Highlights of GAO-05-857T, a testimony to the Subcommittee on Housing and Community Opportunity, Committee on Financial Services, House of Representatives

Why GAO Did This Study

To assist Congress in considering legislation to authorize the Secretary of the Department of Housing and Urban Development (HUD) to carry out a pilot program to insure zero down payment mortgages, this testimony provides information about practices mortgage institutions use in designing and implementing low and no down payment products. It also contains information about how these practices could be instructive for FHA in managing risks associated with a zero down payment product – a product for which the risks are not well understood. This testimony is primarily based on GAO's February 2005 report, *Mortgage Financing: Actions Needed to Help FHA Manage Risks from New Mortgage Loan Products*, (GAO-05-194).

What GAO Recommends

GAO suggests that Congress consider limiting any new no down payment product it may authorize. GAO recommends that HUD, among other things, consider piloting a no down payment product and that HUD establish a framework for when and how to pilot this and other new or changed products. HUD told us that they face challenges in administering a pilot program. We believe that HUD needs to further consider piloting or limiting volume of new or changed products, including a zero down payment product.

www.gao.gov/cgi-bin/getrpt?GAO-05-857T.

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

June 30, 2005

FEDERAL HOUSING ADMINISTRATION

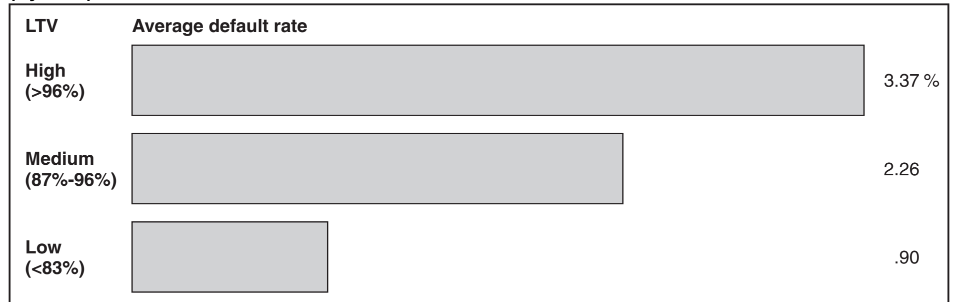
Managing Risks from a New Zero Down Payment Product

What GAO Found

In recent years, many mortgage institutions have become increasingly active in supporting low and even no down payment mortgage products. In considering the risks of these new products, a substantial amount of research GAO reviewed indicates that loan-to-value (LTV) ratio and credit score are among the most important factors when estimating the risk level associated with individual mortgages. GAO's analysis of the performance of low and no down payment mortgages supported by FHA and others corroborates key findings in the literature. Generally, mortgages with higher LTV ratios (smaller down payments) and lower credit scores are riskier than mortgages with lower LTV ratios and higher credit scores.

Some practices of other mortgage institutions offer a framework that could help FHA manage the risks associated with introducing new products or making significant changes to existing products. Mortgage institutions sometimes require additional credit enhancements, such as higher insurance coverage, and stricter underwriting, such as credit score thresholds, when introducing a new low or no down payment product. FHA is authorized to require an additional credit enhancement, but does not currently use this authority. FHA has used stricter underwriting criteria, but told us it is unlikely they would use a credit score threshold for a new zero down payment product. Mortgage institutions may also impose limits on the volume of the new products they will permit and on who can sell and service these products. FHA officials question the circumstances in which they can limit volumes for their products and believe they do not have sufficient resources to manage a product with limited volumes, but the potential costs of making widely available a product with risk that is not well understood could exceed the cost of initially implementing such a product on a limited basis.

Average Four-Year Default Rates for FHA Insured Loans Originated in 1998, 1999, and 2000 (by LTV)



Source: FY 2003 Actuarial Review of the Mutual Mortgage Insurance Fund.