United States Government Accountability Office

GAO

Testimony
Before the Subcommittee on Transportation, Housing, and Urban Development, and Related Agencies, Committee on Appropriations, United States Senate

For Release on Delivery Expected at 9:30 a.m. EDT Thursday, March 15, 2007

FEDERAL HOUSING ADMINISTRATION

Ability to Manage Risks and Program Changes Will Affect Financial Performance

Statement of William B. Shear, Director
Financial Markets and Community Investment

Madam Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to share information and perspectives with the committee as it examines issues concerning the financial performance of the Department of Housing and Urban Developmentôs (HUD) Federal Housing Administration (FHA). FHA provides insurance for single-family home mortgages made by private lenders. In fiscal year 2006, it insured about 426,000 mortgages, representing $55 billion in mortgage insurance. According to FHAôs estimates, the insurance program currently operates with a negative subsidy, meaning that the present value of estimated cash inflows (such as borrower premiums) to FHAôs Mutual Mortgage Insurance Fund (Fund) exceeds the present value of estimated cash outflows (such as claims).

But, the risks FHA faces in todayôs mortgage market are growing. For example, the agency has seen increased competition from conventional mortgage and insurance providers, many of which offer low- and no-down-payment products, and that may be better able than FHA to identify and approve relatively low-risk borrowers. Additionally, because of the worsening performance of the mortgages it insures, FHA has estimated that the program would require a positive subsidyð that is, an appropriation of budget authorityð in fiscal year 2008 if no program changes were made.

To help FHA adapt to market changes, HUD has proposed a number of changes to the National Housing Act that, among other things, would give FHA 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. Whether under its existing authority or using any additional flexibility that Congress may grant, FHAôs ability to manage risks and program changes will affect the financial performance of the insurance program.

My testimony today discusses four reports that we have issued since 2005 on different aspects of FHAôs risk management, as well as ongoing work we are conducting on FHAôs proposed legislative changes and the tools and resources it would use to implement them, if passed. This body of work addresses a number of issues relevant to FHAôs financial performance. Specifically, I will discuss (1) weaknesses in how FHA has managed the risks of loans with down-payment assistance, (2) practices that could be instructive for FHA in managing the risks of new mortgage products, (3) FHAôs development and use of a mortgage scorecard, and (4) FHAôs estimation of subsidy costs for its single-family insurance program.

In conducting this work, we reviewed and analyzed information concerning the standards and controls FHA uses to manage the risks of loans with down-payment assistance; steps mortgage industry participants take to design and implement low- and no-down-payment mortgage products; FHA’s approach to developing its mortgage scorecard and the scorecard’s benefits and limitations; FHA’s estimates of program costs and the factors underlying the agency’s cost reestimates; and FHA’s plans and resources for implementing its proposed legislative changes. We interviewed officials from FHA, the U.S. Department of Agriculture, and U.S. Department of Veterans Affairs; and staff at selected private mortgage providers and insurers, Fannie Mae, Freddie Mac, the Office of Federal Housing Enterprise Oversight, selected state housing finance agencies, and nonprofit down-payment assistance providers. We conducted this work from January 2004 to March 2007 in accordance with generally accepted government auditing standards.

In summary, our work identified a number of weaknesses in FHA’s ability to estimate and manage risk that may affect the financial performance of the insurance program:

FHA has not developed sufficient standards and controls to manage risks associated with the substantial proportion of loans with down-payment assistance. Unlike other mortgage industry participants, FHA does not restrict homebuyers’ use of down-payment assistance from nonprofit organizations that receive part of their funding from home sellers. However, our analysis of a national sample of FHA-insured loans found that the probability of loans with this type of down-payment assistance resulting in an insurance claim was 76 percent higher than comparable loans without such assistance. Additionally, the financial risks of these loans recently have been realized in effects on the credit subsidy estimates. According to FHA, high claim and loss rates for loans with this type of down-payment assistance were major reasons why the estimated credit subsidy rate—the expected cost—for the single-family insurance program would be positive, or less favorable, in fiscal year 2008 (absent any program changes).

Some of the practices of other mortgage institutions offer a framework that could help FHA manage the risks associated with new products such as no-down-payment mortgages. For example, mortgage institutions may limit the volume of new products issued—that is, pilot a product—and sometimes require stricter underwriting on these products. While FHA has utilized pilots or demonstrations when making changes to its single-family mortgage insurance, it generally has done so in response to a legislative requirement and not on its own initiative. Moreover, FHA officials have questioned the circumstances under which pilot programs were needed and also said that they lacked sufficient resources to appropriately manage a pilot. However, FHA officials have indicated that they would institute stricter underwriting standards for any no-down-payment mortgage authorized by their legislative proposal.

While generally reasonable, the way that FHA developed its mortgage scorecardð an automated tool that evaluates the default risk of borrowersð limits the scorecardõs effectiveness. More specifically, FHA and its contractor used variables that reflected borrower and loan characteristics to create the scorecard and an accepted modeling process to test the variablesô accuracy in predicting default. But, the data used to develop the scorecard were 12 years old by the time that FHA began using the scorecard in 2004, and the market has changed significantly since then. In addition, the scorecard does not include all the important variables that could help explain expected loan performance such as the source of the down payment. With competition from conventional providers, limitations in the scorecard could cause FHA to insure mortgages that are relatively more risky. Our ongoing work indicates that FHA plans to use the scorecard to help set insurance premiums if legislative changes are enacted. Accordingly, any limitations in the scorecardõs ability to predict defaults could result in FHA mispricing its products.

Although FHA has improved its ability to estimate the subsidy costs for its single-family insurance program, it generally has underestimated these costs. To meet federal requirements, FHA annually reestimates subsidy costs for each loan cohort.[1] The current reestimated subsidy costs for all except the fiscal year 1992 and 1993 cohorts are less favorableð that is, higherð than originally estimated. Increases in the expected level of insurance claimsð potentially stemming from changes in underwriting guidelines, among other factorsð were a major cause of a particularly large reestimate that FHA submitted as of the end of fiscal year 2003.

On the basis of our findings from the reports I have summarized, we made several recommendations designed to improve FHAõs risk management. For example, to improve its assessment of borrowersô default risk, we recommended that FHA develop policies for updating the scorecard, incorporate the risks posed by down-payment assistance into the scorecard, and explore additional uses for this tool. To more reliably estimate program costs, we recommended that FHA study and report in the annual actuarial review of the Fund the impact of variables not in the agencyõs loan performance models (the results of which are

[1]Essentially, a cohort includes the loans insured in a given year.

used in estimating and reestimating program costs) that have been found in other studies to influence credit risk.[2]

FHA has taken actions in response to some of our findings and recommendations. For example, FHA has developed and begun putting in place policies for annually updating the scorecard and testing additional predictive variables. To more reliably assess program costs, an FHA contractor incorporated the source of down-payment assistance and borrower credit scores in recent actuarial reviews of the Fund.

While these actions represent improvements in FHA's risk management, sustained management attention to the issues that we have identified and continued Congressional oversight of FHA will play an important role in ensuring that FHA is able to expand homeownership opportunities for low- and middle-income families while operating in a manner that is financially sound.

Background

Congress established FHA in 1934 under the National Housing Act (P.L. 73-479) to broaden homeownership, protect lending institutions, and stimulate employment in the building industry. FHA's single-family programs insure private lenders against losses (up to almost 100 percent of the loan amount) from borrower defaults on mortgages that meet FHA criteria. In 2005, more than three-quarters of the loans that FHA insured went to first-time homebuyers, and about one-third of these loans went to minorities. From 2001 through 2005, FHA insured about 5 million mortgages with a total value of about $590 billion. However, FHA's loan volume fell sharply over that period, and in 2005 FHA-insured loans accounted for about 5 percent of single-family home purchase mortgages, compared with about 19 percent in 2001.[3] Additionally, default rates for FHA-insured mortgages have risen steeply over the past several years, a period during which home prices have generally appreciated rapidly.

FHA determines the expected cost of its insurance program, known as the credit subsidy cost, by estimating the program's future performance.[4] Similar to other

[2]Since 1990, the National Housing Act has required an annual and independent actuarial analysis of the economic net worth and soundness of the Fund. 12 U.S.C. Section 1711 (g).

[3]These figures represent mortgages for owner-occupied homes only.

[4]Pursuant to the Federal Credit Reform Act of 1990, HUD must annually estimate the credit subsidy cost for its mortgage insurance programs. Credit subsidy costs are the net present value of estimated payments HUD makes less the estimated amounts it receives, excluding administrative costs.

agencies, FHA is required to reestimate credit subsidy costs annually to reflect actual loan performance and expected changes in estimates of future loan performance. FHA has estimated negative credit subsidies for the Fund from 1992, when federal credit reform became effective, through 2007. However, FHA has estimated that, assuming no program changes, the loans it expects to insure in fiscal year 2008 would require a positive subsidy, meaning that the present value of estimated cash inflows would be less than the present value of estimated cash outflows. The economic value, or net worth, of the Fund that supports FHA's insurance depends on the relative size of cash outflows and inflows over time. Cash flows out of the Fund for payments associated with claims on defaulted loans and refunds of up-front premiums on prepaid mortgages. To cover these outflows, FHA receives cash inflows from borrowers' insurance premiums and net proceeds from recoveries on defaulted loans. An independent contractor's actuarial review of the Fund for fiscal year 2006 estimated that the Fund's capital ratio—the economic value divided by the insurance-in-force—is 6.82 percent, well above the mandated 2 percent minimum.[5] If the Fund were to be exhausted, the U.S. Treasury would have to cover lenders' claims directly.

Two major trends in the conventional mortgage market have significantly affected FHA.[6] First, in recent years, members of the conventional mortgage market (such as private mortgage insurers, Fannie Mae, and Freddie Mac) increasingly have been active in supporting low- and even no-down-payment mortgages, increasing consumer choices for borrowers who may have previously chosen an FHA-insured loan. Second, to help assess the default risk of borrowers, particularly those with high loan-to-value ratios (loan amount divided by sales price or appraised value), the mortgage industry has increasingly used mortgage scoring and automated underwriting systems.[7] Mortgage scoring is a technology-based tool that relies on the statistical analysis of millions of previously originated mortgage loans to determine how key attributes such as the borrower's credit history, property characteristics, and terms of the mortgage affect future loan performance. As a result of such tools, the mortgage industry is able to process loan applications more quickly and consistently than in the past. In 2004, FHA implemented a mortgage scoring tool, called the FHA Technology

[5]In fiscal year 2006, the Fund's estimated economic value was $22 billion and the unamortized insurance-in-force was $323 billion.

[6]Conventional mortgages do not carry government insurance or guarantees.

[7]Underwriting refers to a risk analysis that uses information collected during the origination process to decide whether to approve a loan.

Open to Approved Lenders (TOTAL) Scorecard, to be used in conjunction with existing automated underwriting systems.

Partly in response to changes in the mortgage market, HUD has proposed legislation intended to modernize FHA. Provisions in the proposal would authorize FHA to change the way it sets insurance premiums and reduce down-payment requirements. 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 borrowersô risk of default. Currently, FHA also requires homebuyers to make a 3 percent contribution toward the purchase of the property. HUDôs proposal would eliminate this contribution requirement and enable FHA to offer some borrowers a no-down-payment product.

FHA Has Not Implemented Sufficient Standards and Controls to Manage Financial Risks of Loans with Down-Payment Assistance

In our November 2005 report examining FHAôs actions to manage the new risks associated with the growing proportion of loans with down-payment assistance, we found that the agency did not implement sufficient standards and controls to manage the risks posed by these loans.[8] Unlike other mortgage industry participants, FHA does not restrict homebuyersô use of down-payment assistance from nonprofit organizations that receive part of their funding from home sellers. According to FHA, high claim and loss rates for loans with this type of down-payment assistance were major reasons for changing the estimated credit subsidy rate from negative to positive for fiscal year 2008 (in the absence of any program changes). Furthermore, incorporating the impact of such loans into the actuarial study of the Fund for fiscal year 2005 resulted in almost a $2 billion (7 percent) decrease in the Fundôs estimated economic value.

Loans with Down-Payment Assistance Are a Substantial Portion of FHAôs Portfolio and Pose Greater Financial Risks Than Similar Loans without Assistance

Homebuyers who receive FHA-insured mortgages often have limited funds and, to meet the 3 percent borrower investment FHA currently requires, may obtain down-payment assistance from a third party, such as a relative or a charitable organization (nonprofit) that is funded by the property sellers. The proportion of FHA-insured loans that are financed in part by down-payment assistance from various sources has increased substantially in the last few years, while the overall number of loans that FHA insures has fallen dramatically. Money from nonprofits funded by seller contributions has accounted for a growing percentage of that assistance. From 2000 to 2004, the total proportion of FHA-insured purchase loans that had a loan-to-value ratio greater than 95 percent and that also

[8] GAO, *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).

involved down-payment assistance, from any source, grew from 35 percent to nearly 50 percent. Approximately 6 percent of FHA-insured purchase loans in 2000 received down-payment assistance from nonprofits (the large majority of which were funded by property sellers), but by 2004 nonprofit assistance grew to about 30 percent. The corresponding percentages for 2005 and 2006 were about the same.

We and others have found that loans with down-payment assistance do not perform as well as loans without down-payment assistance. We analyzed loan performance by source of down-payment assistance, using two samples of FHA-insured purchase loans from 2000, 2001, and 2002ð a national sample and a sample from three metropolitan statistical areas (MSA) with high rates of down-payment assistance.[9] Holding other variables constant, our analysis indicated that FHA-insured loans with down-payment assistance had higher delinquency and claim rates than similar loans without such assistance. For example, we found that the probability that loans with nonseller-funded sources of down-payment assistance (e.g., gifts from relatives) would result in insurance claims was 49 percent higher in the national sample and 45 percent higher in the MSA sample than it was for comparable loans without assistance. Similarly, the probability that loans with nonprofit seller-funded down-payment assistance would result in insurance claims was 76 percent higher in the national sample and 166 percent higher in the MSA sample than it was for comparable loans without assistance. This difference in performance may be explained, in part, by the higher sales prices of comparable homes bought with seller-funded down-payment assistance. Our analysis indicated that FHA-insured homes bought with seller-funded nonprofit assistance were appraised and sold for about 2 to 3 percent more than comparable homes bought without such assistance. The difference in performance also may be partially explained by the homebuyer having less equity in the transaction.

Stricter Standards and Additional Controls Could Help FHA Manage the Risks Posed by Loans with Down-Payment Assistance

FHA has implemented some standards and internal controls to manage the risks associated with loans with down-payment assistance, but stricter standards and additional controls could help FHA better manage the financial risks posed by these loans while meeting its mission of expanding homeownership opportunities. Like other mortgage industry participants, FHA generally applies the same underwriting standards to loans with down-payment assistance that it

[9]The data (current as of June 30, 2005) consisted of purchase loans insured by FHAœ 203(b) program, its main single-family program, and its 234(c), condominium program. The three MSAs were Atlanta, Indianapolis, and Salt Lake City.

applies to loans without such assistance. One important exception is that FHA, unlike others, does not limit the use of down-payment assistance from seller-funded nonprofits. Some mortgage industry participants view assistance from seller-funded nonprofits as a seller inducement to the sale and, therefore, either restrict or prohibit its use. FHA has not treated such assistance as a seller inducement and, therefore, does not subject this assistance to the limits it otherwise places on contributions from sellers.

Concerns about loans with nonprofit seller-funded down-payment assistance have prompted FHA and IRS to initiate steps that could curb their use. For example, FHA has begun drafting a proposed rule that, as described by FHA, would appear to prohibit down-payment assistance from seller-funded nonprofits. FHA's legislative proposal could also eliminate the need for such assistance by allowing some FHA borrowers to make no down payments for an FHA-insured loan. Finally, in May 2006, IRS issued a ruling stating that organizations that provide seller-funded down-payment assistance to home buyers do not qualify as tax-exempt charities. FHA permitted these organizations to provide down-payment assistance because they qualified as charities. Accordingly, the ruling could significantly reduce the number of FHA-insured loans with seller-funded down payments. However, FHA officials told us that as of March 2007, they were not aware of IRS rescinding the charitable status of any of these organizations.

Our report made several recommendations designed to better manage the risks of loans with down-payment assistance generally, and more specifically from seller-funded nonprofits. Overall, we recommended that in considering the costs and benefits of its policy permitting down-payment assistance, FHA also consider risk-mitigation techniques such as including down-payment assistance as a factor when underwriting loans or more closely monitoring loans with such assistance. For down-payment assistance providers that receive funding from property sellers, we recommended that FHA take additional steps to mitigate the risks of these loans, such as treating such assistance as a seller contribution and, therefore, subject to existing limits on seller contributions. In response, FHA agreed to improve its oversight of down-payment assistance lending by (1) modifying its information systems to document assistance from seller-funded nonprofits and (2) more routinely monitoring the performance of loans with down-payment assistance. Also, as previously noted, HUD has initiated steps to curb and provide alternatives to seller-funded down-payment assistance.

Practices That Other Mortgage Institutions Use Could Help FHA Manage Risks from Low- or No-Down-Payment Products

If Congress authorized FHA to insure mortgages with smaller or no down payments, practices that other mortgage institutions use could help FHA to design and manage the financial risks of these new products. In a February 2005 report, we identified steps that mortgage institutions take when introducing new products.[10] Specifically, mortgage institutions often utilize special requirements when introducing new products, such as requiring additional credit enhancements (mechanisms for transferring risk from one party to another) or implementing stricter underwriting requirements, and limiting how widely they make available a new product. By adopting such practices, FHA could reduce the potential for higher claims on products whose risks may not be well understood.

Mortgage Institutions Require Additional Credit Enhancements, Stricter Underwriting, and Higher Premiums for Low- and No-Down-Payment Products

Some mortgage institutions require additional credit enhancements on low- and no-down payment products, which generally are riskier because they have higher loan-to-value ratios than loans with larger down payments. For example, Fannie Mae and Freddie Mac mitigate the risk of low- and no-down payment products by requiring additional credit enhancements such as higher mortgage insurance coverage. Although FHA is required to provide up to 100 percent coverage of the loans it insures, FHA may engage in co-insurance of its single-family loans. Under co-insurance, FHA could require lenders to share in the risks of insuring mortgages by assuming some percentage of the losses on the loans that they originated (lenders would generally use private mortgage insurance for risk sharing).

Mortgage institutions also can mitigate the risk of low- and no-down-payment products through stricter underwriting. Institutions can do this in a number of ways, including requiring a higher credit score threshold for certain products, requiring greater borrower reserves, or requiring more documentation of income or assets from the borrower. Although the changes FHA could make are limited by statutory standards, it could benefit from similar approaches. The HUD Secretary has latitude within statutory limitations to change underwriting requirements for new and existing products and has done so many times. For example, FHA expanded its definition of what could be included as borrower's effective income when calculating payment-to-income ratios. In commenting on our February 2005 report, FHA officials told us that they were unlikely to mandate a credit score threshold or borrower reserve requirements for a no-down-payment product because the product was intended to serve borrowers who were underserved by the conventional market, including those who lacked credit

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

scores and had little wealth or personal savings. However, in the course of our ongoing work on FHA's legislative proposal, FHA officials indicated that they would likely set a credit score threshold for any no-down-payment product.

Finally, mortgage institutions can increase fees or charge higher premiums to help offset the potential costs of products that are believed to have greater risk. For example, Fannie Mae officials stated that they would charge higher guarantee fees on low- and no-down payment loans if they were not able to require higher insurance coverage.[11] Our ongoing work indicates that FHA, if authorized to implement risk-based pricing, would charge higher premiums for loans with higher loan-to-value ratios, all other things being equal.

We recommended that if FHA implemented a no-down-payment mortgage product or other new products about which the risks were not well understood, the agency should (1) consider incorporating stricter underwriting criteria such as appropriate credit score thresholds or borrower reserve requirements and (2) utilize other techniques for mitigating risks, including the use of credit enhancements. In response, FHA said it agreed that these techniques should be evaluated when considering or proposing a new FHA product.

Before Fully Implementing New Products, Some Mortgage Institutions May Limit Availability

Some mortgage institutions initially may offer new products on a limited basis. For example, Fannie Mae and Freddie Mac sometimes use pilots, or limited offerings of new products, to build experience with a new product type. Fannie Mae and Freddie Mac also sometimes set volume limits for the percentage of their business that could be low- and no-down-payment lending. FHA has utilized pilots or demonstrations when making changes to its single-family mortgage insurance but generally has done so in response to legislative requirement rather than on its own initiative. For example, FHA's Home Equity Conversion Mortgage insurance program started as a pilot that authorized FHA to insure 2,500 reverse mortgages.[12] Additionally, some mortgage institutions may limit the origination and servicing of new products to their better lenders and servicers. Fannie Mae and Freddie Mac both reported that these were important steps in introducing a new product.

We recommended that when FHA releases new products or makes significant changes to existing products, it consider similar steps to limit the initial

[11]Fannie Mae and Freddie Mac charge fees for guaranteeing timely payment on mortgage-backed securities they issue. The fees are based, in part, on the credit risk they face.

[12]Under this program, homeowners borrow against equity in their home and receive payments from their lenders.

availability of these products. FHA officials agreed that they could, under certain circumstances, envision piloting or limiting the ways in which a new product would be available, but pointed to the practical limitations of doing so. For example, FHA officials told us that administering the Home Equity Conversion Mortgage pilot program was difficult because of the challenges of equitably selecting a limited number of lenders and borrowers. FHA generally offers products on a national basis and, if they did not, specific regions of the county or lenders might question why they were not able to receive the same benefit. FHA officials told us they have conducted pilot programs when Congress has authorized them, but they questioned the circumstances under which pilot programs were needed, and also said that they lacked sufficient resources to appropriately manage a pilot. Consistent with these views, FHA officials told us more recently that they would not limit the initial availability of any products authorized by its legislative proposal. However, if FHA does not limit the availability of new or changed products, the agency runs the risk of facing higher claims from products whose risks may not be well understood.

The Way FHA Developed TOTAL Limits the Scorecard's Effectiveness in Assessing the Default Risk of Borrowers

A primary tool that FHA uses to assess the default risk of borrowers who apply for FHA-insured mortgages is its TOTAL scorecard. TOTAL's capabilities are important, because to the extent that conventional mortgage lenders and insurers are better able than FHA to use mortgage scoring to identify and approve relatively low-risk borrowers and charge fees based on default risk, FHA may face adverse selection. That is, conventional providers may approve lower-risk borrowers in FHA's traditional market segment, leaving relatively high-risk borrowers for FHA. Accordingly, the greater the effectiveness of TOTAL, the greater the likelihood that FHA will be able to effectively manage the risks posed by borrowers and operate in a financially sound manner.

In reports we issued in November 2005 and April 2006, we noted that while FHA's process for developing TOTAL generally was reasonable, some of the choices FHA made in the development process could limit the scorecard's effectiveness.[13] FHA and its contractor used variables that reflected borrower and loan characteristics to create TOTAL, as well as an accepted modeling process to test the variables' accuracy in predicting default. However, we also found that

The data used to develop TOTAL were 12 years old by the time FHA implemented the scorecard. Specifically, when FHA began developing TOTAL

[13]GAO, *Mortgage Financing: HUD Could Realize Additional Benefits from its Mortgage Scorecard,* GAO-06-435 (Washington, D.C.: Apr. 13, 2006) and GAO-06-24.

in 1998, the agency chose to use 1992 loan data, which would be old enough to provide a sufficient number of defaults that could be attributed to a borrowerôs poor creditworthiness. However, FHA did not implement TOTAL until 2004 and has not subsequently updated the data used in the scorecard. Best practices of private-sector organizations call for scorecards to be based on data that are representative of the current mortgage marketð specifically, relevant data that are no more than several years old. In the past 12 years, significant changesð growth in the use of down-payment assistance, for exampleð have occurred in the mortgage market that have affected the characteristics of those applying for FHA-insured loans. As a result, the relationships between borrower and loan characteristics and the likelihood of default also may have changed.

TOTAL does not include certain key variables that could help explain expected loan performance. For example, TOTAL does not include a variable for the source of the down payment. However, FHA contractors, HUDôs Inspector General, and our work have all identified the source of a down payment as an important indicator of risk, and the use of down-payment assistance in the FHA program has grown rapidly over the last 5 years. Further, TOTAL does not include other important variablesð such as a variable for generally riskier adjustable rate loansð included in other scorecards used by private-sector entities.

Although FHA had a contract to update TOTAL, the agency did not develop a formal plan for updating TOTAL on a regular basis. Best practices in the private sector, also reflected in bank regulator guidance, call for having formal policies to ensure that scorecards are routinely updated. Without policies and procedures for routinely updating TOTAL, the scorecard may become less reliable and, therefore, less effective at predicting the likelihood of default.

To improve TOTALôs effectiveness, we recommended, among other things, that HUD develop policies and procedures for regularly updating TOTAL and more fully consider the risks posed by down-payment assistance when underwriting loans, such as including the presence and source of down-payment assistance as a loan variable in the scorecard. In response, FHA has developed and begun putting in place policies and procedures that call for annual (1) monitoring of the scorecardôs ability to predict loan default, (2) testing of additional predictive variables to include in the scorecard, and (3) updating the scorecard with recent loan performance data.

We also recommended that HUD explore additional uses for TOTAL, including using it to implement risk-based pricing of mortgage insurance and to develop new products. These actions could enhance FHAôs ability to effectively compete in the mortgage market and avoid adverse selection. Our ongoing work indicates that FHA plans to use borrowers' TOTAL scores to help set insurance premiums. Accordingly, any limitations in TOTAL's ability to predict defaults could result in FHA mispricing its products.

FHA's Current Reestimated Subsidy Costs Are Generally Less Favorable than its Original Estimates

As previously noted, FHA, like other federal agencies, is required to reestimate credit subsidy costs annually to reflect actual loan performance and expected changes in estimates of future loan performance. In doing so, FHA reestimates subsidy costs for each loan cohort.

As we reported in September 2005, FHA's subsidy reestimates generally have been less favorable (i.e., higher) than the original estimates since federal credit reform became effective in 1992.[14] 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 less favorable than originally estimated.

With respect to reestimates across cohorts, our report examined factors contributing to an unusually large $7 billion reestimate (more than twice the size of other recent reestimates) that FHA submitted as of the end of fiscal year 2003 for the fiscal year 1992 through 2003 cohorts. These factors included increases in estimated claims and prepayments (the payment of a loan before its maturity date). Several policy changes and trends may have contributed to changes in the expected claims. For example:

Revised underwriting guidelines made it easier for borrowers who were more susceptible to changes in economic conditions—and therefore more likely to default on their mortgages—to obtain an FHA-insured loan.

Competition from conventional mortgage providers could have resulted in FHA insuring more risky borrowers.

FHA insured an increasing number of loans with down-payment assistance, which generally have a greater risk of default.

FHA's loan performance models did not include key variables that help estimate loan performance, such as credit scores, and as of September 2005, the source of down payment.

[14]GAO, *Mortgage Financing: FHA's $7 Billion Reestimate Reflects Higher Claims and Changing Loan Performance Estimates,* GAO-05-875 (Washington, D.C.: Sep. 2, 2005).

The major factors underlying the surge in prepayment activity were declining interest rates and rapid appreciation of housing prices. These trends created incentives and opportunities for borrowers to refinance using conventional loans.

To more reliably estimate program costs, we recommended that FHA study and report on how variables found to influence credit risk, such as payment-to-income ratios, credit scores, and down-payment assistance would affect the forecasting ability of its loan performance models. We also recommended that when changing the definitions of key variables, FHA report the impact of such changes on the modelsô forecasting ability. In response, HUD indicated that its contractor was considering the specific variables that we had recommended FHA include in its annual actuarial review of the Fund. The 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.

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

Contacts and Acknowledgments

For further information on this testimony, please contact William B. Shear at (202) 512-8678 or shearw@gao.gov. Individuals making key contributions to this testimony included Barbara Roesmann, Paige Smith, Laurie Latuda, and Steve Westley.