

GAO

Testimony
Before the Committee on Banking,
Housing, and Urban Affairs, U.S. Senate

For Release on Delivery
Expected at 9:30 a.m. EDT
Wednesday, July 18, 2007

FEDERAL HOUSING ADMINISTRATION

Proposed Legislative Changes Would Affect Borrower Benefits and Risks to the Insurance Funds

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Highlights of [GAO-07-1109T](#), a testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate

Why GAO Did This Study

Fewer borrowers are using the Federal Housing Administration's (FHA) single-family and manufactured housing insurance programs. To help counter this trend, proposed changes to the single-family program would raise loan limits, allow risk-based pricing of premiums, and reduce down payments. Changes such as higher loan limits also were proposed for the manufactured housing program. To assist Congress in considering the impact of these changes, this testimony provides information from recently issued GAO reports and preliminary views from ongoing work. Specifically, GAO discusses (1) trends in FHA's share of the mortgage market, (2) likely impacts of proposed changes to the single-family program, (3) practices important to implementing the changes to the single-family program, if passed, and (4) preliminary observations from our work on the manufactured housing program. To conduct this work, GAO analyzed agency, Home Mortgage Disclosure Act, and Census data and interviewed agency and lending industry officials and other stakeholders.

What GAO Recommends

While making no new recommendations, GAO reemphasizes the need for continued management attention to prior GAO recommendations that could help address risks and challenges associated with the single-family legislative proposals.

www.gao.gov/cgi-bin/getrpt?GAO-07-1109T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact William B. Shear at (202) 512-8678 or shearw@gao.gov.

FEDERAL HOUSING ADMINISTRATION

Proposed Legislative Changes Would Affect Borrower Benefits and Risks to the Insurance Funds

What GAO Found

FHA's share of the single-family mortgage market declined 13 percentage points from 1996 through 2005, with conventional lenders gaining notably increased percentages of lower-income and minority borrowers. This decline in market share was associated with a number of factors, including FHA's product restrictions and product innovations in the conventional market.

The proposed changes to the single-family program could affect borrowers as well as program costs. For example, GAO estimated that in 2005 FHA could have insured 9 to 10 percent more loans if proposed mortgage limits were in effect. But, if the risk-based pricing proposal had been in effect in 2005, 20 percent of borrowers would not have qualified for FHA insurance. FHA determined that the expected claim rates of these borrowers were higher than it found tolerable for either the borrower or the Mutual Mortgage Insurance Fund. Absent any program changes, FHA estimates that the fund would require an appropriation of approximately \$143 million in fiscal year 2008. If proposed changes were passed, FHA estimates that the fund would generate \$342 million in negative subsidies (i.e., net cash inflows).

Although FHA is taking steps to enhance tools important to implementing the proposed changes to its single-family program, it does not plan to use a common industry practice, piloting, to mitigate the risks of any zero-down-payment product. In response to prior GAO recommendations, FHA improved its loan performance models and is refining its mortgage scorecard (which evaluates the default risk of borrowers). However, the proposals would introduce new risks and challenges. The proposal to lower down payments is of particular concern given the greater default risk of these loans and the difficulty of setting prices for new products whose risks may not be well understood. One of the ways FHA plans to mitigate new or increased risks is through stricter underwriting standards, but it does not plan to pilot any zero-down-payment product. Other mortgage institutions use pilots to manage risks associated with changing or expanding product lines.

Proposals for the manufactured home loan program would increase loan limits, insure each loan made, incorporate stricter underwriting requirements, and set premium rates. While the changes could benefit borrowers, according to FHA and the Congressional Budget Office, the potential costs could expand the government's liability. However, FHA has not articulated which borrowers would be targeted if the program were expanded, specified changes in its underwriting requirements, developed a risk-based pricing structure for the proposed legislation, or estimated costs to the General Insurance Fund. As a result, the potential effects of the changes on the program and the insurance fund are unclear.

Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to share information and perspectives with the committee as it considers modernization proposals for the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA). FHA provides insurance for single-family home mortgages made by private lenders. In fiscal year 2006, it insured almost 426,000 mortgages representing \$55 billion in mortgage insurance. According to FHA's estimates, the single-family insurance program currently operates with a negative subsidy, meaning that the present value of estimated cash inflows (such as borrower premiums) to FHA's Mutual Mortgage Insurance Fund exceeds the present value of estimated cash outflows (such as insurance claims). However, absent any program changes, FHA has estimated that the program would require a positive subsidy—that is, an appropriation of budget authority—in fiscal year 2008. In addition to single-family home mortgages, FHA insures loans for manufactured housing—that is, factory-built housing designed to meet HUD's national building code. Comparatively, this is a much smaller program than the single-family insurance program, insuring 1,438 loans in 2006 representing \$54 million in mortgage insurance. FHA insures its manufactured home loans under the General Insurance Fund.

FHA has faced several challenges in recent years. Its single-family insurance program has experienced rising delinquency rates and a sharp decline in the number of participating borrowers, due partly to increased competition from conventional mortgage providers.¹ The conventional market has prime and subprime segments. Prime borrowers typically have strong credit scores and obtain the most competitive interest rates and mortgage terms.² In contrast, subprime borrowers typically have blemished credit and lower credit scores, may have difficulty providing income documentation, and generally pay higher interest rates and fees than prime borrowers. As conventional providers have improved their ability to evaluate risk, FHA has experienced adverse selection—that is, conventional providers have identified and approved relatively lower-risk borrowers in FHA's traditional market segment, leaving relatively higher-risk borrowers for FHA.

¹The conventional market comprises mortgages that do not carry government insurance or guarantees.

²Credit scores, which assign a numeric value to a borrower's credit history, have become a common tool for assessing loan applications.

Additionally, the lending market associated with manufactured homes has undergone significant changes over the last 15 years. Market growth in the 1990s was followed by a large number of repossessions from 2000 to 2002 due to the deteriorating credit quality of borrowers, and many lenders exited the manufactured home loan market. The FHA-insured segment of the market experienced a dramatic decline over this period. The number of manufactured home loans insured by FHA decreased from 23,897 loans in 1990 to 1,438 loans in 2006, a 94 percent decline.

To adapt to market changes, FHA has implemented new administrative procedures in its single-family insurance program and proposed legislation designed to modernize its insurance processes and products. FHA's recent administrative changes include allowing higher-performing single-family lenders to endorse, or approve, loans for FHA insurance without prior review by FHA and adopting conventional market appraisal requirements. The legislative proposals for the single-family insurance program also would raise FHA's mortgage limits, give the agency flexibility to set insurance premiums based on the credit risk of borrowers, and reduce down-payment requirements from the current 3 percent to potentially zero. In addition, legislative changes have been proposed for FHA's Title I Manufactured Home Loan program that include increasing the loan limits, incorporating stricter underwriting requirements, and revising the premium structure.

My testimony today discusses two reports that we issued in June 2007 on FHA's share of the single-family mortgage market and FHA's proposals to modernize its single-family insurance program, as well as preliminary views from ongoing work we are conducting on FHA's Title I Manufactured Home Loan program.³ Specifically, I will discuss (1) trends in FHA's share of the home purchase mortgage market and factors underlying these trends; (2) likely program and budgetary impacts of proposed changes to FHA's single-family insurance program; (3) tools, resources, and risk-management practices important to FHA's implementation of the legislative proposals for its single-family insurance

³See GAO, *Federal Housing Administration: Decline in the Agency's Market Share Was Associated with Product and Process Developments of Other Mortgage Market Participants*, [GAO-07-645](#) (Washington, D.C.: June 29, 2007) and 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).

program, if passed; and (4) preliminary observations from our ongoing work on the Manufactured Home Loan program.⁴

In conducting this work, we analyzed loan data from 1996 through 2005 collected under the Home Mortgage Disclosure Act (HMDA) to assess trends in the overall market for home purchase mortgages and used 2005 HMDA data (the most current available) to examine the effect of raising loan limits on demand for FHA-insured single-family loans. We estimated the effects of risk-based pricing on borrowers' eligibility for FHA single-family insurance and the premiums they would pay by analyzing Single Family Data Warehouse (SFDW) data on FHA's 2005 home purchase borrowers. We also analyzed data from the Manufactured Home Loan program, Census data from the Manufactured Housing and American Housing Surveys, and other sources. We interviewed officials from FHA, Ginnie Mae, Fannie Mae, and Freddie Mac; FHA lenders, private mortgage insurers, and mortgage and real estate industry groups; and academic researchers. We conducted this work from September 2006 to July 2007 in accordance with generally accepted government auditing standards.

In summary, we found that:

- From 1996 through 2005, FHA's share of the market for home purchase mortgages declined from 19 to 6 percent, while the prime and subprime shares increased 3 and 13 percentage points, respectively. The agency experienced a sharp decrease among minority and lower-income populations where it traditionally has had a strong presence. This decline in market share was associated with a number of factors—including FHA's product restrictions and product innovations in the conventional market, particularly in the subprime market—and has been accompanied by higher ultimate costs for certain conventional subprime borrowers.
- FHA's proposed changes to its single-family insurance program could affect borrower demand and the cost and availability of its insurance as well as the budgetary costs of the program. Based on our analysis of 2005 HMDA data, we estimated that the number of FHA-insured loans in 2005 could have been from 9 to 10 percent greater had the higher, proposed mortgage limits been in effect. In addition, our analysis of data for FHA home purchase borrowers in 2005 showed that, under FHA's risk-based pricing proposal, about 43 percent of those borrowers would have paid the same or less than they actually paid, 37 percent would have paid more, and

⁴Home purchase mortgages do not include mortgages for refinancing existing loans.

20 percent would not have qualified for FHA insurance based on FHA's plans as of May 2007. The 20 percent were borrowers with expected lifetime claim rates more than 2.5 times greater than the average claim rate. Finally, while to be viewed with caution, FHA has made estimates indicating that the loans it expects to insure in 2008 would result in negative subsidies of \$342 million if the major legislative changes were enacted, rather than requiring an appropriation of \$143 million absent any program changes.

- FHA has taken or has planned steps to enhance the tools and resources important to implementing the proposed changes to its single-family insurance program—and help address risks and challenges associated with the proposals. However, it does not intend to use a common industry practice, piloting, to mitigate the risks of any zero-down-payment product it is authorized to offer. To implement its risk-based pricing proposal, FHA would rely on statistical models that estimate the performance of loans and its mortgage scorecard (an automated tool that evaluates the default risk of borrowers). In response to our prior recommendations, FHA has improved its loan performance models by incorporating additional variables and is in the process of addressing a number of limitations in its mortgage scorecard. Although FHA has taken actions to enhance key tools and resources, the legislative proposals would introduce new risks and challenges. The proposal to lower down-payment requirements is of particular concern given the greater default risk of these loans and the difficulty of setting prices for new products whose risks may not be well understood. FHA plans to take steps, such as instituting stricter underwriting standards, to mitigate these risks. However, while other mortgage institutions use pilot programs to manage the risks associated with changing or expanding their product lines, FHA has indicated that it does not plan to pilot any zero-down-payment product it is authorized to offer.
- In response to the dramatic decline in FHA-insured manufactured home loans, legislative proposals for the Manufactured Home Loan program would increase loan limits, insure each loan made, incorporate stricter underwriting requirements, and establish up-front and adjust annual insurance premiums. According to FHA and some industry officials, the potential benefits of proposed changes for borrowers include obtaining larger loans and additional financing with lower interest rates as more lenders likely would participate because a greater portion of their portfolios could be insured. The Congressional Budget Office (CBO) and FHA also noted potential costs, such as expanded liability for the General Insurance Fund. Additionally, risk factors unique to manufactured home lending affect loan performance. But, FHA has not yet articulated which

borrowers would be targeted or undertaken risk assessments to estimate the effects of the proposed legislation on the volume of lending and claims and the overall financial soundness of the program.

While the two reports I have summarized make no new recommendations, they include observations about how developments in the different segments of the mortgage market could affect FHA's market share in the future and the need for careful implementation of the legislative proposals, if passed. We noted that, notwithstanding the actions of conventional providers, FHA could be a vehicle to provide lower-priced and more sustainable mortgage options for some borrowers who are considering or struggling to maintain higher-priced subprime loans. However, careful assessment and management of the risks associated with serving these borrowers would be necessary to avoid exacerbating problems in the financial performance of FHA's single-family insurance program. We also acknowledged that FHA has performed considerable analysis to support its legislative proposals for the single-family insurance program and has made or planned enhancements to many of the specific tools and resources that would be important to its implementation of them, but stated that the proposals present risks and challenges and should be viewed with caution. Continued management attention to our prior recommendations, including piloting new products and improving its mortgage scorecard, could help FHA address these risks.

Background

Congress established FHA in 1934 under the National Housing Act (P.L. 73-479) to broaden homeownership, protect and sustain lending institutions, and stimulate employment in the building industry. FHA's single-family program insures private lenders against losses from borrower defaults on mortgages that meet FHA criteria for properties with one to four housing units. FHA has played a particularly large role among minority, lower-income, and first-time homebuyers and generally is 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 are experiencing economic downturns. In fiscal year 2006, 79 percent of FHA-insured home purchase loans went to first-time homebuyers, 31 percent of whom were minorities. The Title I Manufactured Home Loan program was created to reduce the risk to lenders through insurance or a guarantee, and thereby expand access to funding for buyers of manufactured homes. According to data from FHA, the majority of its Title I borrowers from 2004 to 2007 were lower-income and 34 years of age or younger.

FHA insures most of its single-family mortgages under its Mutual Mortgage Insurance Fund, which is supported by borrowers' insurance premiums. The single-family insurance program has maintained a negative overall credit subsidy rate, meaning that the present value of estimated cash inflows from premiums and recoveries exceeds estimated cash outflows for claim payments (excluding administrative costs). In addition to insuring mortgages on single-family homes, FHA has insured loans for manufactured housing since 1969. FHA insures its manufactured home loans under the General Insurance Fund, which is supported by lenders' insurance premiums (currently an annual premium of 1 percent, based on the initial loan amount).

Borrowers insured under FHA's single-family program are required to make a cash investment of a minimum of 3 percent. FHA allows down-payment assistance from third-party sources, including nonprofit organizations that receive contributions from property sellers. When a homebuyer receives down-payment assistance from one of these organizations, the organization requires the property seller to make a financial payment to their organization. These nonprofits are commonly called "seller-funded" down-payment assistance providers.

Partly in response to changes in the mortgage market, HUD has proposed legislation intended to modernize FHA. Provisions in the proposal relating to its single-family insurance program would among other things authorize FHA to change the way it sets insurance premiums, reduce down-payment requirements, and insure larger loans. The proposed legislation would enable FHA to depart from its current, essentially flat, premium structure and charge a wider range of premiums based on individual borrowers' risk of default. HUD's proposal also would eliminate the minimum cash investment requirement and enable FHA to offer some borrowers a no-down-payment product. FHA is subject to limits in the size of the loans it can insure. For example, for a one-family property in a high-cost area, the FHA limit is 87 percent of the limit established by Freddie Mac. In a low-cost area, the limit is 48 percent of the Freddie Mac limit. The legislative proposal would raise these limits to 100 percent and 65 percent of the Freddie Mac limit, respectively. In addition, Congress has proposed changes to FHA's Title I Manufactured Home Loan program that would increase loan limits and index them annually; insure each loan made instead of capping insurance at 10 percent of the value of a lender's portfolio; incorporate stricter underwriting requirements; and establish up-front and annual premiums.

Decline in FHA's Market Share Was Associated with Product and Process Developments of Other Mortgage Market Participants

In a report we issued in June 2007, we noted that a combination of factors created conditions that favored conventional mortgages over FHA products resulting in FHA losing a considerable market share to the conventional market, especially to the subprime market.⁵ Based on our analysis of HMDA data, FHA's share of the market for home purchase mortgages (in terms of numbers of loans) declined 13 percentage points from 1996 through 2005, while the prime share increased slightly, and the subprime share grew 13 percentage points.⁶ In addition, the agency experienced a sharp decrease among minority and lower-income populations where it traditionally has had a strong presence.

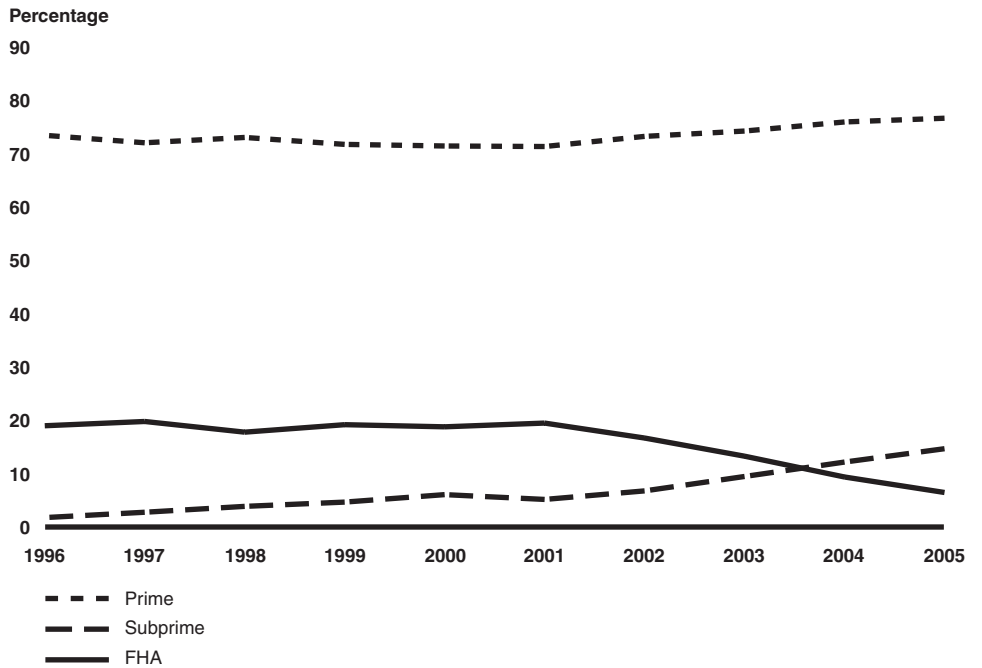
Specifically, we found that:

- From 1996 through 2005, FHA's share of the home purchase mortgage market declined while the conventional share increased. As shown in figure 1, FHA's market share fell from almost 19 percent (about 583,000 loans) in 1996 to about 6 percent (about 295,000 loans) in 2005, with almost all of the decline occurring after 2001. Over the 10-year period, the market share for conventional mortgages rose from almost 75 percent (about 2.3 million loans in 1996) to about 91 percent (about 4.2 million loans in 2005), with much of the increase due to growth in subprime lending. More specifically, prime market share increased from 73 percent to 76 percent overall, falling somewhat from 1996 through 2000 but then increasing about 5 percentage points after 2000. Subprime market share increased substantially over the 10-year period, from 2 percent to 15 percent, with most of the increase occurring after 2001 (growing from 5 percent in 2001 to 15 percent in 2005).

⁵GAO-07-645.

⁶HMDA data capture about 80 percent of the mortgage loans funded each year according to estimates by the Board of Governors of the Federal Reserve System and are one of the most comprehensive sources of information on mortgage lending.

Figure 1: Market Shares for Home Purchase Loans, 1996-2005



Source: GAO analysis of HMDA data.

- FHA traditionally played a major role among minority borrowers. However, over the 10-year period, FHA’s share of this submarket fell substantially. Specifically, FHA’s market share dropped from 32 to 7 percent among minority borrowers. In contrast, prime market share increased from 59 to 65 percent among minority borrowers and subprime market share increased from 2 to 26 percent.
- Lower-income (that is, low- and moderate-income) borrowers historically relied heavily on FHA products, but FHA’s market share dropped in this submarket as well.⁷ From 1996 through 2005, FHA’s market share decreased among borrowers of all income levels, but particularly among lower-income borrowers, where it declined from 26 to 10 percent. Over the same period, prime market share increased from 65 to 72 percent and subprime market share increased from 1 to 15 percent.

⁷We defined low income as less than 80 percent of the median income for the census tract, moderate income as at least 80 percent but less than 120 percent, and upper income as 120 percent and above.

The decline in FHA's market share was associated with a number of factors and has been accompanied by higher ultimate costs for certain conventional borrowers. FHA's lack of process improvements and product restrictions relative to the conventional market provided conditions that favored conventional over FHA-insured mortgages. According to mortgage industry officials that we interviewed, processing FHA-insured loans is more costly, time consuming, and labor intensive than processing conventional mortgages. FHA and mortgage industry officials with whom we spoke also cited FHA loan limits as a factor that contributed to the decline in FHA market share. In some areas of the country, particularly in parts of California and the Northeast, the loan limits were significantly lower than the median home price. Some mortgage industry officials also pointed to other product restrictions as a reason why FHA loans have been less competitive than conventional loans. For example, many borrowers do not or cannot make a down payment, and unlike FHA, in recent years members of the conventional mortgage market have been increasingly active in supporting low- and no-down-payment mortgages.

During the 10-year period we examined, several developments occurred in the conventional market that contributed to FHA's declining market share. I will discuss four of these developments. First, the conventional market offered products that increased consumer choices for borrowers, including those who may have previously chosen an FHA-insured loan. These products—interest-only loans, no- and low-documentation mortgages, piggyback loans, and hybrid adjustable rate mortgages (ARM)—became popular, especially during the subprime market's rapid growth after 2001, because they featured flexible payment and interest options that increased initial affordability.⁸ In combination with historically low interest rates, these products made it easier for homebuyers to purchase homes in a period of strong house price appreciation.

Second, advances in underwriting technology, particularly mortgage scoring and automated underwriting systems, allowed conventional mortgage providers to process loan applications more quickly and

⁸Interest-only loans allow borrowers to defer the principal payments for some period and hybrid ARMs allow borrowers to pay a lower interest rate for a specified time, usually between 2 and 5 years, before the loan resets to the fully indexed interest rate. Piggyback loans are simultaneous second mortgages that allow borrowers to make little or no down payment. No- and low-documentation loans allow for less detailed proof of income or assets than lenders traditionally require.

consistently than in the past and broaden their customer base. FHA implemented its own mortgage scoring tool, called the Technology Open to Approved Lenders (TOTAL) scorecard, in 2004. However, in prior work we found that the way FHA developed TOTAL may limit the scorecard's effectiveness.⁹ To the extent that conventional mortgage providers were better able than FHA to use scoring tools to identify lower-risk borrowers in FHA's traditional market segment, these borrowers may have migrated toward conventional products, contributing to the decline in FHA's market share.

Third, there was an increase in mortgage originations through third parties such as loan correspondents and mortgage brokers, particularly in the subprime market. This trend has been associated with the decline in FHA's market share because the third-party originators primarily market non-FHA products. Finally, the growth in private mortgage securitization (the bundling of mortgage loans into bond-like securities that can be bought and sold on the secondary market), particularly for subprime loans, allowed lenders to sell loans from their portfolios, transferring credit risk to investors, and use the proceeds to make more loans.

As a result of these developments and lower interest rates, more homebuyers—especially minority and lower-income families—were able to obtain conventional loans, but many of these loans had high ultimate costs. As previously discussed, much of the increase in mortgages to minorities and lower-income borrowers was due to the growth in subprime lending, and many of these loans offered lower initial costs through their interest-only features and low introductory interest rates. However, these mortgages became more costly as the interest rates on many of these loans reset to higher rates, typically 2 to 3 percentage points higher in a relatively short period.

Highly leveraged and weaker credit borrowers—the typical subprime borrowers who have obtained nontraditional mortgage products such as hybrid ARMs—are the most vulnerable to payment shocks. As a result, borrowers who obtained subprime mortgages have experienced relatively high rates of default (defined as payments more than 90 days past due) and foreclosure (in any stage of the foreclosure process). According to the Mortgage Bankers Association, as of December 31, 2006, the cumulative

⁹GAO, *Mortgage Financing: HUD Could Realize Additional Benefits from Its Mortgage Scorecard*, GAO-06-435 (Washington, D.C.: Apr. 13, 2006).

default and foreclosure rates for all subprime mortgages were 7.78 and 4.53 percent, respectively.¹⁰ Some mortgage industry researchers predict that subprime default and foreclosure rates likely will worsen as the loans age; a substantial portion of these loans have yet to reach the age when loans tend to experience the highest rates of default and foreclosure—between 4 and 7 years. Furthermore, because most recent subprime loans have adjustable-rate features, default and foreclosure rates for ARMs are in particular danger of increasing as resetting interest rates cause monthly mortgage payments on the loans to rise.

Single-Family Modernization Proposals Likely Would Affect Program Participation and Costs

In our June 2007 report on FHA’s modernization efforts, we noted that FHA’s proposed legislative changes to its single-family insurance program likely would affect program participation and costs.¹¹ For example, we estimated that raising the FHA loan limits could increase demand for FHA-insured loans, all other things being equal. The risk-based pricing proposal would decrease premiums for lower-risk borrowers, increase them for higher-risk borrowers, and disqualify other potential borrowers. In addition, FHA estimates that the legislative proposals would have a favorable budgetary impact.

Raising Loan Limits Likely Would Increase Demand for FHA Loans

Our analysis indicated that raising the loan limits for FHA’s single-family insurance program likely would increase the number of loans insured by FHA by making more loans eligible for FHA insurance. In some areas of the country, median home prices have been well above FHA’s maximum loan limits, reducing the agency’s ability to serve borrowers in those markets. For example, the 2005 loan limit in high-cost areas was \$312,895 for one-unit properties, while the median home price was about \$399,000 in Boston, Massachusetts; about \$432,000 in Newark, New Jersey; and about \$646,000 in San Francisco, California. If the limits were increased, FHA insurance would be available to a greater number of potential borrowers.

¹⁰For subprime ARMs, the corresponding figures were 9.16 and 5.62 percent. In comparison, as of the same date, the default and foreclosure rates for FHA-insured loans were 5.78 and 2.19 percent, respectively (6.62 and 2.54 percent for ARMs) and for prime loans, 0.86 and 0.50, respectively (1.45 and 0.92 for ARMs).

¹¹[GAO-07-708](#).

Our analysis of HMDA data indicated that the agency could have insured from 9 to 10 percent more loans in 2005 had the higher mortgage limits been in place.¹² The greatest portion of this increase resulted from raising the loan limit floor in low-cost areas from 48 to 65 percent of the conforming loan limit. In particular, 82 percent of the additional loans that would have been insured by FHA were in areas where the loan limits were set at the floor. Only 14 percent of the new loans would have resulted from increasing the loan limit ceiling. Our analysis also found that the average size of an FHA-insured loan in 2005 would have increased from approximately \$123,000 to about \$132,000 had the higher loan limits been in place.

Risk-Based Pricing Could Help Address Adverse Selection but Would Affect the Cost and Availability of FHA Insurance for Some Borrowers

To help address the problem of adverse selection, FHA has sought authority to price insurance premiums based on borrower risk, which would affect the cost and availability of FHA insurance for some borrowers. Currently, all FHA-insured borrowers pay the same premium rates. Under this flat pricing structure, lower-risk borrowers subsidize higher-risk borrowers. In recent years, innovations in the mortgage market have allowed conventional mortgage lenders and insurers to identify and approve relatively low-risk borrowers and charge fees based on default risk. As relatively lower-risk borrowers in FHA's traditional market segment have selected conventional financing, FHA has been left with more high-risk borrowers who require a subsidy and fewer low-risk borrowers to provide that subsidy. FHA has proposed risk-based pricing as a solution to the adverse selection problem.

As of May 2007, FHA's risk-based pricing proposal established six different risk categories, each with a different premium rate, for purchase and refinance loans.¹³ FHA used data from its most recent actuarial review to establish the six risk categories and corresponding premiums based on the relative performance of loans with various combinations of loan-to-value (LTV) ratio (loan amount divided by sales price or appraised value) and

¹²Our analysis considered the number of additional loans that would have been eligible for FHA insurance if the loan limits in 2005 had been raised to 100 percent of the local median home price, with a floor in low-cost areas of \$233,773 and a ceiling in high-cost areas of \$359,650. We made different assumptions about the share of newly eligible loans that likely would be insured by FHA, all of which yielded similar results.

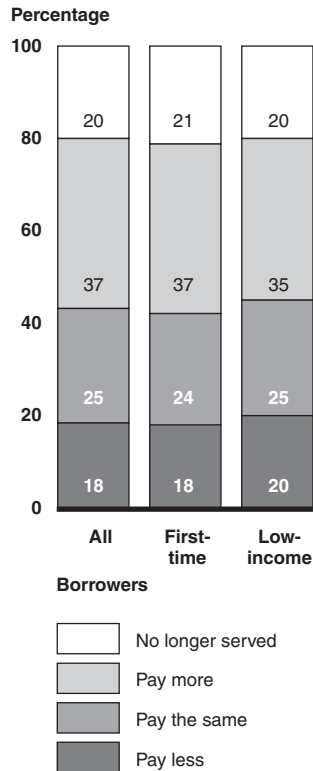
¹³Different pricing would apply to refinances of existing FHA-insured mortgages.

credit score.¹⁴ Borrowers in categories with higher expected lifetime claim rates would have higher premiums than those in categories with lower claim rates. If FHA were granted the authority to implement its risk-based pricing proposal, the agency would publish a pricing matrix that would allow borrowers to identify their likely premiums based on their credit scores and LTV ratios. However, FHA would use its TOTAL mortgage scorecard to make the final determination of a borrower's placement in a particular risk category. Because TOTAL takes into account more borrower and loan characteristics than LTV ratio and credit score (such as borrower reserves and payment-to-income ratio), a borrower's TOTAL score could indicate that a borrower belongs in a higher risk category than would be suggested by LTV ratio and credit score alone.

Our analysis of how the proposed pricing structure would affect home purchase borrowers similar to those insured by FHA in 2005 found that approximately 43 percent of borrowers would have paid the same or less while 37 percent would have paid more. Twenty percent would not have qualified for FHA insurance had the risk-based pricing proposal been in effect. As shown in figure 2, risk-based pricing would have had a similar impact on first-time and low-income homebuyers FHA served in 2005.

¹⁴The Omnibus Budget Reconciliation Act of 1990 requires an annual independent actuarial review of the economic net worth and soundness of the Mutual Mortgage Insurance Fund.

Figure 2: Impact of FHA’s Risk-Based Pricing Proposal on Borrowers’ Premiums, Including First-Time and Low-Income Homebuyers



Sources: GAO, SFDW.

Note: We analyzed Single Family Data Warehouse data on 2005 home purchase borrowers. The figure shows how these borrowers would have fared under FHA’s risk-based pricing proposal. Low-income homebuyers are those whose incomes are less than or equal to 80 percent of the area median income. The figure excludes the approximately 2 percent of borrowers for whom SFDW did not contain either an LTV ratio or credit score (the two variables FHA would use to determine risk-based premiums).

Risk-based pricing also would affect the availability of FHA insurance for some borrowers. Approximately 20 percent of FHA’s 2005 borrowers would not have qualified for FHA mortgage insurance under the parameters of the risk-based pricing proposal we evaluated. FHA determined that the expected claim rates of these borrowers were higher than it found tolerable for either the borrower or the Mutual Mortgage Insurance Fund. Those borrowers who would not have qualified had high LTV ratios and low credit scores. Their average credit score was 584, and

their expected lifetime claim rates are more than 2.5 times higher than the average claim rate of all FHA loans.¹⁵ FHA officials stated that setting risk-based premiums for potential future FHA borrowers with similar characteristics would require prices higher than borrowers might be able to afford.

Legislative Proposals Likely Would Have a Beneficial Budgetary Impact

According to FHA's estimates, the three major legislative proposals would have a beneficial impact on HUD's budget due to higher estimated negative subsidies. According to the President's fiscal year 2008 budget, the credit subsidy rate for the Mutual Mortgage Insurance Fund would be more favorable if the legislative proposals were enacted. Absent any program changes, FHA estimates that the fund would require an appropriation of approximately \$143 million. If the legislative proposals were not enacted, FHA would consider raising premiums to avoid the need for appropriations. If the major legislative proposals were passed, FHA estimates that the fund would generate \$342 million in negative subsidies.

FHA's subsidy estimates for fiscal year 2008 should be viewed with caution given that FHA has generally underestimated the subsidy costs for the Mutual Mortgage Insurance Fund. To meet federal requirements, FHA annually reestimates subsidy costs for each loan cohort dating back to fiscal year 1992.¹⁶ The current reestimated subsidy costs for all except the fiscal year 1992 and 1993 cohorts are higher than the original estimates. For example, the current reestimated cost for the fiscal year 2006 cohort is about \$800 million higher than originally estimated. As discussed below, FHA has taken some steps to improve its subsidy estimates.

¹⁵ Additionally, the vast majority of these borrowers (90 percent) received down-payment assistance from nonprofits, most of which received funding from property sellers.

¹⁶ Agencies are required to reestimate subsidy costs annually to reflect actual loan performance and expected changes in estimates of future loan performance. Essentially, a cohort includes the loans insured in a given year.

FHA Has Enhanced Tools and Resources Important to Implementing Single-Family Proposals but Does Not Intend to Mitigate Risks by Piloting New Products

FHA has planned or taken steps to enhance the tools and resources that would be important to implementing the legislative proposals for its single-family insurance program. For example, we found that:

- FHA has improved the loan performance models it would use to implement risk-based pricing by adding factors that have been found to influence credit risk. In a September 2005 report, we recommended that FHA study and report the impact (on the forecasting ability of its loan performance models) of variables that have been found in other studies to influence credit risk, such as payment-to-income ratios, credit scores, and the presence of down-payment assistance.¹⁷ In response, HUD's contractor subsequently incorporated the source of down-payment assistance in the fiscal year 2005 actuarial review and borrower credit scores in the fiscal year 2006 review.
- FHA is in the process of addressing a number of limitations in its mortgage scorecard that could reduce its effectiveness for risk-based pricing. For instance, as we reported in April 2006, the scorecard does not include a number of important variables included in other mortgage institutions' scorecards, such as the source of the down payment, whether the loan is an adjustable-rate mortgage, and property type.¹⁸ An FHA contractor is helping the agency test additional variables to include in the scorecard and is scheduled to issue a final report on its work in August 2007.
- FHA has identified changes in information systems needed to implement the legislative proposals and has obligated or requested a total of \$11 million for this purpose.
- To address human capital needs, the President's fiscal year 2008 budget requests 21 additional staff for FHA to help analyze industry trends, align the agency's business processes with current mortgage industry practices, and promote new FHA products.

Although FHA has taken actions to enhance key tools and resources, the legislative proposals would introduce new risks. Our past work has shown

¹⁷See GAO, *Mortgage Financing: FHA's \$7 Billion Reestimate Reflects Higher Claims and Changing Loan Performance Estimates*, [GAO-05-875](#) (Washington, D.C.: Sept. 2, 2005). While loan performance models are critical to subsidy cost estimation, other factors such as assumptions about the losses per insurance claim and economic conditions influence subsidy estimates.

¹⁸[GAO-06-435](#).

that FHA has not always utilized risk-management practices used by other mortgage institutions. For example, we reported in November 2005 that HUD needed to take additional actions to manage risks related to the approximately one-third of its loans with down-payment assistance from seller-funded nonprofits.¹⁹ Unlike other mortgage industry participants, FHA does not restrict homebuyers' use of such assistance. Our 2005 analysis found that the probability that these loans would result in an insurance claim was 76 percent higher than for comparable loans without such assistance, and we recommended that FHA revise its underwriting standards to consider such assistance as a seller contribution (which cannot be used to meet the borrower contribution requirement).²⁰ Despite the detrimental impact of these loans on the Mutual Mortgage Insurance Fund, FHA did not act promptly to mitigate the problem by adjusting underwriting standards or using its existing authority to raise premiums. However, in May 2007, FHA published a proposed rule that would prohibit seller-funded down-payment assistance.²¹

While FHA plans to take some steps, such as instituting stricter underwriting standards, to mitigate the risks associated with lowering down-payment requirements, it does not plan to pilot any zero-down-payment product the agency is authorized to offer. The proposal to lower down-payment requirements is of particular concern given the greater default risk of low-down-payment loans, housing market conditions that could put borrowers with such loans in a negative equity position, and the difficulty of setting prices for new products whose risks may not be well understood. As we reported in February 2005, other mortgage institutions limit the availability of or pilot new products to manage risks associated with changing or expanding product lines.²² We indicated that, if Congress

¹⁹GAO, *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).

²⁰We reviewed a national sample of FHA-insured home purchase loans from 2000, 2001, and 2002.

²¹See 72 Fed. Reg. 27048 (May 11, 2007). FHA also has been anticipating a reduction in the number of loans with down-payment assistance from seller-funded nonprofit organizations as a result of actions taken by the Internal Revenue Service (IRS). IRS issued a ruling in May 2006 stating that these organizations do not qualify as tax-exempt charities, effectively making loans with such assistance ineligible for FHA insurance. According to FHA, as of June 2007, IRS had rescinded the charitable status of three of the 185 organizations that IRS is examining.

²²GAO, *Mortgage Financing: Actions Needed to Help FHA Manage Risks from New Mortgage Loan Products*, [GAO-05-194](#) (Washington, D.C.: Feb. 11, 2005).

authorizes FHA to insure new products, it should consider a number of means, including limiting their initial availability, to mitigate the additional risks these loans may pose. We also recommended that FHA consider similar steps for any new or revised products.

FHA Has Not Assessed the Effects of Proposed Changes to Its Manufactured Home Loan Program

Now I will make some preliminary observations based on our ongoing work for you and Senators Reed and Schumer on FHA's Manufactured Home Loan program. Our objectives are to (1) describe selected characteristics of manufactured housing and the demographics of the owners, (2) compare federal and state consumer and tenant protections for owners of manufactured homes, and (3) describe the proposed changes to the Manufactured Home Loan program and assess potential benefits and costs to borrowers and the federal government.

Currently, this is the only active federal loan program that includes an option for a "home-only" product; that is, a personal property loan for the purchase of a manufactured home without the land on which the home will be located. Available data on selected characteristics of manufactured homes and their owners in 2005 indicate that manufactured homes can be an affordable housing option, with monthly housing costs considerably lower than other housing types. In addition, we found most manufactured homes were located in rural areas and more were located in Southern states than in other regions. Further, owners of manufactured homes have more consumer protections if homes are considered real rather than personal property, but the laws in the eight states we visited provide varying protections.²³

Legislative proposals for the Manufactured Home Loan program would increase loan limits, insure each loan made, incorporate stricter underwriting requirements, establish up-front insurance premiums, and adjust the annual premium. For instance, limits for a home-only loan would rise from \$48,600 to \$69,678, loan guarantees would apply to individual loans rather than be capped at 10 percent of the value of a lender's portfolio, and underwriting requirements would be revised with the stated intent of strengthening the financial soundness of the program.

²³We selected the eight states (Arizona, Florida, Georgia, Missouri, New Hampshire, North Carolina, Oregon, Texas) based on factors including the volume of FHA Title I loans in the state from 1990 to 2007; the concentration of manufactured housing as a percentage of housing units in the state; information from our interviews of industry and consumer officials; and previous studies conducted on manufactured housing.

According to FHA and some industry officials, the potential benefits of proposed changes for borrowers include obtaining loan amounts sufficient to buy larger homes, additional financing with lower interest rates as more lenders would likely participate in a program where a greater portion of their portfolios could be insured, and an expansion of the secondary market that could provide more liquidity for lenders to make more loans.

According to FHA and CBO, the potential costs of the proposed changes could involve an expansion of the government's liability under the program because FHA would be insuring individual loans rather than a limited portion of a lender's portfolio. Additionally, industry officials identified risk factors unique to manufactured housing that affect loan performance, which in turn could affect claims to FHA's General Insurance Fund. For instance, the ability of the owner of a manufactured home to build equity may be limited when the land is leased, which also often increases the risks associated with the loan. If a borrower with a home on leased land were to default, lenders could face higher costs and lower recoveries (relative to site-built homes) in trying to repossess, move, and resell the personal property.

To gain an understanding of the effects of the proposed changes, we developed a model with various scenarios based on the experience of FHA loans and loan performance data from manufactured home lenders. Although risk factors unique to manufactured home lending (such as placement on leased land) as well as commonly used predictors of loan performance (such as credit scores) are associated with default risk, these data were not available. Instead, we presented low, medium, and high levels of borrower default risk and incorporated other factors (such as premiums and lender recovery) to illustrate how variations in these key factors affect potential gains and losses to FHA's General Insurance Fund. The preliminary results of our analysis show that in all cases when borrowers had medium or high default risk, the fund experienced a loss.

While our scenario analysis offers a very general illustration of how the proposed changes could affect the General Insurance Fund, the effects of the proposed changes are unclear because FHA has not articulated which borrowers would be targeted if the program were expanded, specified changes in its underwriting requirements, developed a risk-based pricing structure for the proposed legislation, or estimated costs to the General Insurance Fund. Our internal control standards for federal agencies

require that an agency identify risks that may be posed by new legislation.²⁴ FHA has stated that it has not yet made these risk assessments because the legislation has not yet passed and that they chose to focus their resources on the much larger single-family insurance program. As a result, FHA has yet to determine the effects the proposed legislation may have on the volume of lending and claims and the overall financial soundness of the program.

Mr. Chairman, this concludes my prepared statement. I would be happy to answer any questions at this time.

Contacts and Acknowledgments

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²⁴GAO, *Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (Washington, D.C.: Nov. 1, 1999).

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