Property Sales*, [GAO-13-542](#) (Washington, D.C.: June 20, 2013).

⁹⁷[GAO-12-15](#).

programs and activities, including those that support homeownership, with the potential for realizing efficiencies. In 2000, we suggested that Congress consider requiring RHS and HUD to examine the benefits and costs of merging programs serving similar markets and providing similar products.⁹⁸ In 2012, we found that the administration had formed a task force to evaluate the potential for coordinating or consolidating loan programs at HUD, RHS, and VA.⁹⁹ However, we found that the task force's efforts had not yet incorporated key collaborative practices. We therefore recommended that HUD, USDA, and VA, and the Director of the Office of Management and Budget (OMB) take steps to establish a more rigorous approach to collaboration. In addition, we recommended that officials from HUD, Treasury, USDA, and VA evaluate and report on the specific opportunities for consolidating similar housing programs, including those that would require statutory changes. HUD and OMB expressed concern about implementing the recommendations while HUD was focused on the ongoing housing recovery. As we stated in the report, in addition to focusing on the ongoing housing crisis and government support for the housing market, focusing on achieving efficiencies and cost savings and the delivery of government support for housing is important. Given its financial condition, now more than ever it is important that FHA optimize its effectiveness across all aspects of its operations.

Broader Housing Market Reforms Could Impact FHA's Role

Following the collapse of the mortgage market, policymakers proposed a number of mortgage reforms that could impact FHA's market share and role. These reforms could affect the willingness of the conventional market to serve future home buyers of varying credit risk profiles and the fees that lenders would charge for conventional loans. The administration has put forth several options for reforming the federal role in the mortgage market, including reforming the enterprises (Fannie Mae and Freddie Mac). Each of these options has potential implications for FHA. Some of our recent work—a 2009 report on options for resolving the enterprises and our 2013 high-risk series—discussed the trade-offs associated with

⁹⁸See GAO, *Rural Housing: Options for Optimizing the Federal Role in Rural Housing Development*, [GAO/RCED-00-241](#) (Washington, D.C.: Sept. 15, 2000).

⁹⁹See GAO, *Housing Assistance: Opportunities Exist to Increase Collaboration and Consider Consolidation*, [GAO-12-554](#) (Washington, D.C.: Aug. 16, 2012).

options for resolving the enterprises, as well as how these efforts could affect FHA.¹⁰⁰

Recent Statutory and Regulatory Changes Could Affect FHA's Market Share

Recent statutory and regulatory changes related to qualified mortgages (QM) and qualified residential mortgages (QRM) have the potential to affect FHA's market share. The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) required lenders to make a reasonable and good faith determination, based on verified and documented information, that borrowers seeking residential mortgages have a reasonable ability to repay the loan according to its terms.¹⁰¹ The Dodd-Frank Act also established a presumption of compliance with the ability-to-repay requirements for a certain category of mortgages called QM. The ability to repay provisions are similar to those implemented by the Board of Governors of the Federal Reserve System (Federal Reserve Board) in 2008 but cover all mortgages.¹⁰² The Dodd-Frank Act shifted rulemaking authority for these provisions and QM from the Federal Reserve Board to the CFPB. On January 30, 2013, CFPB published its final rule on ability to repay and QMs (effective January 10, 2014).¹⁰³

Among other things, CFPB's final rule establishes general underwriting criteria for QMs, including that the borrower have a DTI ratio of less than or equal to 43 percent. As previously discussed, FHA underwriting standards allow some borrowers to have DTI ratios that are greater than 43 percent. While acknowledging that many borrowers with high DTI ratios likely could afford mortgages, CFPB was concerned that lenders would not make loans to these consumers in light of the current economic conditions. As a result, CFPB expanded the definition of a QM to include

¹⁰⁰See GAO, *Fannie Mae and Freddie Mac: Analysis of Options for Revising the Housing Enterprises' Long-term Structures*, [GAO-09-782](#) (Washington, D.C.: Sept. 10, 2009), and *High-Risk Series: An Update*, [GAO-13-283](#) (Washington, D.C.: Feb. 14, 2013).

¹⁰¹Pub. L. No. 111-203, sec. 1411 (15 U.S.C. sec 1539c(a)).

¹⁰²In 2008, the Federal Reserve Board adopted a rule under the Truth in Lending Act (Regulation Z) prohibiting lenders from making "higher-priced mortgage loans" without assessing borrowers' ability to repay the loans. The Federal Reserve Board implemented this rule in response to lending practices—for example, using loose underwriting standards and attracting borrowers with misleading rates—that ultimately contributed to the housing crisis and recession. Lenders have had to follow these requirements since October 2009. See 73 Fed. Reg. 44522 (July 30, 2008).

¹⁰³See 78 Fed. Reg. 6408 (Jan. 30, 2013).

any loan that is eligible to be purchased, guaranteed, or insured by various federal agencies, including FHA, VA, USDA, and USDA's RHS, or by the enterprises while they are operating under conservatorship. This rule is temporary and in general will remain in effect until these agencies finalize their own QM regulations. According to FHA, the agency is currently developing its QM regulations.

The Dodd-Frank Act also requires mortgage securitizers to retain a financial exposure of no less than 5 percent of the credit risk of any securitized residential mortgage that does not meet a separate set of criteria (to be defined by regulators) that are associated with a lower risk of default.¹⁰⁴ Securitized mortgages that meet these criteria are exempt from this risk retention requirement and are considered QRM. All FHA-insured mortgages are exempt from the risk-retention requirement, and Fannie Mae and Freddie Mac mortgages are exempt as long as the agencies are in conservatorship. Federal regulators published a proposed QRM rule on April 29, 2011, that included a 20 percent down-payment requirement.¹⁰⁵ However, federal regulators issued another proposed rule on August 28, 2013.¹⁰⁶ The new proposed rule offers two approaches. The first approach would define a QRM to have the same meaning as the term QM defined by the CFPB and, thus, would not include a down-payment requirement. The alternative approach, which according to the regulators "was not selected as the preferred approach," would require lenders to retain risk in any loan with a down payment of less than 30 percent.

Because the QM and QRM regulations will affect whether and at what price the conventional market will be willing to serve higher-risk borrowers, some have suggested that they could push these borrowers to FHA. For example, a recent HUD paper outlined several factors that may make higher-risk borrowers migrate to FHA: (1) conventional lenders are unlikely to originate non-QM loans (which by definition are also non-QRM loans, as QRM is a subset of QM) because they will face significantly higher capital retention requirements; (2) lenders that are willing to

¹⁰⁴Through securitization, the purchasers (securitizers) package mortgages into pools and issue securities, for which the mortgages serve as collateral. These securities pay interest and principal to their investors.

¹⁰⁵See 76 Fed. Reg. 24090 (Apr. 29, 2011).

¹⁰⁶As of August 30, 2013, the proposed rule had not yet been published in the Federal Register.

originate non-QM loans will do so only at a higher cost to the borrower; and (3) the April 2011 QRM proposal is quite narrow, requiring for example, that borrowers make a 20 percent down payment, which may be a difficult threshold for first-time borrowers to meet.¹⁰⁷ Another paper we reviewed concurred, positing that the April 2011 proposed QRM rule could make it extremely difficult to securitize high-LTV loans made to first-time home buyers and other borrowers who could prudently manage low down-payment mortgages, resulting in a flood of loans to the enterprises and FHA.¹⁰⁸ Depending on how the enterprises are ultimately resolved, most of these loans could flow to FHA.

The Resolution of Fannie Mae and Freddie Mac Could Impact FHA's Role

On September 6, 2008, FHFA placed Fannie Mae and Freddie Mac into conservatorship because of concern that their deteriorating financial condition threatened the stability of the financial markets. According to FHFA, the two enterprises had a worldwide debt and other financial obligations totaling \$5.4 trillion at the time they were placed in conservatorship. Defaulting on those obligations would have significantly disrupted the U.S. financial system. While the conservatorships can remain in place indefinitely as efforts are undertaken to stabilize Fannie Mae and Freddie Mac and restore confidence in financial markets, FHFA has said that the conservatorships were not intended to be permanent. Recent policy changes and proposals on how to restructure or wind down the two enterprises are likely to have an impact on FHA's role in the mortgage market.

In August 2012, FHFA directed the enterprises to increase their guarantee fees on single-family mortgages by an average of 10 basis points. According to FHFA, the increase represented a step toward

¹⁰⁷See HUD, Office of Policy Development and Research, *The FHA Single-Family Insurance Program: Performing a Needed Role in the Housing Finance Market* (Washington, D.C.: December 2012).

¹⁰⁸Basil N. Petrou, Managing Partner of Federal Financial Analytics, Inc., *Establishing the Proper Role of the Federal Housing Administration in the U.S. Mortgage-Finance System*, testimony before the House Financial Services Committee, 113th Cong., 1st sess., February 6, 2013.

encouraging greater participation in the mortgage market by private firms. One impact of this change could be to push business to FHA.¹⁰⁹

In addition, in February 2011, Treasury and HUD jointly issued a proposal for reforming the federal role in housing finance.¹¹⁰ The proposal would make private markets the primary source of mortgage credit and would place the burden of losses on the private market. In addition, banks would be required to adhere to underwriting standards that were more conservative than those currently in place and that would require homeowners to hold more equity in their homes. The plan also includes proposals for reducing the roles of Fannie Mae and Freddie Mac, and ultimately winding down both institutions, while at the same time ensuring access to quality, affordable housing. To this end, the report presents several proposals for structuring the government's long-term role in a housing finance system in which the private sector is the dominant provider of mortgage credit:

- *Option 1.* A privatized system of housing finance with the government insurance role limited to FHA, USDA, and VA assistance for narrowly targeted groups of borrowers.
- *Option 2.* A privatized system of housing finance with assistance from FHA, USDA, and VA for narrowly targeted groups of borrowers and a guarantee mechanism that could be scaled up during times of crisis.
- *Option 3.* A privatized system of housing finance with FHA, USDA, and VA assistance for low- and moderate-income borrowers and catastrophic reinsurance behind significant private capital.

Under each of these options, FHA would continue to play a central role in providing mortgage credit to low- and moderate-income borrowers.

In a 2009 report, we also identified several options for revising the structure of the enterprises and outlined a framework for identifying the trade-offs associated with them:

¹⁰⁹Both the enterprises and Ginnie Mae compete in the mortgage securitization market—the enterprises through the issuance of securities and Ginnie Mae through the guarantee of timely payment of principal and interest on securities issued by others.

¹¹⁰Treasury and HUD, *Reforming America's Housing Finance Market*.

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- reconstitute the enterprises as for-profit corporations with government sponsorship but place additional restrictions on them,
 - establish the enterprises as government corporations or agencies, or
 - privatize or terminate the enterprises.¹¹¹

In evaluating the trade-offs associated with these options, we noted that the credit needs of certain groups no longer served by the enterprises could be met by FHA. However, we also pointed out that some have questioned FHA's capacity to manage large increases in its business, which could raise taxpayer risks. In addition, we previously had identified "modernizing the U.S. financial regulatory system" as a high-risk area. Because of continuing uncertainty over the resolution of Fannie Mae and Freddie Mac, the potential impact of their resolution on FHA, and concerns about FHA's financial condition, in February 2013 we included FHA in this high-risk area, now called "modernizing the U.S. financial regulatory system and the federal role in housing finance."¹¹²

As of March 31, 2013, over 90 percent of new mortgage volume had federal backing, either through FHA and Ginnie Mae or the enterprises. The heightened federal role in mortgage lending and the increased reliance on FHA insurance highlights the need for policymakers to ensure that changes made to FHA and the enterprises recognize the interdependence of these entities and that changes to federal regulations governing the mortgage market consider the interaction between public and private capital and reflect the roles and capacities of the agencies. Ultimately, FHA's place in the housing finance system will depend on how the private market reacts to new regulations and how the federal government resolves Fannie Mae and Freddie Mac. It will also depend on which, if any, of the options outlined in this report policymakers pursue and how they are implemented.

¹¹¹See [GAO-09-782](#).

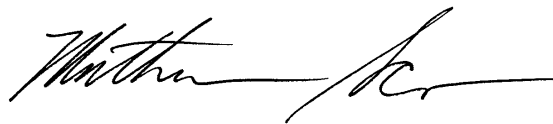
¹¹²See [GAO-13-283](#).

Agency Comments

We provided a draft report to HUD for review and comment, and HUD had no comments.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to the Secretary of Housing and Urban Development and other interested parties. In addition, the report will be available at no charge on GAO's website at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact me at (202) 512-8678 or sciremj@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs are listed on the last page of this report. GAO staff who made major contributions to this report are listed in appendix II.



Mathew J. Scire
Director, Financial Markets and
Community Investment

Appendix I: Objectives, Scope, and Methodology

Our objectives were to examine options that have been proposed for improving the long-term viability of the Federal Housing Administration (FHA) or reducing its market presence and the implications of these options. Specifically, we discuss the implications of options related to (1) changing FHA's product terms and conditions for single-family mortgage insurance, (2) restricting FHA's presence in the single-family housing market, and (3) enhancing FHA's operations and powers within its single-family program. In addition, we discuss the possible effects of broader housing finance reform on FHA.

To identify proposed options for improving the long-term viability of FHA or limiting its market presence, we obtained relevant academic and industry studies based on our past and ongoing work and conducted a literature search of relevant databases. We reviewed and summarized the literature identifying options for change at FHA, including congressional testimonies and other documents from mortgage market participants (such as the Mortgage Bankers Association) and researchers (such as the Urban Institute, Cato Institute, and others). As noted above, we sorted these options into three categories: changes related to product terms and conditions, changes that could affect the market FHA serves, and changes related to FHA's organizational structure or powers. We also reviewed and summarized the literature for implications associated with the proposed options (including the effects on the cost or risk to the taxpayer, borrowers' access to credit, FHA's role and the market it serves, and other mortgage market participants). Finally, we reviewed these materials for information on broader housing refinance issues that may affect FHA, including mortgage reforms and proposals for reform of Fannie Mae and Freddie Mac, two government-sponsored enterprises. We assessed the reliability of the key studies we used and determined them to be reliable for our purposes. We also obtained and reviewed documentation from the Department of Housing and Urban Development, FHA, and Ginnie Mae. This documentation included FHA's mortgagee letters, which we reviewed to determine existing program policies and procedures and recent changes.

We obtained FHA data on (1) loans originated in 2009, including credit scores and down-payment percentages, (2) the effect of a potential increase in the down-payment requirement on loans for which applications were submitted in August 2010 through July 2011, (3) the percentage of loan originations in 2009 and 2010 that had seller concessions of more than 3 percent of the property value, (4) the percentage of loans that FHA insured in fiscal year 2012 that were above \$450,000, by state, (5) the income distribution of FHA borrowers in fiscal years 2000-2013 (October through April), and (6) delinquency rates for all

active loans as of October 31, 2011, by loan size. To determine the reliability of this information, we reviewed information on the data and queried FHA officials about how its data are collected, verified, and maintained to identify potential data limitations. The FHA officials agreed these data were generally accurate and complete. Based on this work, we concluded that the data we received from FHA were sufficiently reliable for our purposes. We also used data published by *Inside Mortgage Finance* on mortgage originations for the first quarter of 2013. To determine the reliability of these data, we reviewed information on the data source and queried a knowledgeable official about the accuracy of the data. We determine the data were sufficiently reliable for our purposes.

Finally, we conducted interviews with mortgage industry participants, researchers, consumer groups, and three former FHA commissioners to discuss the proposed options and, in particular, their implications. Specifically, we interviewed representatives from the following organizations:

- American Enterprise Institute,
- Cato Institute,
- Center for American Progress,
- Center for Responsible Lending,
- Harvard Business School,
- Harvard University's Joint Center for Housing Studies,
- Hudson Institute,
- Independent Community Bankers of America,
- Mortgage Bankers Association,
- Mortgage Insurance Companies of America,
- National Association of Home Builders,
- National Association of Realtors,
- National Community Reinvestment Coalition,
- National Council of State Housing Agencies, and
- Urban Institute.

We also interviewed FHA and Ginnie Mae officials. At each interview, we sought to obtain any additional relevant studies or papers.

We conducted this performance audit from April 2013 to September 2013 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our

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

Appendix II: GAO Contact and Staff Acknowledgments

GAO Contact

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Staff Acknowledgments

In addition to the individual named above, Paige Smith, Assistant Director; Stephen Brown; Marcia Carlsen; Emily Chalmers; Cory Marzullo; John McGrail; Marc Molino; Josephine Pérez; Andrew Stavisky; Julie Trinder; and Heneng Yu made major contributions to this report.

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