United States General Accounting Office
Washington, DC 20548

Resources, Community, and
Economic Development Division

B-285175

September 8, 2000

The Honorable Rick Lazio
Chairman, Subcommittee on Housing
and Community Opportunity
Committee on Banking and Financial Services
House of Representatives

Subject: Mortgage Financing: Level of Annual Premiums That Place a Ceiling on Distributions to FHA Policyholders

Dear Mr. Chairman:

From 1943 to 1990, the programs supported by the Federal Housing Administration's (FHA) Mutual Mortgage Insurance Fund paid distributive shares to homeowners who had voluntarily terminated their mortgages by paying off the mortgage on time, or early, such as when refinancing.[1] In 1990, after the Fund began experiencing substantial losses, the Congress required FHA to stop paying distributive shares until the Fund had accumulated adequate reserves—current cash plus the net present value of future cash flows. While not defining what level of reserves are adequate, the Congress required that the Secretary take steps to ensure that the Fund achieve minimum reserves equaling 2 percent of the insurance-in-force. Thus, in determining whether there is a surplus for distributing to borrowers, the Secretary must now take into account the actuarial status of the entire Fund.[2] After several years of improved Fund performance, the reserve was estimated to have first met the 2-percent minimum requirement in 1995 and was estimated to have reached 3.66 percent in 1999. FHA has not renewed paying distributive shares and believes that it would only be prudent to consider doing so if the Fund's capital ratio exceeded 3 percent.

[1] Because the risk of an insurance claim is usually the greatest during the first 7 years of a mortgage, FHA generally did not pay distributive shares to borrowers who had terminated their mortgages within 7 years of receiving them.

[2] In contrast, borrowers who had voluntarily terminated their mortgages within a specified time period—now 7 years—have received refunds of their up-front insurance premiums regardless of the actuarial status of the Fund.

You asked us to report on the number of borrowers insured by the Mutual Mortgage Insurance Fund who might have been eligible to receive dividends, or distributive shares, from their mortgage insurance if FHA had been required to pay distributive shares in fiscal year 1999. You also asked us to provide information on the amount of annual premiums these individuals had paid because this amount serves as the maximum amount of any distributive share they might have been eligible to receive.[3]

In summary, we found that in fiscal year 1999, between 132,508 and 186,032 FHA borrowers who had voluntarily terminated their mortgages might have been eligible for distributive shares if FHA had paid such shares (see table 1). Specifically, 186,032 FHA borrowers who had voluntarily terminated their mortgages in fiscal year 1999 had received their mortgages in fiscal year 1992 or earlier, and these mortgages were originated in years that produced profitable mortgages. Furthermore, 53,524 of these borrowers had their loans originated in fiscal year 1992. Some of these borrowers would not have been eligible for distributive shares because they had their loans for less than 7 years when they voluntarily terminated them in 1999. The range of estimates we provide recognizes this. The remaining 132,508 borrowers had loans originated before 1992.[4] Thus, the number of borrowers who voluntarily terminated their mortgages in 1999 and may have been eligible for distributive shares is between132,508 and 186,032. Using a similar methodology, we determined that the total annual premiums paid by these borrowers was between $271 million and $395 million.

[3] The amount of any such payment is based on the extent to which the annual premiums paid by a group of homeowners exceeded the actual cost of insuring that group of homeowners. However, in no event can the size of a distributive share for an individual homeowner exceed the amount of the annual premium the homeowner had paid over the life of the mortgage. Some groups of mortgages, especially those originated in the 1980s, had revenues that were lower than their costs and would thus not have been eligible to receive any distributive shares.

[4] Actually, all of these loans were originated prior to 1980. Loans originated in fiscal years 1980 through 1991 are not included here because either they did not pay annual premiums and/or they were not profitable. Loans originated between September 1, 1983, and June 30, 1991, did not pay annual premiums, and loans originated in fiscal years 1980 through 1986 and 1988 through 1991 were not profitable.

Table 1: Data on FHA Borrowers Who Terminated Their Mortgages in Fiscal Year 1999 and Might Have Been Eligible for Distributive Shares

	Eligible mortgages terminated in fiscal year 1999 and originated in fiscal year 1991 or earlier[a]	Eligible mortgages terminated in fiscal year 1999 and originated in fiscal year 1992 or earlier[b]
Total number of mortgages	**132,508**	**186,032**
Total annual premiums	**$270,678,146**	**$394,858,427**
Average annual premiums	$2,043	$2,123

Note: Includes only those mortgages for which borrowers had paid required annual premiums and had voluntarily terminated in fiscal year 1999 and which were originated in a year that produced profitable mortgages.

[a]Loans originated in fiscal years 1980 through 1991 are not included here because either they did not pay annual premiums and/or they were not profitable. Thus, only loans originated prior to fiscal year 1980 are included. Data on loans originated prior to 1975 are from summary FHA data.

[b]Includes loans originated prior to fiscal year1980 and in fiscal year 1992.

Source: GAO's analysis of FHA's data.

For several reasons, actual distributions are likely to be less than the amount of premiums paid. First, for some groups of borrowers, the amount by which revenues exceed the costs associated with them may be less than the full amount of the annual premiums they paid. According to FHA's chief actuary, it would be reasonable to assume that rebates would have been equal to about 2 percent of the original value of the mortgage for eligible borrowers if FHA had paid distributive shares in 1999. Since the average value of the mortgages of eligible borrowers was about $35,500,[5] the average distributive share would be about $710.[6] In comparison, borrowers who terminated their mortgages last year paid, on average, between $2,043 and $2,123 in annual premiums. Second, any distributions are likely to be less than the total amount calculated because the Department of Housing and Urban Development (HUD) is not always able to locate eligible recipients. HUD officials said that, historically, HUD has located 80 to 90 percent of the eligible recipients but expected the Department would have better success now because of improved databases.

Scope and Methodology

To determine the number of insured borrowers who might have been eligible to receive distributive shares in fiscal year 1999 and the amount of annual premiums they had paid, we determined how many homeowners had received their mortgages in fiscal year 1992 and in earlier years, had paid annual premiums, and had voluntarily terminated their mortgage in 1999. We obtained data for fiscal years 1975 through 1999 from FHA's A-43 database, which provides current and historical information on

[5] This is a weighted average for loans originated prior to fiscal year 1980 and in fiscal year 1992. For loans originated between fiscal years 1975 and 1979 and in fiscal year 1992, the weighted average is based on the proportion of terminating loans that originated in a given eligible year. This calculation assumes that loans terminating in 1999 were typical of all loans originating in a given year.

[6] In the future, FHA might include in the cost of each group of mortgages contributions toward the capital reserve, and therefore the amount of any distribution could be lower than it had been in the past.

the mortgage loans that FHA insures. We used data reported by PricewaterhouseCoopers in 1999 on the economic value or profitability of mortgages by year of origination to identify the years between 1975 and 1999 in which mortgages that were profitable originated. All data on loans originated prior to 1975 that were prepaid in fiscal year 1999 were provided by FHA in summary form. FHA also provided summary data, including data on annual insurance premiums, for loans originated in fiscal years 1975 through 1979. Using FHA summary data for borrowers who originated their mortgages in these years and terminated them in 1999 would have resulted in a 7-percent lower average annual premium than our data show for these years. We did not reconcile the differences between the summary data FHA provided and the results of our analysis of FHA's A-43 database. We also reviewed program regulations and handbooks concerning distributive shares.

We performed our work from July through August 2000 in accordance with generally accepted government auditing standards.

Agency Comments and Our Evaluation

We provided a draft copy of this report to HUD for its review and comment. HUD had concerns in four areas of the draft report. First, HUD stated that our report appeared to strongly imply that FHA should have been paying distributive shares since the Mutual Mortgage Insurance Fund reached the congressionally mandated minimum capital ratio of 2 percent in 1995. This certainly was not intended, so we clarified the report to show that before distributive shares may be declared, the Secretary must first determine that the Fund had accumulated adequate reserves, but what constitutes an adequate capital ratio is not defined. We also added information to reflect FHA's belief that a capital ratio in excess of 3 percent would be prudent before considering reinstituting distributive shares.

Second, HUD stated that we appeared to inaccurately estimate in many respects the number of persons who may have been qualified for distributive share payments in fiscal year 1999. Of particular concern was the exclusion of data on loans originated prior to 1975. HUD provided summary data for these years, which we have included in the report.

Third, HUD was concerned that we seemed to assume that it is proper to pursue a very aggressive method of calculating the amount of each distributive share. HUD suggested that eligible borrowers should be restricted to those who received mortgages in years where the mortgages produced sufficient profits to set aside funds equal to 2 percent of their outstanding loan balance. We did not use this criteria because the law specifies that the Secretary shall take into account the actuarial status of the entire Fund when determining whether there is a surplus for distribution. Using FHA's criteria would make loans originated in fiscal year 1992 ineligible. We provide an estimate that excludes loans originated in fiscal year 1992. In addition, we note that in the future FHA might include in the cost of each group of borrowers contributions toward the capital reserve and that therefore the amount of distributions could be lower than it had been in the past.

Fourth, HUD stated that the report does not clearly explain FHA's existing refund policy for borrowers who prepay within 7 years of loan origination. We have added information to make clear FHA's continuing practice of refunding up-front mortgage insurance premiums.

HUD's comments are in enclosure I.

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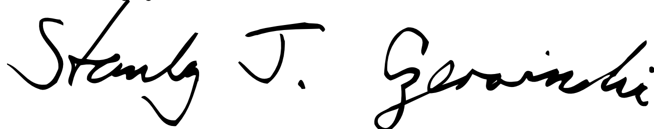
We are sending copies of this report to interested congressional committees and the Honorable Andrew M. Cuomo, Secretary of Housing and Urban Development. We will also make copies available to others upon request.

Please call me on (202) 512-7631 if you or your staff have any questions about this report. Key contributors to this report were Nancy Barry, DuEwa Kamara, Mathew Scire, and Salvatore Sorbello, Jr..

Sincerely yours,



Stanley J. Czerwinski
Associate Director, Housing and
Community Development Issues

Enclosure I

Comments From the Department of Housing and Urban Development

U. S. Department of Housing and Urban Development
Washington, D.C. 20410-8000

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OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

Stanley J. Czerwinski
Associate Director, Housing and Community Development Issues
U.S. General Accounting Office
Washington, DC 20548

Thank you for the opportunity for advance review and comment on the draft GAO report, "Mortgage Financing: Level of Annual Premiums That Place a Ceiling on Distributions to FHA Policyholders" (GAO/RCED-00-280R, Code 385882). The Federal Housing administration (FHA) has several concerns with this draft report, which are highlighted below:

1. FHA finds it curious that GAO appears to strongly imply that FHA should have been paying distributive shares since the MMI Fund reached the Congressionally mandated minimum capital ratio of 2.00 in 1995. The GAO states in its draft report that "After several years of improved performance, the reserve was estimated to have first met the 2 percent requirement in 1995 and was estimated to have reached 3.66 percent in 1999. However, distributive shares have not been reissued." FHA, like many in Congress, always has viewed the 2.00 capital ratio as the **bare minimum** reserve required by Congress. In fact the National Housing Act in Section 205 (f)(2) states "The Secretary shall endeavor to ensure that the Mutual Mortgage Insurance Fund attains a capital ratio of **not less than** 2.0 percent within 10 years after the date of the enactment of this subsection, and shall ensure that the Fund maintains **at least** such capital ratio at all times thereafter." Moreover, Congress has clearly instructed the Secretary to exercise his discrecion in determining whether and when distributive shares should be paid. In Section 205 (e) of the National Housing Act states "In determining whether there is a surplus for distribution of the mortgagors under this section, the Secretary shall take into account the actuarial status of the entire Fund."

   Following the near disastrous financial collapse of the MMI Fund in the late 1980s due to severe mismanagement, the Clinton Administration always has determined that it is prudent to go well beyond the minimum 2.00 percent capital ratio prior to proposing spending of the FHA reserves. In fact, for some time, the current Administration has targeted a 3.00 percent capital ratio as the amount of additional cushion sufficient to consider alternative uses of the Fund. Consistent with this plan, in March of this year when for the first time FHA released actuarial data demonstrating that the Fund had a capital ratio in excess of 3.00, the Administration invited a national debate of how to use the proceeds of our success in managing the fund. In FHA's opinion, considering payment of distributive shares prior to that time would not have been prudent. Finally, FHA would be interested in a garnering a fuller understanding of GAO's implicit rational for determining that 2.00 percent is a sufficient maximum capital ratio, as a opposed to a minimum as interpreted by the current Administration.

2. GAO appears to inaccurately estimate in many respects the number of persons who may have qualified for distributive share payments in FY1999. First, in preparing these estimates, GAO used a truncated database consisting of the mortgages endorsed for insurance since FY 1975. As a result,

Enclosure I

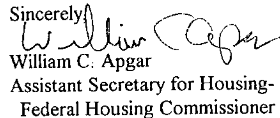
the number of potentially eligible borrowers is underestimated and so is the potential cost of paying distributive shares. Using PricewaterhouseCoopers figures, GAO determined that the books of business potentially eligible for distributive shares were FY 1975-1979 and FY 1992 and estimated the eligible borrowers at 36,003 for the FY 1975-1979 period and 89,527 including FY 1992. On the basis of these figures, GAO estimated the average original mortgage amount to be about $55,000 and the average distributive share to be two percent of this figure, or $1,100. Using these assumptions, the approximate cost of distributive shares for FY 1999 would be $40 million for the FY 1975-1979 period and $98 million including FY 1992. In fact, a substantial number of mortgages that terminated in FY 1999 were originated prior to FY 1975. Assuming that all of the books of business prior to FY 1980 generated more revenue than they consumed, the total number of eligible borrowers is 143,992. These borrowers paid premiums totaling $295 million. At two percent of the original mortgage amount, the approximate cost of distributive shares for FY 1999 could be up to $62 million for the pre-1980 period. Moreover, GAO does not does not consider the impact of the mandated capital ratio on the calculation of the profitability of MMIF books of business. Preliminary analysis suggests that the eligibility of the FY 1992 book for distributive shares will depend on whether or not the book is required to contribute to the MMIF capital reserve. In light of Congress' clear direction to immediately begin moving toward meeting the 2.00 percent capital ratio, FHA rightly set aside funds equal to 2.00 percent of the outstanding loan amount in calculating the profitability of this book of business. With this additional calculation, the FY1992 does not appear to be profitable, and therefore should not be included in GAO's estimate.

3. GAO also seems to assume that the it is proper to pursue a very aggressive method of calculating the amount of each distributive share. In a footnote to the report GAO states that "the amount of any such payment is based on the extent to which the annual premiums paid by a group of homeowners exceeded the actual cost of insuring that group of homeowners." While this is an approximate description of how distributive shares were calculated in the past, this method seems somewhat suspect, as it would result in no allocation to reserves to protect the Fund against future losses. In fact, the Administration believes that such an aggressive method of calculating distributive share may have contributed to the extremely poor financial condition of the MMI Fund in the 1980s.

4. Finally, the report does note clearly explain FHA's existing refund policy for borrowers who prepay within seven years of loan origination. The report does state that "FHA generally did not pay distributive shares to borrowers who had terminated their mortgages within 7 years of receiving them," but it fails to mention that FHA pays borrowers who paid one-time or upfront premiums a declining-percentage premium refund. FHA believes that this is an important compliment to any distributive share payment policy and accordingly should be fully discussed and explained in the subject GAO report.

Thank you again for the opportunity to comment on this report. FHA looks forward to continuing to work with GAO on this and other review assignments.

Sincerely,



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