United States Government Accountability Office

GAO

Testimony

Before the Subcommittee on Housing and Community Opportunity, Committee on Financial Services, House of Representatives

For Release on Delivery
Expected at 10:00 a.m. EDT
Thursday, June 30, 2005

FEDERAL HOUSING ADMINISTRATION

Managing Risks from a New Zero Down Payment Product

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



June 30, 2005

FEDERAL HOUSING ADMINISTRATION

Managing Risks from a New Zero Down Payment Product

GAO Accountability · Integrity · Reliability

Highlights

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.

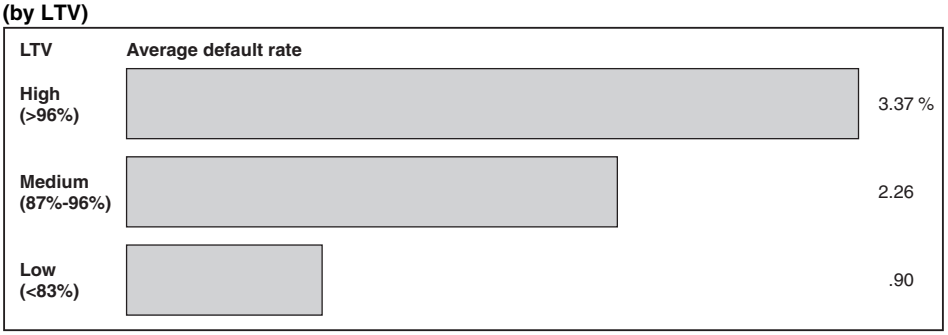
To view the full product, including the scope and methodology, click on the link above. For more information, contact William Shear at (202) 512-8678 or shearw@gao.gov.

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.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to provide the committee with information and perspectives as it considers legislation that would authorize the Secretary of Housing and Urban Development (HUD) to carry out a pilot program to insure zero down payment mortgages. The Federal Housing Administration (FHA) at HUD currently insures low down payment mortgages to homebuyers across the nation. FHA requires homebuyers to make a 3 percent contribution toward the purchase of the home, though some of this may come in the form of a gift from others. FHA also permits some closing costs to be financed. My testimony today is primarily based on a report we completed for this Subcommittee on managing risks associated with low and no down payment loans, which was issued in February, 2005.[1] I will focus my discussion on the practices mortgage institutions use in designing and implementing low and no down payment products and how these practices could be instructive for the FHA in managing risks associated with a zero down payment product. A substantial body of research indicates that loans with lower down payments are generally riskier than those with higher down payments.

To obtain information for our report, we interviewed officials from FHA; staff at selected conventional mortgage providers;[2] private mortgage insurers; and two government-sponsored enterprises (GSE), Fannie Mae and Freddie Mac. We obtained information about the standards of low and no down payment mortgage products they support and the steps they take to design, implement, and monitor these products. However, we did not verify that these institutions, in fact, used these practices. We conducted this work from January through December 2004 in accordance with generally accepted government auditing standards.

In summary, there are several risk-management practices mortgage institutions use in designing, implementing, and monitoring low and no down payment products, and we believe these practices could be instructive for FHA in managing risks associated with a zero down payment product.

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

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

- Mortgage institutions can mitigate the risk of low and no down payment products by requiring additional credit enhancements such as higher mortgage insurance coverage. For example, Fannie Mae and Freddie Mac require higher mortgage insurance for loans with a loan-to-value ratio (LTV) of great than 95 percent.[3] While FHA already will pay up to 100 percent of the losses from a foreclosure on a house, it does have the authority to share risk but does not currently use this authority.

- Mortgage institutions sometimes implement stricter underwriting to manage the additional risks associated with a new mortgage product. For example, institutions can require a higher credit score or higher reserves from the borrower. FHA has made adjustments to its underwriting criteria on its existing products but FHA officials told us that FHA is unlikely to mandate a credit score threshold for a zero down payment product.

- Mortgage institutions increase fees and charge higher premiums to compensate for the additional risks associated with a new mortgage product. 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 the higher insurance coverage. FHA is authorized to make, and has made, adjustments to its up-front and annual premiums on its existing products. The administration proposed higher premiums as part of its 2006 budget proposal for a zero-down payment product.

- Mortgage institutions sometimes use pilots or limit the initial availability of new products to build experience or better understand the factors that contribute to risk for these products. For example, Freddie Mac limited the initial availability of its 100 LTV product. Some mortgage institutions also may limit the origination and servicing of the product to their better lenders and servicers. However, FHA officials told us they face challenges in piloting and limiting mortgage products to certain approved lenders or servicers.

- According to officials of mortgage institutions, including FHA, they also often put in place more substantial monitoring and oversight mechanisms for their new products and then make changes based on what they learn. Some mortgage institutions, such as Fannie Mae, told us that they may conduct rigorous quality control sampling of new acquisitions, early payment defaults, and nonperforming loans. Depending on the scale of a new initiative, and its perceived risk, these quality control reviews could

[3]LTV is a ratio of the loan amount divided by the property sales price or appraised value of the house.

include a review of up to 100 percent of the loans that are part of the new product. FHA officials told us they also more closely monitor loans underwritten under revised guidelines.

In light of the risks that new lending products present and in recognition of established risk management practices, in our report, we suggested that Congress consider limiting the initial availability of any new single-family insurance product it may authorize, including a zero down payment product. We also suggested that Congress consider directing HUD to consider using various techniques for mitigating risks for a no down payment product, or products about which the risks are not well understood. We recommended that FHA consider using pilots for new products and for making significant changes to its existing products, regardless of any new products Congress may authorize. Additionally, we recommended that FHA explore various techniques for mitigating risks when implementing new products that have greater risk or for which risk is not well understood, such as a zero down payment product.

However, during the course of our work, HUD officials told us that they face challenges in administering a pilot program and they question the circumstances in which they can limit the availability of a new product. We believe that HUD needs to further consider piloting or limiting volume of new or changed products, including a zero down payment product. There are several available techniques for limiting an initial product that could help to address HUD's concerns, including limiting the time period in which it is available. Further we believe that in some circumstances the potential costs of making widely available a product when the risks of that product are not well understood could exceed the cost of initially implementing such a product on a limited basis. To the extent HUD believes it does not have the authority for exercising the options we describe, we recommend it seek the authority from Congress.

Background

Mortgage insurance, a commonly used credit enhancement, protects lenders against losses in the event of default, and FHA is a government mortgage insurer in a market that also includes private insurers. During fiscal years 2001 to 2003, FHA insured a total of about 3.7 million mortgages with a total value of about $425 billion. FHA plays a

particularly large role in certain market segments, including low-income and first-time homebuyers. In 2000, almost 90 percent of FHA-insured home purchase mortgages had an LTV higher than 95 percent. FHA insures most of its mortgages for single-family housing under its Mutual Mortgage Insurance (MMI) Fund. To cover lender's losses, FHA collects premiums from borrowers. These premiums, along with proceeds from the sale of foreclosed properties, pay for claims that FHA pays lenders as a result of foreclosures.

In recent years, other members of the conventional mortgage market (such as private mortgage insurers, government-sponsored enterprises such as Fannie Mae and Freddie Mac, and large private lenders) have been increasingly active in supporting low and even no down payment mortgage products. For example, Fannie Mae and Freddie Mac's no down payment mortgage products were introduced in 2000; and many private mortgage insurers will now insure a mortgage up to 100 percent LTV. However, the characteristics and standards for low and no down payment products vary among mortgage institutions. Currently, homebuyers with FHA-insured loans need to make a 3 percent contribution toward the purchase of the property and may finance some of the closing costs associated with the loan. As a result, an FHA-insured loan could equal nearly 100 percent of the property's value or sales price. In recent years, a growing proportion of borrowers have received down payment assistance, which further helps them meet the hurdle of accumulating sufficient funds to purchase a home. Based on our preliminary analysis of FHA-insured loans that had LTVs above 95 percent, use of down payment assistance has grown to over half of such loans insured during the first seven months of 2005.

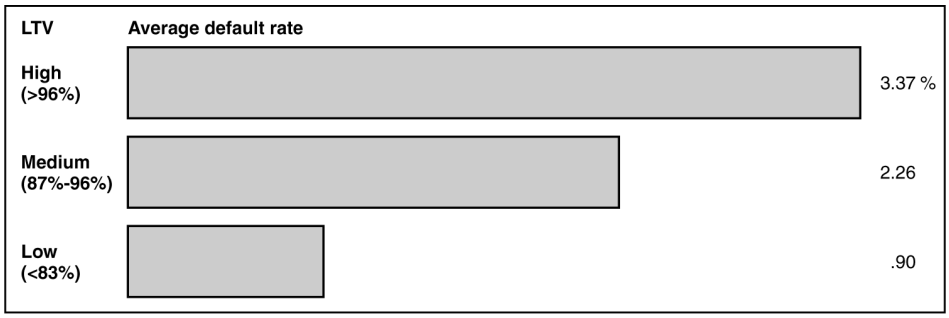
When considering the risk of mortgages, a substantial amount of research GAO reviewed indicates that the LTV ratio and the borrower's credit score are among the most important factors when estimating the risk level associated with individual mortgages.[4] We also analyzed the performance, expressed by the percent of borrowers defaulting within four years of mortgage origination, of low and no down payment mortgages supported by FHA and others.[5] Our analysis supports the findings we found in the research literature. Generally, mortgages with higher LTV ratios (smaller

[4]Credit scores are a single numerical score, based on an individual's credit history, which measures that individual's creditworthiness.

[5]Mortgage defaults and foreclosures typically occur at the highest rates 4 to 7 years after the mortgages are issued.

down payments) and lower credit scores are riskier than mortgages with lower LTV ratios and higher credit scores. As can be seen in Figure 1, when focusing only on LTV for FHA loans, default rates increase as the LTV ranges increase. In theory, LTV ratios are important because of the direct relationship that exists between the amount of equity borrowers have in their homes and the risk of default. The higher the LTV ratio, the less cash borrowers will have invested in their homes and the more likely it is that they may default on mortgage obligations, especially during times of economic hardship (e.g., unemployment, divorce, home price depreciation).

Figure 1: 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.

Risk assessment is a very important component of issuing and insuring mortgages, particularly when introducing a mortgage product that has the risk associated with a higher LTV. To help assess the risks associated with mortgages, the mortgage industry has moved toward greater use of mortgage scoring and automated underwriting systems.[6] 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

[6]The mortgage industry also uses credit scoring models for estimating the credit risk of individuals— these methodologies are based on information such as payment patterns. Statistical analyses identifying the characteristics of borrowers who were most likely to make loan payments have been used to create a weight or score associated with each of the characteristics. According to Fair, Isaac and Company sources, credit scores are often called "FICO scores" because most credit scores are produced from software developed by Fair, Isaac and Company. FICO scores generally range from 300 to 850 with higher scores indicating better credit history. The lower the credit score, the more compensating factors lenders might require to approve a loan. These factors can include a higher down payment and greater borrower reserves.

such as the borrower's credit history, the property characteristics, and the terms of the mortgage note affect future loan performance.

During the 1990s, private mortgage insurers, the GSEs, and larger financial institutions developed automated underwriting systems. Automated underwriting systems refer to the process of collecting and processing the data used in the underwriting process. These systems rely, in part, on individuals' credit scores or credit history, and they have played an integral role in the provision of low and no down payment mortgage products. These systems allow lenders to quickly assess the riskiness of mortgages by simultaneously considering multiple factors including the credit score and credit history of borrowers. FHA has developed and recently implemented a mortgage scoring tool, called the FHA TOTAL Scorecard, to be used in conjunction with existing automated underwriting systems. More than 60 percent of all mortgages—conventional and government-insured—were underwritten by an automated underwriting system, as of 2002, and this percentage continues to rise.[7]

Several Practices Mortgage Institutions Use in Designing and Implementing Low and No Down Payment Products Could Be Instructive for FHA in Managing Risk of a No Down Payment Product

According to representatives of mortgage institutions we interviewed, they use a number of similar practices in designing and implementing new products. These practices can be especially important when designing and implementing new products with higher or less well understood risk, such as low and no down payment products. Some of these practices could be helpful to FHA in its design and implementation of a zero down payment product, as well as other new products. More specifically, mortgage institutions often establish additional requirements for new products such as additional credit enhancements or underwriting requirements. Although FHA has less flexibility in imposing additional credit enhancements it does have the authority to seek co-insurance, which it is not currently using. FHA makes adjustments to underwriting criteria and to its premiums, but told us that it is unlikely to use a credit score threshold for a new zero down payment product. Further, mortgage institutions also use different means to limit how widely they make available a new product, particularly during its early years. FHA does sometimes use practices for limiting a

[7]Susan Wharton Gates, Vanessa Gail Perry, and Peter Zorn, "Automated Underwriting in Mortgage Lending: Good News for the Underserved," *Housing Policy Debate*, 13, no. 2, 2002.

new product but usually does not pilot products on its own initiative. FHA officials with whom we spoke question the circumstances in which they can limit the availability of a program and told us they do not have the resources to manage programs with limited availability. Finally, according to officials of mortgage institutions, including FHA, they also often put in place more substantial monitoring and oversight mechanisms for their new products including lender oversight. In an earlier report, we made recommendations designed to improve HUD's oversight of FHA lenders.[8]

Mortgage Institutions Require Additional Credit Enhancements

Some mortgage institutions require additional credit enhancements—mechanisms for transferring risk from one party to another such as mortgage insurance—on low and no down payment products. Mortgage institutions such as 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. Fannie Mae and Freddie Mac believe that the higher-LTV loans represent a greater risk to them and they seek to partially mitigate this risk by requiring higher mortgage insurance coverage on these loans. For example, Fannie Mae and Freddie Mac require insurance coverage of 35 percent of the claim amount (on individual loans that foreclose) for loans that have an LTV of greater than 95 percent and require lower insurance coverage for loans with LTVs below 95 percent.

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). FHA has used co-insurance before, primarily in its multifamily programs, but does not currently use co-insurance at all.[9] FHA officials told us they tried to put together a co-insurance agreement with Fannie Mae and Freddie Mac and, while they were able to come to

[8]GAO, *Single-Family Housing: Progress Made, but Opportunities Exist to Improve HUD's Oversight of FHA Lenders*, GAO-05-13 (Washington, D.C.: Nov. 12, 2004).

[9]According to FHA officials, FHA discontinued the multifamily co-insurance program after experiencing significant losses. Since then, Congress provided FHA authority to enter into risk-sharing agreements with GSEs and housing finance agencies on certain multifamily insurance.

agreement on the sharing of premiums, they could not reach agreement on the sharing of losses and it was never implemented.

Mortgage Institutions May Require Stricter Underwriting for New Low and No Down Payment Products

Mortgage institutions also can mitigate risk through stricter underwriting. For example, mortgage institutions such as Fannie Mae and Freddie Mac sometimes introduce stricter underwriting standards as part of the development of new low and no down payment products (or products about which they do not fully understand the risks). Institutions can do this in a number of ways, including requiring a higher credit score threshold for certain products, or requiring greater borrower reserves or more documentation of income or assets from the borrower. Once the mortgage institution has learned enough about the risks that were previously not understood, it can change the underwriting requirements for these new products. FHA could also benefit from mitigating risk such as through stricter underwriting. Although FHA has to meet some statutory standards, it retains some flexibility in how it implements a newly authorized product or changes an existing product. The HUD Secretary has latitude within statutory limitations in changing underwriting requirements for new and existing products and has done this many times.

The requirements in H.R. 3043 that prospective zero down payment loans go through FHA's TOTAL Scorecard and that borrowers receive prepurchase counseling are consistent with stricter underwriting. However, in addressing the final recommendations in our February report, FHA wrote that is unlikely to mandate a credit score threshold for a new zero down payment product because the new product is intended to serve borrowers who are underserved by the conventional market including those who lack credit scores. Also, FHA wrote that it is unlikely to mandate borrower reserve requirements since the purpose of a zero down payment product is to serve borrowers with little wealth or personal savings.

Mortgage Institutions May Increase Fees or Charge Higher Premiums

Mortgage institutions can increase fees or charge higher premiums to help offset the potential costs of a program that is 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.[10] FHA could set higher premiums in anticipation of higher claims from no down payment loans. Within statutory limits, the HUD Secretary has the authority to set up-front and annual premiums that are charged to borrowers who have FHA-insured loans. In fact, in the administration's 2006 budget proposal for a zero down payment product, it included higher up front and annual premiums for these loans.

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

Some mortgage institutions may limit in some way a new product before fully implementing the new product. For example, Fannie Mae and Freddie Mac sometimes use pilots, or limited offerings of new products, to build experience with a new product type or to learn about particular variables that can help them better understand the factors that contribute to risk for these products. Freddie Mac and Fannie Mae also sometimes set volume limits for the percentage of their business that could be low and no down payment lending. Fannie Mae and Freddie Mac officials provided numerous examples of products that they now offer as standard products but which began as part of underwriting experiments. These include the Fannie Mae Flexible 97® product, as well as the Freddie Mac 100 product.

FHA has utilized pilots or demonstrations as well when making changes to its single-family mortgage insurance. Generally, HUD has done this in response to legislation that requires a pilot and not on its own initiative. For example, FHA's Home Equity Conversion Mortgage (HECM) insurance program started as a pilot. Congress initiated HECM in 1987; the program is designed to provide elderly homeowners a financial vehicle to tap the equity in their homes without selling or moving from their homes (sometimes called a "reverse mortgage"). Through statute, HECM started as a demonstration program that authorized FHA to insure 2,500 reverse mortgages. Through subsequent legislation, FHA was authorized to insure an increasing number of these mortgages until Congress made the program permanent in 1998. Under the National Housing Act, the HECM program was required to undergo a series of evaluations and it has been evaluated four times since its inception. FHA officials told us that administering this demonstration for 2,500 loans was difficult because of

[10]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.

the challenges of selecting a limited number of lenders and borrowers. FHA ultimately had to use a lottery to limit loans to lenders.

H.R. 3043 also would mandate that FHA pilot the zero down payment program: it limits the annual number of zero down mortgages to 10 percent of the aggregate number of loans insured during the previous fiscal year, and sets an aggregate limit of 50,000 loans. The appropriate size for a pilot program depends on several factors. For example, the precise number of loans needed to detect a difference in performance between standard loans and loans of a new product type depends in part on how great the differences are in loan performance. If delinquencies early in the life of a mortgage were about 10 percent for FHA's standard high LTV loans, and FHA wished to determine whether loans in the pilot had delinquency rates no more than 20 percent greater that the standard loans (delinquency no more than 12 percent), a sample size of about 1,000 loans would be sufficient to detect this difference with 95 percent confidence. If delinquency rates or FHA's desired degree of precision were different, a different sample size would be appropriate.

FHA officials told us they have conducted pilot programs when Congress has authorized them, but they questioned the circumstances under which pilot programs are needed. FHA officials also said that they lacked sufficient resources to appropriately manage a pilot.

Additionally, some mortgage institutions may also limit the initial implementation of a new product by limiting the origination and servicing of the product to their better lenders and servicers. Mortgage institutions may also limit servicing on the loans to servicers with particular product expertise, regardless of who originates the loans. Fannie Mae and Freddie Mac both reported that these were important steps in introducing a new product and noted that lenders tend to take a more conservative approach when first implementing a new product. FHA officials agreed that they could, under certain circumstances, envision piloting or limiting the ways in which a new or changed product would be available but pointed to the practical limitations in doing so. FHA approves the sellers and services that are authorized to support FHA's single-family product, but FHA officials told us they face challenges in offering any of their programs only in certain regions of the country or in limiting programs to certain approved lenders or servicers. FHA generally offers products on a national basis and, when they do not, specific regions of the county or lenders might question why they are not able to receive the same benefit (even on a demonstration or pilot basis). However, these officials did provide examples in which their products had been initially limited to particular

regions of the country or to particular lenders, including the rollout of the HECMs and their TOTAL Scorecard.

Mortgage Institutions Establish Enhanced Monitoring and Oversight for New Low and No Down Payment Products and Make Changes Based on What They Learn

Mortgage institutions, including FHA, may take several steps related to increased monitoring of new products and subsequently make changes based on what they learned. Fannie Mae and Freddie Mac officials described processes in which they monitor actual versus expected loan performance for new products, sometimes including enhanced monitoring of early loan performance. Some mortgage institutions, such as Fannie Mae, told us that they may conduct rigorous quality control sampling of new acquisitions, early payment defaults, and nonperforming loans. Depending on the scale of a new initiative, and its perceived risk, these quality control reviews could include a review of up to 100 percent of the loans that are part of the new product. FHA officials told us they also monitor more closely loans underwritten under revised guidelines. Specifically, FHA officials told us that FHA routinely conducts a review of underwriting for approximately 6 to 7 percent of loans it insures. According to FHA officials, as part of the review, it may place greater emphasis on reviewing those aspects of the insurance product that are the subject of a recent change.

Fannie Mae and Freddie Mac also reported that they conduct more regular reviews at mortgage servicer sites for new products. In some cases, Fannie Mae and Freddie Mac have staff who conduct on-site audits at the sellers and servicers to provide an extra layer of oversight. According to FHA officials, they have staff that conduct reviews of lenders that they have identified as representing higher risk to FHA programs. However, we recently reported that HUD's oversight of lenders could be improved and identified a number of recommendations for improving this oversight.[11]

Conclusions

Loans with low or no down payments carry greater risk. Without any compensating measures such as offsetting credit enhancements and increased risk monitoring and oversight of lenders, introducing a new FHA no down payment product would expose FHA to greater credit risk. The administration's proposal for a zero down product included increased premiums to help compensate for an increase in the cost of the FHA program which would permit FHA to potentially offset additional costs

[11] GAO-05-13.

stemming from a new product that entails greater risk or not well understood risk. The proposed bill also requires that borrowers receive prepurchase counseling.

Although FHA appears to follow many key practices used by mortgage institutions in designing and implementing new products, several practices not currently or consistently followed by FHA stand out as appropriate means to manage the risks associated with introducing new products or significantly changing existing products. Moreover, these practices can be viewed as part of a formal framework used by some mortgage institutions for managing the risks associated with new or changed products. The framework includes techniques such as limiting the availability of a new product until it is better understood and establishing stricter underwriting standards—all of which would help FHA to manage risk associated with any new product it may introduce. For example, FHA could set volume limits or limit the initial number of participating lenders in the product. Further, changes in FHA's premiums, an important element of the administration's 2006 budget proposal for a zero down payment product would permit FHA to potentially offset additional costs stemming from a new product that entails greater risk or not well understood risk.

However, FHA officials believe that the agency does not have sufficient resources to implement products with limited volumes, such as through a pilot program. Yet, when FHA makes new products widely available or makes significant changes to existing products with less-understood risks, these products or actions also can introduce significant risks. Products that would introduce significant risks can impose significant costs. We believe that FHA could mitigate these risks and potential costs by using techniques such as piloting. Moreover, FHA told us that it believes that pilot programs are not needed because the risks of every new year of loans are assessed annually as part of credit subsidy budgetary transactions and in its annual actuarial study, and it could terminate the program early in its life if it identified problems.[12] However, because it may take a few years to determine the risks of a new loan product, early termination could still

[12]The Federal Credit Reform Act of 1990 requires that federal government programs that make direct loans or loan guarantees (including insuring loans) account for the full cost of their programs on an annual budgetary basis. Specifically, federal agencies must develop subsidy estimates of the net cost of their programs that include estimates of the net costs and revenues over the projected lives of the loans made in each fiscal year. The Cranston Gonzales National Affordable Housing Act requires an independent actuarial analysis of the economic net worth and soundness of FHA's MMI Fund.

expose the government to significant financial risk without some type of limits on the number of loans insured. If FHA is unsure about its authority to conduct pilots or concerned about expectations of equitable distribution of its products, Congress can make clear that FHA has this authority by requiring a product to be implemented as part of a pilot, or by explicitly giving the HUD Secretary the authority to establish and implement pilots for new products.

If Congress authorizes FHA to insure a no down payment product or any other new single-family insurance products, Congress may want to provide guidance and clear authority to FHA on this new product. Congress may want to consider a number of means to mitigate the additional risks that these loans may pose. Such means may include limiting the initial availability of such a new product, requiring higher premiums, requiring stricter underwriting standards, or requiring enhanced monitoring. Such risk mitigation techniques would serve to help protect the Mutual Mortgage Insurance Fund while allowing FHA the time to learn more about the performance of loans using this new product. Limits on the initial availability of the new product would be consistent with the approach Congress took in implementing the HECM program. The limits could also come in the form of an FHA requirement to limit the new product to better performing lenders and servicers as part of a demonstration program or to limit the time period during which the product is first offered.

Mr. Chairman, this completes my prepared statement. I would be pleased to respond to any questions you or other members of the Committee may have at this time.

GAO Contacts and Staff Acknowledgments

For more information regarding this testimony, please contact William B. Shear at (202) 512-8678 or shearw@gao.gov or Mathew Scirè at (202) 512-6794 or sciremj@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on this last page of this testimony. Individuals making key contributions to this testimony also included Anne Cangi, Bert Japikse, Austin Kelly, Andy Pauline, Susan Etzel, and Barbara Roesmann.

This is a work of the U.S. government and is not subject to copyright protection in the United States. It may be reproduced and distributed in its entirety without further permission from GAO. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately.

GAO's Mission

The Government Accountability Office, the audit, evaluation and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site (www.gao.gov). Each weekday, GAO posts newly released reports, testimony, and correspondence on its Web site. To have GAO e-mail you a list of newly posted products every afternoon, go to www.gao.gov and select "Subscribe to Updates."

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are $2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. Government Accountability Office
441 G Street NW, Room LM
Washington, D.C. 20548

To order by Phone: Voice: (202) 512-6000
TDD: (202) 512-2537
Fax: (202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm
E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Gloria Jarmon, Managing Director, JarmonG@gao.gov (202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, D.C. 20548

Public Affairs

Paul Anderson, Managing Director, AndersonP1@gao.gov (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, D.C. 20548

PRINTED ON RECYCLED PAPER