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# HOUSING FINANCE

# FHA's Risk-Sharing Programs Offer Alternatives for Financing Affordable Multifamily Housing

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Economic Development Division

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Congressional Committees

This report responds to a mandate in the Housing and Community Development Act of 1992 (P.L. 102-550) that we evaluate the risk-sharing demonstration programs established under section 542 of the act. More specifically, the report looks at how well the programs are meeting their goals, identifies the benefits for participating financial institutions and HUD, and considers opportunities for improving the programs and HUD's administration of them. The report makes recommendations designed to encourage greater activity in the reinsurance program and to improve HUD's monitoring and oversight of the federal government's risk-sharing partners.

We are sending copies of this report to the appropriate congressional committees and to the Secretary of HUD. Copies are available to others upon request.

If you or your staff have any questions, please call me at (202) 512-7631. Major contributors to this report are listed in appendix X.

Sincerely yours,

Judy England-Joseph

Judy A. England-Joseph
Director, Housing and Community
Development Issues

List of Committees

The Honorable Connie Mack
Chairman
The Honorable John Kerry
Ranking Minority Member
Subcommittee on Housing Opportunity
and Community Development
Committee on Banking, Housing,
and Urban Affairs
United States Senate

The Honorable Rick A. Lazio
Chairman
The Honorable Joseph P. Kennedy II
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Subcommittee on Housing
and Community Opportunity
Committee on Banking and Financial
Services House of Representatives

# Executive Summary

## Purpose

During the 1980s, a decline in the production of affordable housing and an increase in the number of low-income households meant that more low-income households were unable to obtain affordable housing. Although the Congress wished to expand access to capital for the production of affordable housing, it had concerns about risk after the federal government lost over $2 billion from defaults on multifamily mortgage loans insured through the former coinsurance program, administered by the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA). Accordingly, in the Housing and Community Development Act of 1992, the Congress established two new risk-sharing demonstration programs that divide the financial liability for any defaults between the federal government and its risk-sharing partners—state housing finance agencies or other qualified financial institutions.

This report responds to a requirement in the act that GAO review these two risk-sharing demonstration programs and HUD's administration of them, as well as identify any opportunities for improvement. More specifically, the report looks at how well the programs are meeting their goals, identifies their benefits for participating financial institutions and HUD, and considers opportunities for improving the programs and their administration.

## Background

The two risk-sharing demonstration programs established by the 1992 act offer incentives to financial institutions to facilitate the financing of affordable multifamily housing. One program provides credit enhancement[1] to state and local housing finance agencies, while the other provides reinsurance[2] to qualified financial institutions. Both programs rely on risk sharing to ensure sound financial management and delegation to increase the efficiency and lower the costs of providing the credit enhancements. The demonstration programs differ from FHA's traditional mortgage insurance programs in that FHA (1) assumes only a portion (generally 50 percent), rather than all, of the risk of loss and (2) delegates, rather than performs, loan-processing and asset management functions. While the former coinsurance program also relied on risk sharing and delegation, the demonstration programs establish additional requirements

[1]A credit enhancement, such as mortgage insurance, transfers some of the risk of loss from the lender to the credit enhancer. When the federal government assumes a portion of a lender's risk under a risk-sharing agreement, the lender may derive benefits, such as a higher bond rating, that may be passed on to borrowers and tenants in the form of lower costs.

[2]Reinsurance is a form of credit enhancement that occurs after the original financing has taken place. Like mortgage insurance, it increases a loan's security by committing the federal government to pay a portion of any losses incurred through default.

to protect the government's financial interests, including more stringent standards for participation and larger reserve requirements. The demonstration programs are unique in requiring that FHA's credit enhancements be used only for properties that qualify as affordable housing.[3]

Under FHA's traditional mortgage insurance programs, insurance authority is limited by a dollar cap, which the Congress has periodically adjusted upward to accommodate increased demand. Under the demonstration programs, insurance authority is restricted to a fixed number of units. To date, the Congress has authorized 49,500 units for the credit enhancement program and 22,500 units for the reinsurance program. HUD recently recommended, as part of a comprehensive legislative proposal to reform FHA's multifamily programs, that both programs be made permanent and subject to the same kind of insurance authority as FHA's other mortgage insurance programs. Bills consistent with HUD's proposal were introduced in both the Senate and the House in 1997 and were pending in committees as of January 1998.

## Results in Brief

The credit enhancement program, together with the reinsurance program, was established under the Housing and Community Development Act of 1992 to facilitate the financing of affordable multifamily housing and to make that financing available in a timely manner. The credit enhancement program is meeting these goals. As of September 1997, the 32 participating state and local housing finance agencies had reserved[4] about 84 percent of the risk-sharing units allocated to these agencies through March 1996. Most of the insured loans are financing properties that serve more low-income households than required, apparently because the credit enhancement is being used with other subsidies, particularly low-income housing tax credits. While it is still too soon to evaluate the financial performance of the insured loans, the available financial indicators reflect sound underwriting standards. Participation in the credit enhancement program has enabled the housing finance agencies to leverage their reserves and insure loans more quickly. According to the participating

[3]That is, at least 20 percent of a property's units must be rent restricted and occupied by households whose incomes, adjusted for household size, do not exceed 50 percent of the local area's median income, or at least 40 percent (25 percent in New York City) of the property's units must be rent restricted and occupied by households whose adjusted incomes do not exceed 60 percent of the area's median income.

[4]Because insurance authority is provided in risk-sharing units rather than dollars, HUD allocates a fixed number of units to a participating financial institution, and the institution then reserves these units for properties whose loans it decides to insure or reinsure. For each property, the number of risk-sharing units reserved is equal to the number of dwelling units.

agencies, the program would be improved if it were made permanent and the current limits on the number of available risk-sharing units were lifted. These changes, they said, would enable them to market the program and manage their resources for multifamily programs more effectively.

Activity in the reinsurance program has been so limited that the program remains largely untested. Only one institution—Fannie Mae—has participated extensively in the program, and one lender—Banc One Capital Funding Corporation—has originated over half of the loans that Fannie Mae has reinsured. Banc One's activity has demonstrated that the risk-sharing reinsurance program can expand participation in mortgage lending, including lending for smaller properties in rural areas—an unmet capital need, according to HUD's studies. However, for a variety of reasons, HUD's other risk-sharing partners have reserved few or none of their risk-sharing units. Opportunities to expand participation include reallocating unused units to Fannie Mae and allowing the use of risk-sharing reinsurance (1) with 18-year balloon mortgages—an option that is currently available only to Fannie Mae—and (2) with loan pools as well as individual loans.

Participation in the demonstration programs has enabled HUD to facilitate the financing of affordable multifamily housing while limiting its loss exposure through risk sharing. Participation has also allowed HUD to increase the efficiency and reduce the costs of its operations through delegation, compared with FHA's traditional multifamily programs. HUD has retained responsibility for monitoring its risk-sharing partners' performance, but its data system for monitoring the progress of credit enhancement projects is unreliable. HUD is aware of the system's problems and plans to resolve them in the course of overhauling all of its information management systems. HUD has also retained responsibility for overseeing its risk-sharing partners' compliance with the demonstration programs' requirements; however, GAO's review identified one default that was not reported to HUD headquarters for over a year. HUD recognizes that effective oversight is critical, particularly if one or both of the demonstration programs are made permanent and lenders' activity increases.

## Principal Findings

### The Credit Enhancement Program Has Facilitated the Financing of Affordable Multifamily Housing

Through the credit enhancement program, housing finance agencies are insuring loans for newly constructed and substantially rehabilitated properties serving families and the elderly in urban, suburban, and rural areas. All of the completed properties are meeting, and many are exceeding, the credit enhancement program's income-targeting requirements. About three-quarters of the properties that are exceeding these requirements also receive other subsidies—usually low-income housing tax credits—that have income restrictions at least as stringent as the credit enhancement program's.

For most housing finance agencies, the greatest benefit of participation in the credit enhancement program is the ability to leverage their reserves by the percentage of risk that HUD assumes for each risk-sharing loan. Because HUD has assumed 50 percent of the risk for loans financing about 90 percent of the risk-sharing units, the participating agencies have generally been able to cut their reserve requirements for risk-sharing loans in half, effectively doubling their financing capacity. Other benefits of participation include administrative efficiencies and, in some instances, lower interest rates or longer loan terms compared with other forms of credit enhancement.

Housing finance agencies believe that making the credit enhancement program permanent and removing the current limits on the number of available risk-sharing units would assist them in marketing the program and managing their multifamily resources. Such changes would also allow them to keep up with the demand for risk-sharing units, which—given their frequent use of the credit enhancement program to insure loans for properties financed with low-income housing tax credits—is likely to increase if pending bills proposing to raise the states' per-capita tax credit allocations are enacted. Finally, permanency would be consistent with the recently enacted authority allowing the risk-sharing program to assist HUD in its mark-to-market program.[5]

[5]This program is designed to refinance the mortgages of subsidized multifamily properties to bring their rents in line with market rents.

## The Reinsurance Program Has Potential but Has Not Been Tested

HUD's current and designated partners in the reinsurance program represent a wide range of qualified financial institutions with the potential to expand mortgage lending at the national, regional, and local levels. However, Fannie Mae is the only partner that has reserved all of its allocation (7,500 units), and Banc One Capital Funding Corporation has originated 28 of the 48 loans that Fannie Mae has agreed to reinsure. Compared with the properties securing other loans that Fannie Mae has agreed to reinsure, Banc One Capital Funding Corporation generally finances smaller properties in smaller communities. Six properties had been completed as of October 31, 1997. All six are meeting, and four are exceeding, the program's income-targeting requirements; five of these properties are also partially financed with low-income housing tax credits. Fannie Mae has been able to use its allocation because it has (1) a product line that, like the reinsurance program, relies on delegating responsibility and (2) flexible underwriting standards that are suitable for affordable housing. Participation in the reinsurance program has enabled Fannie Mae's lenders to reduce their reserve requirements by 50 percent, thereby doubling their financing capacity. The administrative efficiencies gained through delegation—both from HUD to Fannie Mae and from Fannie Mae to its lenders—have expedited the processing and reduced the transaction costs of loans reinsured through the program.

HUD's other current and designated risk-sharing partners have reserved a small fraction or none of their risk-sharing units or have not signed risk-sharing agreements with HUD for various reasons, many of them particular to the individual institutions. For example, Freddie Mac has reserved 538 of its 5,000 units for one property. Several factors have limited its participation, including the fact that most of the loans it purchases are balloon mortgages, which are not eligible for reinsurance under its risk-sharing agreement.[6] Similarly, two loan consortia[7] with which HUD is currently negotiating risk-sharing agreements—the Community Preservation Corporation (CPC) and the California Community Reinvestment Corporation (CCRC)—will generally not have the loan volumes needed to participate in the program unless their risk-sharing agreements provide for reinsuring multiple loans (loan pools) as well as individual loans.

[6]Specifically, the risk-sharing agreement requires that all reinsured loans be fully amortizing—that is, the entire principal is to be repaid within the term of the loan. Balloon mortgages are not fully amortizing; at the end of the loan term, a substantial portion of the principal remains to be repaid, usually through refinancing.

[7]Associations of commercial banks and thrifts formed to finance affordable housing, particularly multifamily housing.

Given the limited activity in the reinsurance program to date, opportunities for improvement consist primarily of providing additional units to Fannie Mae, considering changes to existing risk-sharing agreements that could facilitate participation, concluding risk-sharing agreements with the loan consortia, and giving two new risk-sharing partners—the State of New York Mortgage Agency (SONYMA) and the Federal Home Loan Bank of New York—time to use their risk-sharing units. HUD has said that it will reallocate 2,000 unused units to Fannie Mae, and it is considering changes to Freddie Mac's risk-sharing agreement. The use of reinsurance with loan pools is authorized under the act and could enable the loan consortia to participate.

## HUD Is Assuming a Smaller Percentage of Risk and Lowering Its Administrative Costs, but Its Data System and Oversight Have Weaknesses

Through the risk-sharing programs, compared with the traditional mortgage insurance programs, HUD has cut its per-loan loss exposure in half[8] and dramatically decreased the time taken to process mortgage insurance. According to HUD officials, they need about 80 hours to process loans for risk-sharing projects, compared with about 880 hours for traditional projects.

The data management system that HUD has established to track and monitor the progress of projects in the credit enhancement program is user unfriendly and largely unreliable. It has no edit function, cannot generate paper printouts, and contains no definitions of required data elements. HUD is overhauling and integrating its information management systems and believes that personal-computer-based software applications would be sufficient for tracking, monitoring, and reporting information for the credit enhancement program. While HUD has established procedures for overseeing the risk-sharing activities of participating financial institutions, it has not always overseen compliance with these procedures. For example, HUD headquarters was not notified that a risk-sharing loan had been in default for over a year.

# Recommendations

GAO recommends that the Secretary of Housing and Urban Development direct the Commissioner, Federal Housing Administration, to explore the feasibility of amending HUD's current risk-sharing agreements with qualified financial institutions, as necessary, to allow the use of reinsurance with 18-year balloon mortgages and loan pools. GAO also

[8]To the extent that the risk-sharing programs expand the volume of multifamily loans that HUD would not have insured otherwise, the federal government's loss exposure is increased. However, losses are incurred only to the extent that the premiums HUD charges for its credit enhancement or reinsurance do not cover its costs associated with defaults.

recommends that the Secretary correct current flaws in the information management systems supporting the risk-sharing demonstration programs and give priority to implementing a comprehensive monitoring system to ensure compliance and timely reporting.

## Agency Comments

HUD agreed with GAO's recommendations and said that it was taking or planned to take steps to implement them.

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## Figures



### Abbreviations

| | |
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| CCRC | California Community Reinvestment Corporation |
| CDBG | Community Development Block Grant |
| CPC | Community Preservation Corporation |
| CRC | Community Reinvestment Corporation |
| DUS | Delegated Underwriting and Servicing |
| FHA | Federal Housing Administration |
| FHLB | Federal Home Loan Bank |
| GAO | General Accounting Office |
| GGD | General Government Division |
| Ginnie Mae | Government National Mortgage Association |
| HUD | Department of Housing and Urban Development |
| NCB | National Cooperative Bank |
| OTS | Office of Thrift Supervision |
| RCED | Resources Community and Economic Development Division |
| RSS | Risk-Sharing Multifamily National System |
| SAMCO | Savings Associations Mortgage Company |
| SONYMA | State of New York Mortgage Agency |

# Introduction

During the 1980s, a decline in the production of affordable housing, coupled with an increase in the number of low-income households,[1] reduced the availability of affordable housing for low-income households. Although the federal government wished to expand the availability of affordable housing, particularly multifamily housing, reductions in federal spending precluded increases in housing subsidies—the federal government's primary means of making rental housing affordable to low-income households. In addition, federal credit enhancements, such as mortgage insurance or reinsurance, came under increased public scrutiny after the federal government lost nearly $2.4 billion by 1992 from defaults on multifamily mortgage loans insured through its former coinsurance program—a program delegating federal loan-processing and asset management functions to approved lenders that HUD implemented in 1983 to meet the market's demands for multifamily mortgage insurance.

To stimulate the production of affordable multifamily housing and to gain the administrative efficiencies but avoid the risks of the coinsurance program, the Congress, in the Housing and Community Development Act of 1992, authorized two new risk-sharing demonstration programs. These programs (1) provide credit enhancements to encourage the financing of affordable multifamily housing and (2) divide the financial liability for any default between the federal government and the financial institutions and agencies selected to become its risk-sharing partners.

This report responds to a requirement in the 1992 legislation that we review these two risk-sharing demonstration programs as well as identify any opportunities for improvement. More specifically, the report looks at how well the programs are meeting their goals, identifies their benefits for participating financial institutions and the Department of Housing and Urban Development (HUD), and considers opportunities for improving the programs and HUD's administration of them.

## Multifamily Production Declined While More Households Sought Affordable Housing

In establishing the risk-sharing demonstration programs, the Congress recognized that the production of multifamily housing had been declining steadily since the mid-1980s. According to Senate Report 102-332[2] and studies of the multifamily mortgage markets conducted in the early 1990s, several key factors were responsible for this decline. Among the more important were (1) changes in government policies and regulations on taxation, banking, and housing subsidies; (2) a sharp decline in multifamily

[1]Households with incomes at or below 80 percent of the local area's median income.

[2]Senate Report 102-332 is part of the legislative history for the Housing and Community Development Act of 1992.

mortgage credit enhancement by the Federal Housing Administration (FHA); and (3) the withdrawal from the multifamily secondary market[3] by Freddie Mac (formerly the Federal Home Loan Mortgage Corporation).

As we reported in 1993,[4] more households were seeking affordable multifamily housing at the same time as the production of such housing declined. Studies issued since 1993 have identified the types of multifamily properties that are needed and the areas where multifamily housing is needed. According to a 1995 HUD analysis,[5] unmet capital needs include smaller properties, larger rehabilitation projects, and housing for the elderly. Affordable new construction is also needed in high-growth markets. Inner-city neighborhoods and rural areas are commonly identified as "underserved housing markets" that often require smaller properties, both subsidized and unsubsidized. However, because these smaller properties have proportionally high transaction costs and low fees, they are less attractive to lenders than larger properties when interest rates are equivalent. The complexity often associated with the multiple subsidies needed to finance affordable housing also acts as a deterrent. According to HUD's 1995 analysis, the secondary market has generally not been active in purchasing rehabilitation loans. Such loans are needed in inner-city neighborhoods to preserve low-cost housing units, stabilize neighborhoods, and improve housing conditions for low-income residents. The study concludes that without rehabilitation loans, many properties in inner-city neighborhoods will be demolished or abandoned.

## Credit Enhancements Complement Housing Subsidies

Governments have several tools, apart from public housing, that they can use to make multifamily housing more affordable—(1) rental subsidies to make up the shortfall between the rents that tenants can afford and the rents that landlords must charge to cover their costs and earn a profit, (2) grants and favorable tax treatment to lower the costs of building or operating housing, and (3) credit enhancements, such as mortgage insurance, to facilitate the financing of affordable housing. While subsidies are the government's primary means of making multifamily housing affordable for low-income households, credit enhancements can

[3]In what is called the secondary market, investors, such as pension funds, purchase securities backed by long-term, fixed-rate mortgage loans as investments, thereby creating liquidity for primary lenders and allowing them to make additional loans or otherwise reinvest the funds.

[4]Housing Finance: Expanding Capital for Affordable Multifamily Housing (GAO/RCED-94-3, Oct. 27, 1993).

[5]Economic Analysis, Office of Policy Development and Research, HUD (Nov. 1, 1995).

complement subsidies by increasing the financing available for such housing.

Credit enhancements transfer some of the risk of loss from the lender to the credit enhancer, making loans more secure and encouraging both mortgage lending and investment in mortgage loans. Specifically, credit enhancements encourage primary lenders, such as commercial banks, to make long-term, fixed-rate mortgage loans that they otherwise might not make, and investors, such as pension funds, to buy these loans in the secondary market. The sale of individual loans, or of securities backed by pools of loans, returns funds to primary lenders, creating liquidity and allowing the lenders to make additional loans or otherwise reinvest the funds.

Credit enhancement can occur when a loan is originated or when it is sold in the secondary market. If it occurs at the time of origination, such as when a housing finance agency sells bonds to raise capital to lend to developers of affordable multifamily housing, it can affect the terms of the loan. Because the enhancement provides additional support—usually through mortgage insurance—it improves the housing finance agency's bond rating. The housing finance agency can then obtain a lower interest rate and/or a longer-term loan, the benefits of which it can pass along to the affordable multifamily housing developer. In turn, the developer can convey these benefits to tenants in the form of lower monthly rents. If the credit enhancement occurs when the loan is sold in the secondary market, it transfers the credit risk from the investor purchasing the loan to the credit enhancer. At the same time as this transfer reduces the purchaser's credit risk, it reduces the seller's reserve requirements, freeing capital for further investment. The credit enhancement that occurs when a loan is sold in the secondary market is called reinsurance.

## Demonstration Programs Were Designed to Overcome Flaws in FHA's Earlier Mortgage Insurance Programs

Under the traditional mortgage insurance programs, FHA is involved in all aspects of lending—loan underwriting, loan servicing, asset management, and property disposition. These tasks are time consuming and resource intensive. As a result, FHA has traditionally been slow to approve loans through these programs, and it incurs substantial staff costs.

In 1983, FHA implemented the coinsurance program to expedite loan processing and gain administrative efficiencies by delegating many of its mortgage underwriting, processing, monitoring, and foreclosure functions to approved lenders. The coinsurance program achieved these objectives, but it also resulted in substantial losses to the federal government. Even though the lenders assumed a portion of the credit risk for the loans they approved, this portion was not supported by sufficient reserves to ensure sound underwriting. In addition, the program's fee structure created incentives for the lenders to focus on the volume rather than the quality of the loans they made. Furthermore, the lenders' losses were insured by the Government National Mortgage Administration (Ginnie Mae), a government-sponsored enterprise. Thus, when defaults occurred and the lenders' reserves were not adequate to cover them, Ginnie Mae paid the remaining balance and the federal government was ultimately responsible for the losses.

Like the coinsurance program, the risk-sharing demonstration programs are designed to expedite loan processing and gain administrative efficiencies by delegating many of FHA's traditional loan-processing and asset management responsibilities to other entities. The demonstration programs also resemble the coinsurance program in that they are designed to share the risk of loss from default. However, the demonstration programs differ from the coinsurance program in important ways, reflecting lessons learned about flaws in the design of the coinsurance program.

First, the demonstration programs establish higher standards for participation than the coinsurance program. Entry into the demonstration programs is limited to qualified financial institutions, such as government-sponsored enterprises and state and local housing finance agencies with strong track records in multifamily lending. The housing finance agencies must meet standards of financial soundness and capable management established by a nationally recognized credit rating agency or have a dedicated reserve account with sufficient capital to meet the agency's outstanding obligations under the programs. The participating institutions are either publicly chartered or are regulated by a state or federal agency. In addition, their mission, like FHA's, includes supporting affordable housing. Thus, they are held accountable to public entities other than FHA for ensuring that they have the financial capacity and integrity to implement the risk-sharing programs. In contrast, FHA's partners in the coinsurance program were mortgage bankers unaccountable to a third party.

Second, the risk-sharing partners generally bear a larger share of the risk under the demonstration programs than under the coinsurance program. In most instances, the risk is divided equally under the demonstration programs, whereas, under the coinsurance program, the lenders assumed the first 5 percent of the losses on loans and shared any remaining losses with FHA on a 15-percent/85-percent basis. The more equal division of risk for most loans currently insured under the demonstration programs creates stronger incentives for FHA's risk-sharing partners to use sound underwriting terms and service their loans diligently.

Third, the demonstration programs provide for FHA's oversight of compliance with their requirements for maintaining a high credit rating or sufficient reserves. While the coinsurance program established reserve requirements for lenders, these requirements were not adequate, and neither FHA nor any other HUD authority monitored the lenders' reserves.

Fourth, the demonstration programs explicitly preclude the use of Ginnie Mae's insurance with risk-sharing loans.

## Demonstration Programs Test Risk Sharing as a Means of Providing Credit Enhancement

Section 542 of the Housing and Community Development Act of 1992 directs HUD, through FHA, to test the use of risk sharing as a means of providing federal credit enhancements for multifamily loans. Through two demonstration programs, HUD is to evaluate the effectiveness and efficiency of entering into partnerships or other contractual arrangements, including risk-sharing agreements, with qualified financial institutions (subsection b) and with state and local housing finance agencies (subsection c).

The key statutory objectives of the risk-sharing partnerships with qualified financial institutions are to

- ensure that the qualified participating entities bear a share of the risk that is sufficient to create strong, market-oriented incentives to maintain sound underwriting and loan management practices;
- use the resources of FHA to assist in increasing multifamily lending as needed;
- provide a more adequate supply of mortgage credit for sound multifamily rental housing projects in underserved urban and rural markets;
- encourage major financial institutions to expand their participation in mortgage lending;
- increase the efficiency, and lower the costs to the federal government, of processing and servicing multifamily housing mortgage loans insured by FHA; and

- improve the quality and expertise of FHA staff and other resources, as required for the sound management of reinsurance and other market-oriented forms of credit enhancement.

The act does not explicitly apply these objectives to the risk-sharing partnerships with state and local housing finance agencies. However, HUD has explicitly incorporated two of these objectives—using the resources of FHA to assist in increasing multifamily lending and increasing the efficiency of processing and servicing multifamily mortgage loans—into its regulations for implementing the demonstration program with state and local housing finance agencies. Moreover, according to FHA's Commissioner, all six goals are reflected in the design and implementation of the program with state and local housing finance agencies. In this report, we refer to the subsection (b) program as the reinsurance program and the subsection (c) program as the credit enhancement program.

While both demonstration programs transfer a percentage of the risk of default to HUD's risk-sharing partners, it is important to note that, to the extent the programs promote the development of affordable multifamily housing that HUD otherwise would not have insured, the federal government's loss exposure is increased. However, losses are incurred only to the extent that the premium HUD charges for its credit enhancement or reinsurance does not cover its costs associated with defaults.

## Risk-Sharing Reinsurance Agreements Are Designed to Expand Access to Capital

The act authorizes HUD to enter into risk-sharing reinsurance agreements with qualified financial institutions, three of which are named in the legislation—Fannie Mae (formerly the Federal National Mortgage Association), Freddie Mac, and the Federal Housing Finance Board, which implicitly includes its 12-member Federal Home Loan banks. Qualified housing finance agencies may also participate in the program. Fannie Mae and Freddie Mac are both government-sponsored enterprises that function as intermediaries in the secondary market, purchasing individual and pooled mortgage loans from primary lenders for sale as mortgage-backed securities to investors, such as pension funds and life insurance companies. Although Fannie Mae and Freddie Mac are private corporations and operate without explicit federal guarantees, they enjoy a special relationship with the federal government because they are federally chartered and, in the view of the investment community, have implicit federal guarantees. The Federal Home Loan banks are not technically secondary market intermediaries, but they perform a similar function by selling combined obligation bonds in the capital markets to finance mortgage loans originated and held by their member institutions. These member institutions include over 6,500 financial institutions, primarily commercial banks and thrifts, and are located in every state.

Under the risk-sharing reinsurance program, the qualified financial institutions are responsible for originating, underwriting, and servicing loans; managing assets; and disposing of properties in accordance with the terms of their risk-sharing agreements. The institutions may delegate these responsibilities to approved lenders. Any proposed changes to the terms of the risk-sharing agreements require HUD's approval.

Each risk-sharing reinsurance agreement commits HUD to paying 50 percent of any loss arising from a borrower's default. HUD's risk-sharing partner is responsible for paying the other 50 percent. If a borrower does default, the risk-sharing partner will manage and dispose of the property and pay all of the costs associated with the loan's disposition. HUD will then reimburse its partner for 50 percent of any eligible loss on the loan specified in the risk-sharing agreement. The partner pays HUD an annual risk sharing/reinsurance premium in an amount equal to 25 basis points [6] (0.25 percent) times the average unpaid principal balance on each mortgage loan reinsured under the program.

Under the program, reinsurance may be provided for loans financing the construction, substantial rehabilitation, refinancing, or acquisition of affordable multifamily housing properties. To qualify as affordable, the housing must satisfy the requirements of the Low-Income Housing Tax Credit program.[7] In addition, the property must continue to qualify as affordable for at least 15 years. When reinsurance is provided for acquisition or refinancing loans, the properties must remain affordable for at least 10 years beyond the terms specified in any existing commitments.

Not all loans for affordable multifamily housing projects are eligible for reinsurance under the program. Specifically, loans for properties housing transients or serving as hotels, for nursing homes, and for intermediate care facilities are ineligible. In addition, HUD will not reinsure construction loans or refinancing loans when the qualifying financial entity is the

[6]Each basis point equals one-hundredth of a percent.

[7]These requirements are that at least 20 percent of the units in a property must be rent restricted and occupied by households with incomes no greater than 50 percent of the area's median income, as adjusted for each household's size, or at least 40 percent of the units (25 percent in New York City) must be rent restricted and occupied by households with incomes no greater than 60 percent of the area's median income, as adjusted for each household's size.

mortgagee or guarantor of the original loan. Moreover, HUD will not provide reinsurance until a project is completed and at least 50-percent occupied, although the risk-sharing partner may insure or purchase the loan at any point. Finally, the risk-sharing partner assumes the initial costs of originating the loan and any risk associated with a construction loan.

Although HUD delegates most of its traditional loan management responsibilities to its risk-sharing reinsurance partners, it retains monitoring and oversight functions. HUD headquarters monitors and oversees the reinsurance program and maintains centralized data on the credit enhancement program, while HUD field offices generally monitor and oversee the credit enhancement program.

## Risk-Sharing Credit Enhancement Agreements Are Designed to Encourage Mortgage Lending

The act authorizes HUD to enter into risk-sharing agreements with state or local housing finance agencies that are HUD-approved mortgagees in good standing and have received HUD's approval to participate. To receive such approval, an agency must demonstrate its financial and administrative strength by

- carrying a "top tier" designation from Standard and Poor's or any other nationally recognized rating agency; receiving an "A" rating on its general obligation bonds; or otherwise demonstrating its capacity on the basis of factors such as its experience in financing multifamily housing, fund balances, administrative capabilities, investment policies, internal controls, financial management, portfolio quality, and state or local support;
- having at least 5 years' experience in multifamily underwriting; and
- certifying that it does not have any outstanding civil rights violations unless it is conforming to a court order or implementing a HUD-approved compliance plan to correct the violation.

Under the risk-sharing credit enhancement program, loans for new construction, substantial rehabilitation, and certain acquisitions and refinancings are eligible for full mortgage insurance. Once a housing finance agency presents HUD with the appropriate certification on a loan, HUD will endorse [8] the loan. Housing finance agencies are responsible for the full range of loan-processing and asset management activities. Properties under the program are generally financed through bonds issued by the housing finance agencies and secured by the mortgages on the financed properties.

[8]That is, make a formal commitment to insure a loan.

Through a risk-sharing agreement, a housing finance agency contracts with HUD to assume from 10 to 90 percent of the risk of loss on each loan that the agency underwrites. HUD, in turn, is responsible for assuming the balance of the risk. The agency pays HUD an annual risk-sharing/credit enhancement premium equal to 50 basis points times the percentage of risk FHA has assumed, times the average unpaid principal balance on each mortgage loan insured under the program.

If a foreclosure occurs, HUD is responsible for advancing 100 percent of the outstanding principal balance to the agency so that the agency can repay the investors. The agency is then responsible for disposing of the property, determining the loss (if any), and repaying HUD as necessary to cover its share of the loss as specified in the risk-sharing agreement.

Housing finance agencies that assume 50 to 90 percent of the risk on loans are given level I approval and may use their own underwriting standards and loan terms and conditions without further approval from HUD. HUD allows these agencies to use their own standards because it believes that they will exercise due diligence to protect both their interests and HUD's. Agencies that assume less than 50 percent of the risk are given level II approval and must have their underwriting standards and loan terms and conditions approved by HUD.[9] The actual percentage of risk that an agency assumes may vary from one loan to another but must be documented for each loan.

To ensure that participating housing finance agencies have the resources to cover potential losses, HUD has established certain financial reserve requirements for them. Agencies with a top-tier designation or an overall credit rating of "A" are not required to have additional reserves to meet their obligations under the program so long as they maintain that designation or rating. Agencies that do not meet either of these criteria must establish a liquid asset reserve of at least $500,000, which must be augmented with additional amounts at each loan closing. [10]

Properties must meet the same requirements for tenants' incomes and rents as they would if they were being processed through the risk-sharing

[9]When the loan-to-replacement cost ratio for a new or substantially rehabilitated property or the loan-to-value ratio for an existing property is greater than or equal to 75 percent, the housing finance agency assumes 25 percent of the loss. When these ratios are less than 75 percent, the agency can choose to assume 10 percent or 25 percent of the loss.

[10]In addition to the $500,000, a housing finance agency must, at each loan closing, deposit 1 percent of the mortgage amount for any amount up to $50 million, plus 75 basis points for any amount between $50 million and $150 million, plus 50 basis points for any amount over $150 million.

reinsurance program. HUD's regulations specify that the housing must be maintained as "affordable" for as long as the mortgage is insured under the program. Furthermore, any projects financed with federal low-income housing tax credits must remain affordable for at least 15 years to comply with the Low-Income Housing Tax Credit program's requirements.

## Proposed Legislation Would Make Demonstration Programs Permanent

To date, the Congress has authorized 49,500 units under the risk-sharing credit enhancement program and 22,500 units under the risk-sharing reinsurance program. HUD has allocated the units authorized under the credit enhancement program to 32 housing finance agencies and the units authorized under the reinsurance program to 8 financial institutions. These agencies and institutions have, in turn, reserved[11] their allocated units for multifamily properties, which have either been completed or are in the agencies' pipelines. Most recently, a bill, H.R. 2406, proposed authorizing 15,000 additional units for each program.

In 1997, HUD proposed, as part of a comprehensive legislative proposal to reform FHA's multifamily programs, to make both demonstration programs permanent. Conceptually, the programs are consistent with the transformation of the Department envisioned in its 2020 Management Reform Plan.[12] In this plan, HUD proposes to convert FHA's traditional multifamily insurance programs from retail to essentially wholesale operations, under which FHA would rely primarily on mortgagees or contractors to underwrite loans, manage assets, and dispose of properties. According to HUD, permanency would allow the demonstration programs to operate under the same rules as HUD's other insurance programs.

In response to HUD's proposal, H.R. 1433, introduced in April 1997, and S. 853, introduced in June 1997, included the proposal to make both demonstration programs permanent. As of March 1998, the bills had been referred to the House Committee on Banking and Financial Services and the Senate Committee on Banking, Housing and Urban Affairs, respectively. No further action has been taken on the bills to date.

[11]Throughout this report, the term "reserved" means that housing finance agencies and/or financial institutions have set aside a portion of their allocated units for projects that are being developed (in the pipeline) or are completed and have been insured by FHA.

[12]This plan proposes a fundamental overhaul of HUD's management and delivery of services to ensure the Department's effectiveness into the 21st century.

## Objectives, Scope, and Methodology

As required by the Housing and Community Development Act of 1992, this report assesses HUD's implementation of the risk-sharing demonstration programs by evaluating how each (1) has been used to achieve its statutory and/or regulatory goals, (2) has been administered, and (3) could be improved to serve as a more effective source of housing finance.

To examine how the demonstration programs have been used to achieve their statutory and regulatory goals, we reviewed their legislative history, as well as key studies that documented problems in the capital market for affordable multifamily housing and the congressional purpose in creating the programs to address these problems. We also reviewed nationwide data on the units authorized and allocated under the programs as of September 1997. These data identify all participants and nonparticipants in the demonstration programs, the units allocated to the participants, and the types of properties supported by the programs.

To gain a firsthand perspective on the use and results of the credit enhancement program, we visited seven housing finance agencies, which accounted for over 65 percent of the units allocated to date. We also conducted structured telephone interviews and focus groups with all less active and nonparticipating housing finance agencies. In addition, we visited and conducted structured telephone interviews with institutions that have risk-sharing reinsurance agreements with HUD. Our purpose was primarily to identify impediments to the program's greater use and the benefits these institutions had achieved to date. Finally, we (1) compared the policies and procedures of the demonstration programs with those of FHA's traditional multifamily insurance programs to identify benefits unique to the demonstration programs and (2) reviewed and analyzed data on the characteristics and financial condition of the properties completed and insured under the demonstration programs to further assess the programs' support of affordable multifamily housing.

To review the demonstration programs' administration, we assessed HUD's (1) general administration of the programs and (2) monitoring of approved projects and enforcement of the program's requirements. As part of this assessment, we reviewed the credit enhancement program's regulations and the risk-sharing agreements between HUD and selected participating housing finance agencies and other qualified financial institutions. We also interviewed officials from HUD headquarters and field offices, as well as senior officials from the participating housing finance agencies and other qualified financial institutions. Additionally, we held discussions with representatives of all nonparticipating housing finance agencies and other key financial institutions to identify administrative impediments to their participation.

To identify any opportunities for improving either the credit enhancement or the reinsurance program, we held two separate focus groups with commercial banks and loan consortia—entities created and funded by banks and/or thrifts to provide financing for affordable housing developments, particularly multifamily rental properties. We asked both groups structured questions about their interest in participating in either of the risk-sharing programs, whether indirectly through existing participants or directly as participants in the reinsurance program.[13] We also asked them to identify the benefits they would expect to derive from participating in these programs. In addition, we conducted a structured telephone survey of participants in these focus groups to gain an understanding of their experiences with affordable multifamily lending.

We conducted our work at HUD headquarters and selected field offices throughout the country; the offices of the seven housing finance agencies that accounted for over 65 percent of the units allocated under the credit enhancement program (California; Colorado; Florida; Montgomery County, Maryland; Massachusetts; New Jersey; and New York State); the offices of five of the eight institutions that have received or are scheduled to receive units under the reinsurance program (Fannie Mae, Freddie Mac, the National Cooperative Bank, the Federal Home Loan Bank of New York, and the State of New York Mortgage Agency); and the offices of the Federal Housing Finance Board. To obtain additional perspectives on the demonstration programs, we spoke with representatives of the 4 housing finance agencies that, as of September 1997, had signed risk-sharing agreements but had not reserved any units and of the 24 state housing finance agencies that, as of that date, had not participated in the program. We also either conducted structured phone interviews or held panel discussions with representatives of the 23 remaining housing finance agencies that had signed agreements and had participated to some degree in the program. Finally, we spoke with representatives of the remaining qualified financial institutions that either had signed agreements to participate in the reinsurance program or had units allocated to them by HUD but had not yet signed agreements as of February 1998.

We provided copies of a draft of this report to HUD for its review and comment. The Department's comments appear in appendix IX and are

[13]Because they were not housing finance agencies, they were not eligible to participate in the credit enhancement program.

discussed at the end of chapters 3 and 4. We also provided a copy of a draft of this report to the National Council of State Housing Agencies and copies of relevant portions of the draft of this report to Fannie Mae, Freddie Mac, the Federal Housing Finance Board, the National Cooperative Bank, the Federal Home Loan Bank of New York, the Federal Home Loan Bank of Seattle, the State of New York Mortgage Agency, and Banc One Capital Funding Corporation. These groups offered a number of technical suggestions and clarifications, which we incorporated as appropriate.

We conducted our review from April 1997 through March 1998 in accordance with generally accepted government auditing standards. We relied on data obtained from housing finance agencies and other qualified financial institutions through the use of structured data collection instruments. We determined that the data were generally reliable and usable for our purposes.

# The Risk-Sharing Credit Enhancement Program Is Supporting the Financing of Affordable Multifamily Housing

In the 32 states and localities with participating housing finance agencies, the credit enhancement program is increasing access to capital markets and thereby supporting the production of affordable multifamily housing. Overall, about 84 percent of the 42,000 units allocated to these agencies through 1996 have been reserved for properties that either have been completed or are in the agencies' pipelines. The properties include new construction, rehabilitation, and refinancing in urban, suburban, and rural areas. Most of the properties are serving more low-income households than required because the credit enhancement is being combined with other subsidies, especially low-income housing tax credits.

Participation in the credit enhancement program has enabled housing finance agencies to increase their lending capacity, extend their loan terms, lower their interest rates, and process loans more quickly than they are able to do in their traditional multifamily insurance programs. As a result, the agencies have been able to finance affordable housing more efficiently, over longer periods of time. While it is still too early to evaluate the financial performance of the properties insured through the program, the available financial indicators appear to reflect sound underwriting criteria. Agencies that have not participated in the program identified several barriers to participation, some of which are beyond their control and others of which could be eliminated through training, wider marketing, or making the program permanent.

Participating agencies believe that they would derive even greater benefits if the program were made permanent and the limits on the number of authorized credit enhancement units were lifted. Agencies believe that demand for the program will increase with anticipated increases in the states' tax credit allocations[1] and with HUD's implementation of a mark-to-market initiative, under which HUD will refinance subsidized rental properties to bring their rents in line with local market rents.

## Unit Allocation and Use Vary Widely Among Housing Finance Agencies

To date, the Congress has authorized 49,500 units under the credit enhancement program. These units were made available through three separate authorizations. The first 30,000 units were authorized in October 1992 under the original statute establishing the program, the next 12,000 units were authorized in March 1996, and the last 7,500 units were authorized in June 1997. As of September 1997, 28 state housing finance

[1]The Low-Income Housing Tax Credit program is currently the largest federal program to fund the development and rehabilitation of multifamily housing for low-income families. Each year, states are allocated tax credits in an amount equal to $1.25 per resident. Legislation is being proposed to increase this amount to $1.75.

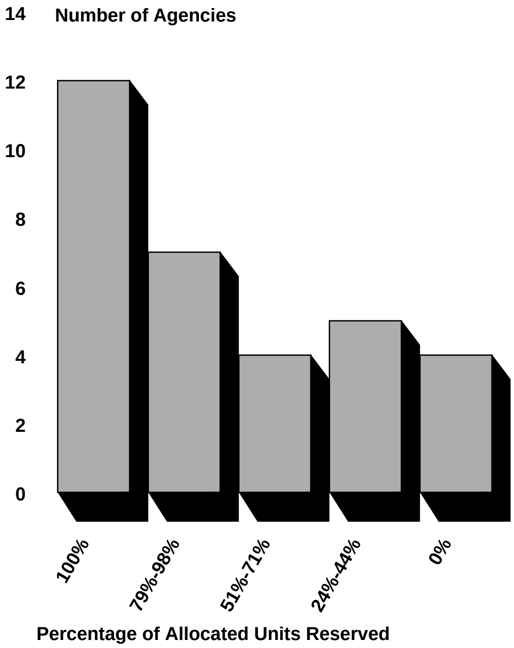
agencies and 4 local housing finance agencies[2] had entered into risk-sharing agreements with HUD and had received allocations.

According to HUD officials, HUD allocated the first 30,000 units on the basis of the population of the states that had signed risk-sharing agreements with HUD. It allocated the two subsequent authorizations on the basis of usage. HUD's application of these criteria has resulted in wide variation among the states in the number of units allocated. Five states—California, Colorado, Florida, Massachusetts, and New York—and one local agency—Montgomery County, Maryland—have received approximately 65 percent of the 42,000 units authorized as of March 1996. California and Florida alone have received over 15,000 units.

In total, as of September 1997, the housing finance agencies had reserved 35,116 units, or about 84 percent of the 42,000 units authorized as of March 1996, for either completed properties (12,851 units) or properties in their pipelines (22,265 units). From state to state, however, this percentage varies widely. Specifically, 19 of the 32 housing finance agencies have reserved more than 75 percent of their allocations for either completed properties or properties in their pipelines. Nine agencies have reserved between 24 and 75 percent of their allocations, and the four remaining agencies have not reserved any of their allocations. Figure 2.1 shows the extent to which the participating agencies have reserved their allocations. (See apps. I and II for detailed information on the uses that the 32 housing finance agencies had made of their allocations as of October 1997.)

[2]The four local agencies are Montgomery County, Maryland; Philadelphia, Pennsylvania; Fairfax County, Virginia; and New York City, New York.

**Figure 2.1: Percentage of Allocations Reserved, by Number of Agencies, as of September 1997**




Source: GAO's analysis of data provided by housing finance agencies.

Several factors are associated with the extent to which housing finance agencies have used their allocations. Those that have reserved over 75 percent of their units generally have active multifamily programs, have a significant demand for multifamily housing within their state, and/or do not have a comparable credit enhancement mechanism available. From the start, many of these agencies appear to have recognized the potential benefits of participation. In contrast, agencies that have reserved fewer than 50 percent of their units generally have less demand for multifamily housing, are not as experienced in operating a multifamily housing finance program, or have an alternative credit enhancement mechanism available.

As of September 1997, four housing finance agencies had not reserved any of their allocations. The Alaska Housing Finance Corporation had not used its 50-unit allocation because it believed that the program's benefits were marginal relative to the cost of the credit enhancement. The New York City Housing Finance Agency had not used its 300-unit allocation because, after allocating most of its revenue bond authority to raise capital for financing single-family housing, it did not have sufficient authority to finance multifamily housing. HUD recaptured these agencies' units and reallocated them to other agencies. In Indiana and Louisiana, the housing finance agencies were slow to use their allocations—300 units and 280 units, respectively—because they did not join the risk-sharing program until a year and a half after other agencies had joined and other priorities delayed the start of their risk-sharing programs. HUD has not sought to recapture their units.

## Program Is Helping to Finance Properties Serving Diverse Markets and Income Groups

Housing finance agencies are insuring properties in urban, suburban, and rural markets. These properties, most of which are newly constructed or substantially rehabilitated, vary in size and serve various populations and income levels. Overall, the percentage of low-income households served through the credit enhancement program is higher than required by statute.

### Agencies Are Serving Different Housing Markets

Data from the housing finance agencies show that 110 completed properties had been insured through the risk-sharing program as of September 1997. Overall, approximately 47 percent of the units in these completed properties are in urban areas, 44 percent in suburban areas, and 9 percent in rural areas. The distribution of units reserved for properties in the agencies' pipelines is somewhat different: 57 percent are in urban areas, 36 percent in suburban areas, and 7 percent in rural areas. Appendix III shows, for each of the 32 housing finance agencies, the significant variation in the distribution of units for properties that have been completed and are in their pipelines.

### Program Is Being Used Primarily to Finance New Construction

Agencies are generally using the credit enhancement program to help finance new properties. Nationwide, 48 percent of the units in the 110 completed properties were in new construction, 32 percent in substantial rehabilitation, 14 percent in refinancing, and 6 percent in acquisition. Units reserved by agencies for properties in their pipelines are concentrated even more heavily in new construction. Specifically, 66 percent of these units are reserved for new construction, 29 percent for rehabilitation, and

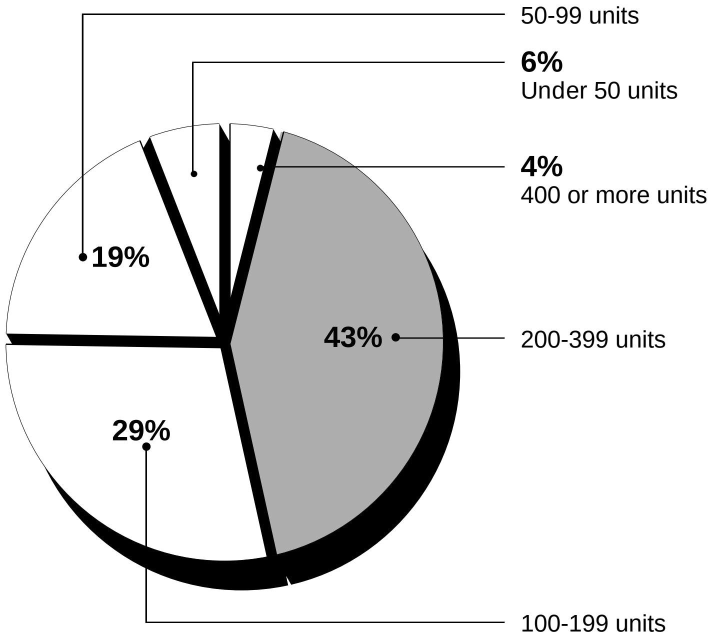
5 percent for refinancing.[3] Appendix IV shows the variation in how the housing finance agencies have used their allocations to finance different types of construction for properties that have been completed or are in their pipelines.

## Properties Vary in Size

The average number of units for the 110 completed properties is 117; however, some of these properties have as few as 8 units, while 1 property has 500 units. Overall, as figure 2.2 shows, the program has primarily supported the financing of larger properties. About half of the units are in properties with more than 200 units, and only about 6 percent of the units are in properties with fewer than 50 units. For properties in the agencies' pipelines, the proportion of smaller properties has increased—about 15 percent have been reserved for properties with 50 or fewer units. As noted in chapter 1, HUD has identified smaller properties as an unmet capital need.

[3]According to housing finance agency officials, the current limits on the number of available units can create a bias in favor of new construction because new construction generally costs more per unit than rehabilitation. Therefore, agencies that use the credit enhancement program to finance new construction may obtain a higher value for their units than agencies that use the program to finance rehabilitation. However, according to HUD, rehabilitation projects are an unmet capital need, especially in inner-city neighborhoods.

Figure 2.2: Percentage of Total Units, by Size, of Completed Properties as of September 1997




Source: GAO's analysis of data provided by housing finance agencies.

Such variation in size is even greater from one housing finance agency to another, reflecting different market conditions and local housing needs. Appendix V shows how, for completed properties, the housing finance agencies used their units to help finance properties of varying sizes.

Despite the variation in the size of the properties financed through the credit enhancement program, most housing finance agencies have not used the program to support properties of fewer than 50 units. According to housing finance agency officials, such properties do not afford the economies of scale that allow them to underwrite and provide long-term permanent financing for affordable housing. The officials also said that they rely on other programs to develop smaller properties. Florida, for example, relies on the HOME[4] program and state funding sources, while

[4]The HOME Investment Partnerships program was established in November 1990 by the HOME Investment Partnerships Act to provide funds to expand the supply of affordable housing for persons with very low and low incomes.

Colorado assists smaller properties by cross-subsidizing some of the costs through fees charged to larger properties. Finally, housing finance agency officials said, smaller properties are generally perceived as riskier than larger ones because they are more prone to management deficiencies and more likely to be located in distressed areas.

## Household Types and Income Levels Vary Widely

Nationally, for completed properties, housing finance agencies have used about 74 percent of their risk-sharing units for properties serving families, 25 percent for properties serving the elderly, and 1 percent for properties serving people with special needs, such as those who are homeless or disabled. However, these percentages vary considerably from one housing finance agency to another. For instance, the Massachusetts agency has used almost half of its risk-sharing units for facilities serving the elderly, while the Florida agency has used 100 percent of its units for properties serving families. Many of the units in the Florida properties have multiple bedrooms to meet the needs of large low-income families.

Besides targeting different types of households, housing finance agencies are using the credit enhancement program to serve households at different income levels. All of the agencies are meeting the program's income eligibility criteria. In addition, the agencies as a group are financing properties that serve more low-income households than the program requires.[5] Specifically, of the 12,851 risk-sharing units in completed properties as of September 1997, 8,400, or about 65 percent, are reserved for households with incomes at or below 60 percent of the local area's median income. This percentage varies from one state to another. In five states and two localities,[6] the housing finance agencies have reported using all of their risk-sharing units for properties that serve only low-income households.

Most of the properties that are exceeding the credit enhancement program's income-targeting requirements are also being financed by other subsidies. Specifically, about 74 percent of these properties also receive

[5]At a minimum, to be eligible for insurance under the risk-sharing program, a property must set aside either 20 percent of its units for households with incomes at or below 50 percent of the area's median income or 40 percent of its units for households with incomes at or below 60 percent of the area's median income. Therefore, the remaining units may be rented at market rates, or they may be subject to rent restrictions if additional restrictions are required to receive or take advantage of other housing subsidies. For example, the Low-Income Housing Tax Credit program establishes the same rent restrictions as the credit enhancement program, but tax credits are available only for rent-restricted units. Thus, in many properties financed with tax credits, all of the units are rent restricted.

[6]The states are Kentucky, Maryland, Montana, Oregon, and Rhode Island. The localities are Philadelphia, Pennsylvania; and Fairfax County, Virginia.

other subsidies that have income restrictions at least as stringent as the risk-sharing program's. For example, 61 properties, containing 7,376 units, were subsidized through the Low-Income Housing Tax Credit program. In our March 1997 report on this program,[7] we estimated that about three-fourths of the households in tax-credit-supported units had incomes in 1996 that were at or below 50 percent of the local area's median income. Appendix VI shows the income levels being served by the 21 housing finance agencies that had completed properties with risk-sharing units as of September 1997.

## Housing Finance Agencies Have Derived Key Benefits From Their Participation in the Credit Enhancement Program

Two key objectives of the credit enhancement program are to (1) increase the production of affordable multifamily housing and (2) make affordable housing available to eligible families and individuals in a timely manner. Another objective is to ensure the financial soundness of the affordable multifamily housing properties insured under the program.[8] Our work shows that housing finance agencies and HUD have essentially met these objectives: First, the program has allowed housing finance agencies to finance affordable housing by leveraging their reserves, lowering their interest rates, and extending their loan terms. Additionally, the program has assisted some housing finance agencies in establishing viable affordable multifamily housing programs. Second, by delegating the underwriting and processing of affordable multifamily housing loans to housing finance agencies, the program has enabled borrowers to obtain loans in a more timely manner. Finally, by creating risk-sharing arrangements predicated upon a sharing of losses, the program has established appropriate incentives for financing economically sound properties.

### Affordable Housing Is Being Developed

The credit enhancement program has facilitated the production of affordable multifamily housing, primarily by allowing housing finance agencies to leverage their reserves and by lowering borrowing costs and extending mortgage terms. In addition, the credit enhancement program has helped three housing finance agencies establish affordable multifamily housing programs.

[7] Tax Credits: Opportunities to Improve Oversight of the Low-Income Housing Program (GAO/GGD/RCED-97-55, Mar. 28, 1997).

[8] As noted in ch. 1, a statutory objective of the reinsurance program is to ensure the maintenance, through risk sharing, of "sound underwriting and loan management practices."

## Leveraging Reserves

In our judgment, the single greatest benefit that housing finance agencies have derived from their participation in the credit enhancement program is the ability to leverage their reserves. To raise capital to finance affordable multifamily housing, these agencies sell bonds to investors. To pay the lowest possible interest rate on the bonds, an agency provides a credit enhancement (i.e., funded reserves) or purchases a credit enhancement (i.e., risk-sharing insurance) to improve its bond rating.[9] If the agency provides a credit enhancement, it is usually required to fund a dedicated reserve account equal to a fixed percentage of its outstanding mortgages, as required by a national rating agency such as Standard and Poor's or Moody's. Consequently, the ability of the agency to finance affordable multifamily housing is limited by its available reserves. The agency can leverage its reserves by participating in the credit enhancement program: When it uses the program to enhance the credit of the loans it offers as collateral for the bonds it sells, it reduces its reserve requirement in direct proportion to the percentage of risk assumed by HUD. For example, when HUD assumes 50 percent of the risk, the agency reduces its reserve requirement by 50 percent, meaning that it can double its financing capacity without increasing its reserves. As of September 1997, about 90 percent of the units were in properties financed by loans for which HUD has assumed at least 50 percent of the risk. All of the participating housing finance agencies with insured loans have derived this leveraging benefit.

The importance of leveraging varies not only with the percentage of risk assumed by HUD but also with the level of reserves maintained by the agency and the agency's demand for financing. The benefit is much greater for an agency that does not have sufficient reserves to meet the current and/or anticipated demand than for an agency that has larger reserves and/or lower demand. The California Housing Finance Agency, which was allocated more risk-sharing units than any other housing finance agency, was one of the agencies that derived substantial benefits from leveraging. When the agency entered into a 50/50 risk-sharing agreement with HUD in 1994, the demand for affordable multifamily housing was very high because, according to agency officials, the savings and loans crisis in the late 1980s and an economic recession that continued in many regions of the state until 1995 had limited the agency to financing about $25 million a

[9]The rating of the bonds is critical to a viable bond issue. The higher the rating, the less the perceived risk to the investor and, thus, the more marketable the bonds. The reduced risk associated with the bonds encourages investors to accept a lower bond yield. The lower the bond yield, potentially the lower the effective mortgage interest rate paid by the developer of the affordable multifamily property. As defined by Moody's, bonds rated "A" possess many favorable investment attributes and are to be considered as upper-medium-grade obligations. A medium-grade obligation indicates that as long as there is no significant economic decline, the bond will be able to meet payments when due.

year, on average, in affordable multifamily housing. After entering the credit enhancement program, the agency increased its financing to about $200 million per year. According to agency officials, about half of this activity is attributable to the leveraging benefit they derive from their 50/50 risk-sharing partnership with HUD.

## Lowering Borrowing Costs

Another benefit of the credit enhancement program—lowering borrowing costs—has helped to increase the production of affordable multifamily housing to the extent that such housing would not have been economically feasible at higher interest rates. Because the credit enhancement program generally enhances the credit rating on bonds issued by housing finance agencies, investors are willing to accept a lower yield (interest rate). If this lower rate is passed on to developers, it makes the development of affordable multifamily housing more feasible. The actual reduction in interest rates attributable to the risk-sharing program varies with the credit ratings of individual housing finance agencies, as well as with market interest rates at given times. Because most housing finance agencies participating in the risk-sharing program generally have at least an "A" credit rating and because market interest rates have been low over the past few years, the risk-sharing program has generally contributed to only a marginal reduction in interest rates (15 to 30 basis points). However, housing finance agencies reported to us that even marginal reductions in interest rates can affect the financial feasibility of affordable multifamily properties.

In at least one instance, participation in the credit enhancement program contributed to a significant reduction in interest rates. The Montgomery County housing finance agency used the program to refinance a 311-unit property. The original mortgage was financed by two bond issues with a combined interest rate of about 8 percent. After the refinanced mortgage was insured through the credit enhancement program—when market interest rates were lower than they had been at the time the property was originally financed—the interest rate dropped to about 6 percent. This 2-percent reduction, together with a write-off of part of the original debt, allowed the housing finance agency to maintain the property as affordable housing.

## Extending Mortgage Terms

Finally, several housing finance agencies have used the credit enhancement program to extend the mortgage repayment period to 40 years. A longer repayment period can make an affordable multifamily property more financially feasible because less operating revenue is required to meet the monthly mortgage payments. For example, the New

York State Housing Finance Agency used the program to provide a 40-year mortgage for an 83-room property with 142 beds designed to serve elderly residents, including those who are mentally ill, handicapped, and/or homeless. Because these residents have very limited incomes, the 40-year mortgage was necessary to make the property financially feasible for the residents. State agency officials said that without the credit enhancement program, the term of the mortgage would have been 30 years because the agency would have had to rely on a state mortgage insurance program that limits mortgages to 30 years or less. Had the agency been required to use this state program, the officials said, additional subsidies would have been needed to reduce the amount of the mortgage loan to make the property financially feasible.

### Establishing Affordable Multifamily Lending Programs

The credit enhancement program has helped three housing finance agencies—in Florida, Kentucky, and New Mexico—establish viable affordable multifamily lending programs. In Florida, the program gave the agency access to a continuous and reasonably priced source of credit enhancement, which it needed as security for its bonds so that it could finance affordable multifamily housing. Similarly, in Kentucky and New Mexico, the program gave the agencies access to an affordable source of credit enhancement that enabled them to compete with other sources of financing available to developers of multifamily housing. In Kentucky, the credit enhancement enabled the housing finance agency to provide financing for developers of smaller properties (24 to 30 units) in rural areas—an important benefit, given recent reductions in funding for the Rural Housing Service's section 515 program. In New Mexico, the credit enhancement also enabled the agency to finance properties with fewer than 100 units, as well as properties for persons with special needs. Such housing was not being developed through other sources.

## Affordable Multifamily Housing Is Being Financed in a Timely Way

The credit enhancement program is achieving its second key objective —making affordable housing available in a timely manner. Because the program delegates to housing finance agencies much of the loan underwriting and processing authority that HUD retains under FHA's traditional insurance programs, it delivers FHA insurance more efficiently than the traditional programs (see ch. 4).

The efficiencies in loan processing gained through the program provide two direct benefits to developers of affordable housing—(1) an earlier determination of a property's financial feasibility and (2) the savings associated with being able to initiate construction sooner rather than later.

Because the development of affordable housing frequently requires multiple subsidies and a property's financial feasibility generally depends on bringing all of these subsidies and any related debt financing together by a specific time, any delay in approving the financing can jeopardize the property's feasibility. The Florida Housing Finance Agency has taken advantage of the program's efficiencies to bring together the financing for both construction loans and permanent mortgage loans in a timely way. This agency issues bonds to finance both types of loans for its affordable multifamily properties. While it uses a private bond insurer to provide a credit enhancement for the construction financing, it uses the risk-sharing program to provide a credit enhancement for the permanent financing. Because the private insurer requires assurance that the permanent financing will be available before it agrees to provide the credit enhancement for the construction financing, the agency needs to obtain the credit enhancement for the permanent loan expeditiously. The program provides the credit enhancement expeditiously, whereas delays could occur in HUD's traditional multifamily insurance programs. Such delays could, in the opinion of agency officials, postpone the development of certain properties long enough to increase their costs to the point that the properties would no longer be financially feasible.

An associated benefit of more prompt approval of a property's permanent financing is reflected in the adage that "time is money." According to officials at various housing finance agencies, by reducing the time required for processing loans, the program has reduced the costs of developing properties. In addition, by shortening the time required for approving permanent mortgages, some of these officials noted, the program has provided developers with better assurance that proposed properties will be financially feasible. The faster approval time avoids potential increases in interest rates that could be high enough to prevent some properties from being built.

## Partnerships Promote the Financial Viability of Insured Properties

As previously discussed, the credit enhancement program establishes economic incentives for HUD and its risk-sharing partners to perform their respective functions properly and makes them financially accountable if they do not. Although little information is currently available for evaluating the financial performance of housing finance agencies as risk-sharing partners, the available indicators suggest that the agencies are generally using the program responsibly.

It is still too early to project the financial performance of the 110 properties insured under the credit enhancement program through September 1997; however, our limited analysis indicates that reasonable underwriting standards were applied. We reviewed two key financial indicators, the debt service coverage ratio[10] and the loan-to-value ratio,[11] and found that the participating housing finance agencies have used generally accepted underwriting criteria for the loans they have insured under the program.

The debt service coverage ratio is used in underwriting to evaluate the potential for a property's income to cover the property's mortgage debt. The higher the ratio, the less the property is likely to face financial difficulties that could lead to default. The benchmark generally used in the housing industry for unsubsidized properties is about 1.20. However, for subsidized properties, this benchmark can range from 1.05 to 1.15. A lower debt service coverage ratio can allow rents to be lower, making a property more affordable to low-income households. Our analysis of data provided by the 21 housing finance agencies showed that, for the 110 properties completed as of September 1997, the median debt service coverage ratio was 1.11. Moreover, as table 2.1 indicates, about 33 percent of the insured units were in properties with a debt service coverage ratio of more than 1.15, and over 95 percent of the units were in properties with a debt service coverage ratio of at least 1.05.

**Table 2.1 Debt Service Coverage Ratio for Insured Properties as of September 1997**

| Debt service coverage ratio | Number of properties | Number of units | Percentage of units |
|---|---|---|---|
| Above 1.15 | 33 | 4,278 | 33.3 |
| 1.10 to 1.15 | 60 | 6,545 | 50.9 |
| 1.05 to 1.09 | 13 | 1,421 | 11.1 |
| Below 1.05 | 3 | 523 | 4.0 |
| Not reported | 1 | 84 | 0.7 |
| **Total** | **110** | **12,851** | **100.0** |

Source: GAO's analysis of questionnaire data provided by housing finance agencies.

The loan-to-value ratio is used to determine whether a property's cash value will be sufficient to cover the mortgage debt in the event of foreclosure. The lower the ratio, the more the property's value is likely to

[10]The debt service coverage ratio is a property's net operating income divided by the required mortgage payments.

[11]The loan-to-value ratio is the outstanding mortgage on a property divided by its market value.

be sufficient to pay off the outstanding mortgage obligation. Among private lenders, the benchmark used to finance unsubsidized properties is about 80 percent, and under FHA's traditional multifamily insurance program for profit-making developers it is 90 percent. Under FHA's traditional multifamily insurance program for nonprofit sponsors, the loan-to-value ratio can be as high as 100 percent. The median loan-to-value ratio for insured units under the risk-sharing program is 80 percent. Table 2.2 presents the loan-to-value ratios for units in properties insured as of September 1997. As the table indicates, most of the units are in properties with loan-to-value ratios ranging from 70 to 90 percent.

**Table 2.2: Loan-To-Value Ratio for Insured Units as of September 1997**

| Loan-to-value ratio | Number of units | Percentage of units |
|---|---|---|
| Equal to 100 percent | 394 | 3.1 |
| 90-99 percent | 1,130 | 8.8 |
| 70-90 percent | 7,796 | 60.6 |
| Below 70 percent | 3,287 | 25.6 |
| Not reported | 244 | 1.9 |
| **Total** | **12,851** | **100.0** |

Source: GAO's analysis of questionnaire data provided by housing finance agencies.

It is too early to project the future performance of loans insured through the credit enhancement program. However, data reported by agencies participating in the program generally indicate that their entire portfolios are performing well. According to these data, the agencies' existing multifamily portfolios show less than 1.28 percent of their total loan dollars in default and less than 0.34 percent in foreclosure. However, one loan, originated by the California Housing Finance Agency under the credit enhancement program, went into default shortly before it received final endorsement from HUD. This loan was one of the three loans with an original debt service coverage ratio below 1.05 (see table 2.1). Although the California Housing Finance Agency should have notified HUD headquarters of this default, it notified the responsible HUD field office instead. The field office did not forward the information to HUD headquarters. Therefore, headquarters officials were not aware of the default until we brought it to their attention. As noted in chapter 4, California is withdrawing this loan from the risk-sharing program.

## Agencies' Reasons for Not Participating in the Credit Enhancement Program Varied

We contacted the 24 state housing finance agencies that have not participated in the credit enhancement program to understand why they have not done so. Their responses are summarized in table 2.3.

**Table 2.3: Housing Finance Agencies' Reasons for Not Participating in the Credit Enhancement Program**

| Reasons for not participating | Number of agencies | Percentage of total response |
|---|---|---|
| State's multifamily program was limited or nonexistent and/or agency could not meet program's reserve requirements | 13 | 55 |
| State policies and legislative processes prevented participation | 5 | 21 |
| Staff lacked sufficient knowledge and skills to operate program | 2 | 8 |
| Agency believes it is ineligible for program | 1 | 4 |
| Agency relies on other options to finance multifamily housing | 2 | 8 |
| Agency provided no reason | 1 | 4 |
| **Total** | **24** | **100** |

Source: GAO's analysis of data from structured telephone interviews with nonparticipating housing finance agencies.

Some of the reasons cited for not participating, such as not having a multifamily program or being subject to state policies that prevent participation, appear to be outside the agencies' control. Eighteen, or about 76 percent, of the agencies identified these reasons as barriers to their participation. Other reasons for not participating, such as not having sufficient knowledge of the program's benefits or staff skills, could be eliminated through training, hiring contractors, and/or marketing the program and its benefits more effectively. The Florida Housing Finance Agency, for example, hires contractors to underwrite its loans because it has not hired in-house staff to perform this function. Two of the agencies identified these reasons as barriers to their participation. Finally, two of the agencies reported relying on other options to finance their multifamily mortgages. One of the agencies said that it works with banks to finance its multifamily housing, while the other indicated that it has a high enough credit rating to finance its properties without the program. However, 42 percent of these agencies indicated that if circumstances changed, they would consider using the credit enhancement program.

## Changes to the Credit Enhancement Program Could Facilitate the Financing of Affordable Multifamily Housing

According to the participating housing finance agencies, several changes would improve the financing and administration of the credit enhancement program. Options for improving the program's administration are discussed in chapter 4. Options for improving the program's financing are discussed in the remainder of this chapter.

Housing finance agencies believe that making the credit enhancement demonstration program permanent and removing the legislative limits on the number of authorized units would assist them in planning for and financing additional affordable multifamily housing. According to the agencies, both the program's demonstration status and the limits on the number of available units are hampering their marketing of the program and management of their multifamily resources. Some agencies have used all or nearly all of their credit enhancement units to meet the current demand, and if bills proposing to increase the states' per-capita tax credit allocations are enacted, they are likely to see an even greater demand for credit enhancement units. Finally, the credit enhancement program may be used to insure mortgages refinanced under the Multifamily Assisted Housing Reform and Affordability Act of 1997, commonly known as "portfolio reengineering" or "mark-to-market." Although the Congress has provided statutory authority to meet any increased demand for risk-sharing units attributable to this program, making the credit enhancement program permanent would logically complement this authority.

### Lack of Permanency Impedes Efficient Management

Because the credit enhancement program was established as a demonstration program, HUD must seek congressional authorization to (1) extend its duration and (2) obtain additional units. If the program is made permanent, its insurance authority will, presumably, be limited by a dollar amount, which can be adjusted with demand, rather than by a unit allocation. FHA's traditional mortgage insurance programs operate under a dollar cap, which the Congress has increased as necessary to provide for greater activity.

According to the housing finance agencies, the program's lack of permanency and limits on the number of available units impede their marketing of the program to lenders, management of multifamily resources, and financing of affordable multifamily properties. For example, the New Mexico Housing Finance Agency noted that the program is difficult to market to affordable multifamily housing developers when the agency is unsure how long the program will continue and whether the agency will have enough units to meet the potential demand. Similarly, officials from the California Housing Finance Agency told us that because it can take 3 to 4 years to structure the financing for and develop an affordable multifamily property, they need an ongoing stream of units or dollars available over a long period of time. Officials from several other agencies confirmed that the uncertainty surrounding the program's future and level of activity hinders their marketing of the program and creates problems for them in planning the financing of additional affordable multifamily properties.

As shown in appendix I, many housing finance agencies have reserved all or nearly all of their allocated units, and some agencies do not have enough additional units to meet the current demand. Specifically, 12 of the 32 participating housing finance agencies had reserved all of their allocated units by September 1997, and another 6 agencies had reserved between 89 and 98 percent of their units. According to officials at several of these agencies, they have other properties in their pipelines that are candidates for the credit enhancement program, but they are waiting to receive additional units before they formally agree to use the program to help finance these properties' development. According to officials at the Florida Housing Finance Agency, the agency has reserved all but 605 of the 7,002 units in its allocation. It has properties with a total of 605 units in its pipeline and estimates that it could use another 1,600 units per year. However, until it receives an additional allocation, it cannot satisfy this demand through the credit enhancement program. Officials at the Maine Housing Finance Agency told us that they had reserved 140 of the 150 units in the agency's original allocation and may not reserve the 10 remaining units unless they receive an additional allocation.

## Demand for Credit Enhancement Units Is Likely to Increase With an Increase in the States' Tax Credit Allocations

Housing finance agencies have frequently used the credit enhancement program in conjunction with the Low-Income Housing Tax Credit program. As previously noted, 61 of the 110 completed properties that were financed through the credit enhancement program were also financed through the Low-Income Housing Tax Credit program. Using the two programs together is logical, given that both have the same income eligibility criteria.

As we reported in March 1997,[12] the Low-Income Housing Tax Credit program is currently the largest federal program to fund the development and rehabilitation of housing for low-income households. Since the program's inception in 1986, the Internal Revenue Service has allocated tax credits to each state in an amount equal to $1.25 per resident to be used to help finance affordable multifamily housing properties. During the 3-year period (1992-94) covered by our study, this allocation supported the development of about 4,100 low-income housing properties containing about 172,000 units.

Currently, according to a general consensus in the housing industry, the demand for low-income housing tax credits is exceeding the supply by about three or four to one. Accordingly, S. 1252 and H.R. 2990, introduced in 1997, propose to increase each state's tax credit allocation to $1.75 per resident and to index, or adjust, this amount annually for inflation. Should these bills become law, the production of affordable housing could be expected to increase. Given the past association between the tax credit and the risk-sharing programs, the demand for risk-sharing units would also be likely to increase.

## Credit Enhancement Program Has Been Authorized to Support HUD's Mark-To-Market Demonstration Program

About 8,600 privately owned multifamily properties with FHA-insured mortgages totaling $17.8 billion receive federal rental subsidies for some or all of their apartments under HUD's section 8 project-based assistance program. These properties contain about 859,000 units. For subsidized units, HUD pays the difference between the rent and 30 percent of the household's income. The rents at many properties exceed market levels, resulting in high subsidies. To reduce the costs of these subsidies and address other problems, HUD proposed adjusting the rents to market levels and writing down the mortgages as needed to allow the properties to operate at market rents.

The Congress generally adopted HUD's proposal when it enacted the Multifamily Assisted Housing Reform and Affordability Act of 1997, which authorized the mark-to-market program. The act encourages owners of eligible multifamily housing properties to restructure their FHA-insured mortgages and project-based assistance contracts before the contracts

[12]Tax Credits: Opportunities to Improve Oversight of the Low-Income Housing Program (GAO/GGD/RCED-97-55, Mar. 28, 1997).

expire. The purposes of this act are to ensure the continued economic and physical viability of the properties, protect FHA's General Insurance Fund from excessive defaults, reduce the long-term costs of these insured properties, and guard against the possible displacement of families.

To restructure these mortgages, the act requires HUD to enter into portfolio restructuring agreements with participating administrative entities that (1) have demonstrated experience in working with low-income residents, (2) have demonstrated the capacity to restructure the financing of eligible multifamily properties, and (3) have a history of financial stability. The act gives preference to housing finance agencies to serve as the participating administrative entities under these agreements. The act also encourages housing finance agencies to use several tools, including the risk-sharing program, to help them restructure the mortgages of eligible multifamily properties. In addition, the act specifies that the number of units used to refinance eligible multifamily housing properties under the mark-to-market legislation will not reduce the number of units available for mortgage insurance under section 542. Moreover, any credit subsidy costs of providing mortgage insurance are to be paid from the Liquidating Accounts of the General Insurance Fund or the Special Risk Insurance Fund.

As of May 1997, HUD had designated 30 state housing finance agencies, with three-quarters of the properties eligible for the mark-to-market initiative within their jurisdiction, to serve as entities under the mark-to-market demonstration program.[13] HUD's guidelines and instructions for implementing the demonstration program require each designated entity to develop a management plan for implementing the program and receive an approved contract from HUD to restructure mortgages. As of the end of January 1998, 17 state and local housing finance agencies, all with risk-sharing agreements, had obtained HUD's approval of their management plans, and 6 agencies had also obtained approved contracts. As of this date, however, none of these agencies had restructured any mortgages.

Housing finance agency officials identified two key impediments to using the credit enhancement program for restructuring mortgages. First, while the mark-to-market legislation authorizes the use of the credit enhancement program as a restructuring tool and thus assumes the program's continuation, the officials have no assurance that the program will continue. Housing finance agency officials told us that before they

[13]Before the enactment of the 1997 act, HUD operated a mark-to-market demonstration program.

plan to use the program in restructuring loans, they need to be assured that the program will be available when the restructuring occurs.

Second, housing finance agency officials were reluctant to use the credit enhancement program to insure these refinanced loans because they would then be exposed to risk if HUD did not renew the properties' section 8 rental assistance contracts. If HUD did not renew the contracts, the properties might not generate enough income to repay the refinanced loans, and the properties' financial solvency might be jeopardized. These housing finance agency officials told us that because the decision to renew the contracts would rest with HUD, they would not want to insure these properties through the credit enhancement program unless FHA assumed total responsibility for any losses resulting from a decision by HUD not to renew the section 8 contracts. We discussed this issue with the senior HUD official responsible for administering the mark-to-market demonstration program. According to him, only 1 of the 17 agencies had expressed an interest in providing the funding for any restructured mortgages. The other agencies had only expressed an interest in facilitating the restructuring of the mortgages and had suggested that the capital for the refinancing should come from a source outside the refinancing agency. According to this official, if HUD were to assume total liability in the event that it chose not to renew section 8 contracts, more housing financing agencies would likely be interested in refinancing restructured mortgages.

A bill (H.R. 2447) was introduced in September 1997 to provide for HUD to "assume an appropriate share of the risk of a loan for affordable multifamily housing in a manner that mitigates uncertainties regarding actions of the Federal Government (including the possible failure to renew short-term subsidy contracts)." This bill has been referred to the House Committee on Banking and Financial Services.

## Conclusions

The credit enhancement demonstration program is meeting several key objectives, including facilitating the financing of affordable multifamily housing and making affordable multifamily housing available in a timely manner. Making the program permanent and lifting the limits on the number of available units could have several benefits. Specifically, housing finance agencies currently participating in the program could be expected to increase their activity to meet both current and anticipated demand, and nonparticipating agencies could be expected to give more consideration to entering the program knowing that its benefits would be available in the future. Agencies might also be encouraged to expand their financing for smaller properties and for rehabilitation projects, particularly in underserved rural and inner-city markets. In addition, permanency would support the program's continued use in financing tax-credit-supported properties and would complement anticipated increases in states' tax credit allocations. Finally, permanency would support the use of the credit enhancement program with the "mark to market" program. However, until a decision has been reached on whether FHA will assume the entire risk of default if HUD does not renew short-term section 8 subsidy contracts on properties with restructured mortgages, housing finance agencies will be unlikely to finance these restructured mortgages. And unless an agency does finance these mortgages, it will not need to use the credit enhancement program to support the mark-to-market initiative.

Finally, permanency implies that HUD will exercise appropriate administrative controls over housing finance agencies to ensure that they are meeting their responsibilities under the program, that the government's interests are being protected, and that the program's results can be evaluated. Problems with these administrative controls and HUD's plans to address them are discussed in chapter 4.

# The Risk-Sharing Reinsurance Program Is Largely Untested Because Participation Has Been Limited

Today, more than 5 years after the reinsurance program was authorized, the program remains largely untested. Although HUD's risk-sharing partners have the potential to expand the participation of major financial institutions in mortgage lending, as envisioned in the risk-sharing statute, only one of the four institutions that was allocated units authorized in 1992—Fannie Mae—has participated extensively in the program, and one lender—Banc One Capital Funding Corporation—has originated over half of the loans that Fannie Mae has reinsured. Banc One Capital's experience has demonstrated that the reinsurance program can expand participation in mortgage lending, including lending for smaller properties in rural areas. Resolving questions about the use of reinsurance with balloon mortgages and loan pools and building on recent initiatives of two Federal Home Loan banks, assuming these initiatives are successful, could expand participation in the program.

## Partnerships Create the Potential for Wider Lending

HUD's current and designated risk-sharing reinsurance partners represent a range of financial institutions that operate nationally and at the state and city levels. All of these institutions have affordable housing goals and, with the exception of the two loan consortia,[1] have strong credit ratings. As a group, they have the potential to expand the participation of major financial institutions in affordable multifamily lending.

Legislation has authorized a total of 22,500 units for the reinsurance program—15,000 in 1992 and 7,500 in 1996. In 1994, HUD signed risk-sharing agreements with four qualified financial institutions and allocated the first 15,000 units among them. Three of these institutions—Fannie Mae, Freddie Mac, and the National Cooperative Bank—operate nationally, and the fourth—the Federal Home Loan Bank of Seattle—operates regionally but is affiliated with the national Federal Home Loan Bank System. The 12 affiliates of this system are regulated by the Federal Housing Finance Board and have 6,504 member banks that operate in all 50 states.

HUD earmarked the 7,500 units authorized in 1996 to four new institutions—the State of New York Mortgage Agency (SONYMA), the Federal Home Loan Bank of New York, the Community Preservation Corporation (CPC), and the California Community Reinvestment Corporation (CCRC). SONYMA is a state agency whose activity is restricted to New York State. CCRC and CPC are loan consortia; CCRC operates at the state

[1]Loan consortia were created and funded by banks and/or thrifts to provide financing for affordable housing developments, particularly multifamily rental properties.

level, while CPC operates at the city and metropolitan-area level. To date, HUD has signed risk-sharing agreements with SONYMA (in April 1997) and the Federal Home Loan Bank of New York (in January 1998) and is negotiating agreements with CPC and CCRC. All of the risk-sharing agreements provide 50-percent FHA reinsurance for loans purchased under the program.

## Only One Institution Has Been Active in the Risk-Sharing Reinsurance Program

Fannie Mae is the only recipient of units authorized in 1992 that has participated extensively in the reinsurance program. Fannie Mae has reserved all of its 7,500 units for 48 properties. As of October 31, 1997, six of these properties, with 956 units, have received final endorsement from HUD, and the remaining 42 properties, with 6,544 reserved units, are in various stages of development. Freddie Mac, the only other original participant with any activity, had reserved 538, or about 11 percent, of its 5,000 allocated units for one property as of October 31, 1997. The National Cooperative Bank and the Federal Home Loan Bank of Seattle did not reserve any of their allocated units. Thus, as of October 31, 1997, 8,038, or about 54 percent, of the 15,000 units authorized in 1992 had been reserved. Recently, the National Cooperative Bank and the Federal Home Loan Bank of Seattle agreed to return their units to HUD. According to HUD, it will reallocate 2,000 units to Fannie Mae and hold the remaining 500 units in reserve.

No loans have received final endorsement for the 7,500 units authorized in 1996. As of October 31, 1997, SONYMA had reserved 306, or about 13 percent, of its 2,400 allocated units for two properties. Table 3.1 indicates how, as of October 31, 1997, the six participating and two designated financial institutions had used the program's 22,500 authorized units.

**Table 3.1: Activity in the Risk-Sharing Reinsurance Program, as of October 31, 1997**

| Qualified financial institution | Number of allocated units | Status of allocated units: Number endorsed by HUD | Number reserved | Number not yet reserved |
|---|---|---|---|---|
| **Designated in 1992, with a risk-sharing agreement signed in 1994** | | | | |
| Fannie Mae | 7,500 | 956 | 6,544 | 0 |
| Freddie Mac | 5,000 | 0 | 538 | 4,462 |
| National Cooperative Bank | 2,000[a] | 0 | 0 | 2,000 |
| Federal Home Loan Bank of Seattle | 500[a] | 0 | 0 | 500 |
| **Designated in 1996, with a risk-sharing agreement signed in 1997 or 1998** | | | | |
| SONYMA | 2,400 | 0 | 306 | 2,094 |
| Federal Home Loan Bank of New York | 2,000 | 0 | 0 | 2,000 |
| **Negotiating a risk-sharing agreement with HUD** | | | | |
| CPC | 2,000 | 0 | 0 | 2,000 |
| CCRC | 1,100 | 0 | 0 | 1,100 |
| **Total** | **22,500** | **956** | **7,388** | **13,154** |

[a]In February 1998, these units were returned to HUD for reallocation.

Source: GAO's analysis of data provided by HUD and participating financial institutions.

## One Product Line and One Lender Account for Most of Fannie Mae's Reinsurance Activity

Fannie Mae has reserved or purchased all but 1[2] of its 48 risk-sharing loans through its Delegated Underwriting and Servicing (DUS) product line. This product line is compatible with the reinsurance program because, like the program, it delegates responsibilities and shares risks. Under DUS, Fannie Mae delegates its authority to underwrite and determine the creditworthiness of a loan to the originating lender and agrees to purchase the loan without prior review. In return for this autonomy, the DUS lender assumes a percentage of the risk of default on the loan. Specifically, the lender is responsible for the first 5 percent of any loss on the loan and shares with Fannie Mae in the next 15 percent of any loss. Both the benefits of autonomy and the risk of loss create incentives for the DUS lender to underwrite the loan prudently and service[3] it diligently.

[2]The single non-DUS loan was approved under Prior Approval authority. When using this authority, Fannie Mae underwrites and approves each loan before purchasing it and assumes all of the credit risk. The approved risk-sharing loan of $40 million was secured by a property with 1,175 units. None of the properties securing DUS/risk-sharing loans exceeded 450 units.

[3]For a multifamily mortgage loan, loan servicing involves regular reviews of the property's financial statements and loan payments and physical inspections of the property to ensure its proper maintenance.

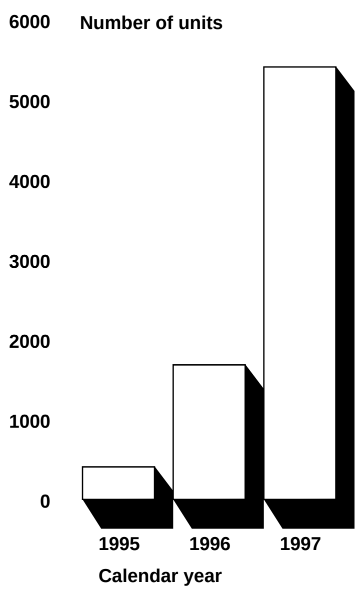
Currently, Fannie Mae does business with about 28 DUS lenders, most of which Fannie Mae considers to be experienced, well-capitalized mortgage bankers. Since the DUS product line's inception in 1987, the loss rate (to lenders) on DUS loans has been less than 1 percent. It is still too early to determine or predict any loss rates under the reinsurance program.

One DUS lender is responsible for more than half of Fannie Mae's reserved loans in the reinsurance program. Banc One Capital Funding Corporation, an affiliate of a large bank holding company, originated the loans for 28 of Fannie Mae's 48 properties. These 28 properties account for 3,175, or about 42 percent, of Fannie Mae's 7,500 reserved units. Eight other DUS lenders had participated in the risk-sharing program as of October 31, 1997, and account for the balance of the properties and units.

## Fannie Mae's Activity Has Increased Over Time

Fannie Mae's activity in the risk-sharing reinsurance program has grown steadily, peaking in 1997. Figure 3.1 tracks Fannie Mae's activity in the program from 1995 through 1997.

**Figure 3.1: Fannie Mae's Risk-Sharing Activity, 1995 Through 1997**




Source: GAO's analysis of data provided by Fannie Mae.

Fannie Mae reserved the last of its risk-sharing units in October 1997. It has asked HUD for additional units, and, as noted, HUD has said that it will reallocate to Fannie Mae 2,000 of the units its expects to be returned. As of February 1998, HUD had not reallocated the units.

## Fannie Mae's Risk-Sharing Properties Vary in Size, Targeted Income Levels, and Geographic Location

Fannie Mae's 48 risk-sharing properties vary in size, and their units are reserved for households of varying income levels. The properties are located in both urban and rural markets, most of which are concentrated in a few states.

### Properties With Risk-Sharing Units Vary in Size, but Units Are Concentrated in Larger Properties

Fannie Mae's risk-sharing properties range in size from 31 to 1,175 units, according to Fannie Mae's data. On average, these properties have 156 units. About half of the properties have fewer than 100 units, and about half have more. However, the larger properties account for about 80 percent of Fannie Mae's total reservation. Table 3.2 shows the distribution of units according to property size.

**Table 3.2: Distribution of Fannie Mae's Risk-Sharing Units, by Property Size**

| Category of property, by number of units | Number of properties in category | Number of units in category | Number of units in category as a percentage of the total number of units |
|---|---:|---:|---:|
| Under 50 units | 4 | 158 | 2 |
| 50-99 units | 19 | 1,369 | 18 |
| 100-199 units | 12 | 1,606 | 21 |
| 200-399 units | 11 | 2,742 | 37 |
| 400 or more units | 2 | 1,625 | 22 |
| **Total** | **48** | **7,500** | **100** |

Source: GAO's analysis of data provided by Fannie Mae.

## Percentage of Lower-Income Households Served Is Generally Higher Than Required

All six of the properties that had received final endorsement from HUD as of October 31, 1997, meet, and four exceed, the reinsurance program's income-targeting requirements.[4] The four that exceed the requirements have reserved all of their units for households with incomes at or below either 50 or 60 percent of the area's median income. The other two properties meet the program's minimum targeting standards: One has reserved 20 percent of its units for households with incomes at or below 50 percent of the area's median income while the other has reserved 40 percent of its units for households with incomes at or below 60 percent of the area's median income.

All four of the properties that exceed, and one of the properties that meet, the program's income-targeting requirements are able to do so because they are partially financed with low-income housing tax credits. The Low-Income Housing Tax Credit program encourages the production of affordable units by making the tax credit subsidy available only to such units.

## Risk Sharing Units Are Concentrated in Three States

Fannie Mae has reserved units in properties serving both urban and rural markets. Although these properties are located in 11 states, most are concentrated in 3—California, Texas and Ohio. These three states account for 29 properties and about 52 percent of Fannie Mae's 7,500 allocated units. In Ohio, Banc One Capital Funding Corporation has funded 14 properties with 1,068 units. Banc One Capital's headquarters and many of its commercial banks are located in Ohio. Because many of these banks are located in rural areas, most of the properties they have financed through the reinsurance program are located in smaller communities. The loans for these properties are, on average, much smaller than the risk-sharing loans financed by Fannie Mae's other DUS lenders. HUD has identified a nationwide need for smaller multifamily rental properties in rural areas.

## Several Factors Have Facilitated Fannie Mae's Use of Risk-Sharing Units

Several factors help to explain why Fannie Mae has used its risk-sharing units more extensively than HUD's other risk-sharing partners. These factors include the previously noted parallels between the DUS product line and the reinsurance program, Banc One Capital's unique affiliation with local lenders that have an incentive to finance affordable housing, and

[4]To be eligible for insurance under the risk-sharing program, properties must be rent restricted and have reserved at least (1) 20 percent of their units for households with incomes at or below 50 percent of the area's median income or (2) 40 percent of their units for households with incomes at or below 60 percent of the area's median income.

Fannie Mae's efforts to both clarify and expand the program's benefits for lenders.

When Fannie Mae signed its risk-sharing agreement with HUD in 1994, it had a product line in place that was uniquely compatible with the reinsurance program. As noted, both the DUS product line and the reinsurance program delegate responsibilities to other parties, and both secure their investment through risk sharing. Because Fannie Mae had been operating the DUS product line since 1988, it and its lenders had experience with delegation and risk sharing when the reinsurance program started. The other original participants in the reinsurance program did not have such experience.

Modifications to the DUS product line created additional incentives for DUS lenders to participate in the reinsurance program. First, in 1994, Fannie Mae introduced the Targeted Affordable Housing product line, which allows DUS lenders to use more flexible underwriting standards than are required for the traditional DUS program.[5] At the same time, Fannie Mae reduced its total loan guarantee fee to DUS lenders.[6] These changes made it easier for lenders to finance affordable multifamily housing. Second, in 1996, Fannie Mae introduced the modified risk supplement, an incentive that allows a DUS lender to terminate its credit risk entirely within 3 years if a loan is performing according to prescribed criteria for payments, cash flow, and rent rates.[7] By comparison, the traditional DUS program does not provide for terminating a lender's credit risk at any time during the term of the loan. Termination frees the lender's cash reserves for redirection to new projects. In addition, termination relieves banks, thrifts, and their mortgage banking subsidiaries of the risk-based capital requirements

[5]Specifically, Fannie Mae (1) reduced the minimum debt service coverage ratio required for purchasing loans to 1.1 for properties whose units are reserved exclusively for low-income households, (2) reduced the guarantee fee for loans with a 1.15 debt service coverage ratio, and (3) increased the maximum loan-to-value ratio on the first mortgage from 80 or 85 percent to 90 percent.

[6]By passing along the savings associated with the lower guarantee fee that FHA charges when it insures 50 percent of the risk of default, Fannie Mae was able to reduce its total loan guarantee fee by 10 to 20 basis points.

[7]After the originating lender's credit risk is terminated, Fannie Mae and HUD each assume 50 percent of any future losses on a risk-sharing loan.

established for them by their respective federal regulatory agencies.[8] According to Fannie Mae, these requirements have deterred multifamily lenders from participating in the DUS product line.

Banc One Capital Funding Corporation's affiliation with a number of local banks has also facilitated Fannie Mae's participation in the reinsurance program. As a subsidiary of a multibank holding company, it has organizational ties to federally insured banks located in several states with multiple branch locations. This affiliation, which is unique among Fannie Mae's DUS/risk-sharing lenders, has provided Banc One Capital with a reliable network of local lenders seeking permanent financing for multifamily affordable housing projects. These lenders have an incentive to finance such projects because they are required, under the Community Reinvestment Act of 1977, to serve the credit needs of their entire community, including low- and moderate-income neighborhoods. Providing these lenders with easy access to the secondary market also allows them to remain short-term lenders and avoid both long-term credit risk liability and risk-based capital requirements.

According to Fannie Mae, its efforts to familiarize the DUS lenders with the reinsurance program have increased their participation. Fannie Mae has provided information about the program through a separate chapter on risk sharing in a guide that it publishes for DUS lenders, as well as through special training on risk sharing. In addition, according to Fannie Mae, the willingness of HUD staff to work with Fannie Mae to resolve programmatic issues, such as the restriction on purchasing fully amortizing loans (discussed later in this ch.), has encouraged participation.

## Risk Sharing Benefits Participants by Encouraging Production and Efficiency

When used with the DUS product line, the reinsurance program offers different but interrelated benefits to Fannie Mae, DUS lenders, and borrowers. All three groups have benefited because participation has encouraged the production of affordable multifamily properties. Fannie Mae has done more business through its Targeted Affordable Housing product line—including more business that counts toward meeting the

[8]Under these requirements for banks, a loan with even a small amount of partial recourse (i.e., first loss position) must be treated as if the entire loan is at risk. Since most multifamily loans fall into this category, multifamily lenders must generally maintain the maximum equity capital required for these loans—8 percent of the loans' total value. Thus, if the first 5 percent of a $1 million loan ($50,000) is in the first loss position but the entire loan is posted on the bank's books as a liability, the bank will have to maintain equity capital equal to 8 percent of the loan's value ($80,000), even though the bank can lose no more than $50,000. While thrifts operate under similar standards, their federal regulator, the Office of Thrift Supervision (OTS), takes into account the percentage of top loss risk in determining how much of the loan is at risk.

federal affordable housing goals for government-sponsored enterprises.[9] DUS lenders have increased their lending capacity, and borrowers have produced more multifamily housing. Production has increased because participation decreases both the lenders' and Fannie Mae's loss exposure by 50 percent and reduces the lenders' reserve requirements by 50 percent, allowing the lenders to finance more properties. Additionally, under Fannie Mae's modified risk supplement, the lenders' loss exposure and reserve requirements are eliminated entirely after 3 years if their loans are performing satisfactorily. While the modified risk supplement largely benefits the participating lenders by further increasing their lending capacity, we believe it also benefits Fannie Mae because, as a performance-based incentive, it strengthens the lenders' motivation to prudently underwrite and diligently service their risk-sharing loans.

Fannie Mae, DUS lenders, and borrowers have benefited from the combination of the DUS product line and the reinsurance program. Because HUD delegates its underwriting responsibility to Fannie Mae and Fannie Mae, in turn, delegates its underwriting responsibility to the DUS lenders, thereby eliminating the need for re-underwriting, loans are processed more quickly and their transaction costs are lowered. Efficient processing is particularly important for affordable housing loans because the costs of delays can make such loans financially infeasible.[10] The Targeted Affordable Housing product line's lower loan guarantee fee also benefits borrowers by further reducing their transaction costs; at the same time, the lower fee benefits Fannie Mae by making its loans more competitive.

Finally, to the extent that the reinsurance program's incentives make lenders more willing to originate loans for affordable multifamily properties, borrowers benefit from the availability of a wider network of DUS lenders, thereby increasing the supply of long-term mortgage financing for these projects.

[9]The Housing and Community Development Act of 1992 (P.L. 102-550) established three separate goals for the enterprises' purchases of mortgages. The purpose of these goals is to provide housing financing for (1) low-and moderate-income families; (2) very-low-income families; and (3) families living in central cities, rural areas, and other underserved areas.

[10]Since affordable multifamily housing projects often rely on multiple sources of financing, each of which generally operates on a tight schedule, a delay in financing the permanent loan can result in the loss of one or more critical sources of financing.

## Other Original Participants Cited Individual Reasons for Not Using the Program

For reasons particular to each, Freddie Mac has made little use of the reinsurance program, and the National Cooperative Bank and the Federal Home Loan Bank of Seattle chose not to use any of their units. Freddie Mac and HUD have been working to overcome some of the barriers to Freddie Mac's use of the program; the National Cooperative Bank did not reach agreement with HUD on when a project becomes a cooperative; and the members of the Federal Home Loan Bank of Seattle showed no interest in the program.

### Several Factors Have Limited Freddie Mac's Participation in the Reinsurance Program

One factor limiting Freddie Mac's activity in the reinsurance program, according to Freddie Mac, is its risk-sharing agreement's requirement that all risk-sharing loans be fully amortizing—that is, that the terms of the loans coincide with their amortization periods. This requirement excludes balloon mortgages from the reinsurance program because the amortization periods for balloon mortgages exceed the principal repayment periods of the loans. Most of the loans that Freddie Mac purchases have balloon mortgages,[11] according to Freddie Mac; therefore, most of its loans are ineligible for the risk-sharing program. On August 21, 1997, Freddie Mac asked HUD to amend its risk-sharing agreement to allow the purchase of balloon mortgages of 10 years or more. Although HUD, in November 1997, approved a request from Fannie Mae to allow the purchase of 18-year balloon mortgages—commonly used in financing properties with low-income housing tax credits—it considers 10-year balloon mortgages less common in financing affordable housing and believes that they may present a greater refinancing risk to the borrower.[12] HUD is therefore waiting for Freddie Mac to demonstrate that this added risk is worth the potential benefit to Freddie Mac.

Another impediment to Freddie Mac's participation in the reinsurance program is uncertainty over the applicability of the term "refinancing loan," which appears in Freddie Mac's risk-sharing agreement. Freddie Mac has asked HUD to resolve this uncertainty. According to a senior Freddie Mac official, the term's usage currently appears to require a 10-year extension of any existing affordability requirements when a borrower with a first mortgage on a multifamily property refinances that

[11]Freddie Mac said that (1) 86 percent of the multifamily loans that it purchased from January 1995 through October 1997 were balloon mortgages and (2) most of the multifamily loans that it purchased had 10-year balloons and 20- to 25-year amortization periods.

[12]Specifically, because 10-year balloon mortgages require refinancing virtually all of the loan principal after 10 years, HUD is concerned that income-restricted properties may not be able to generate the cash flow needed to repay the refinanced mortgages if interest rates rise substantially during the 10 years between the dates of originating the first mortgage and the refinanced mortgage.

mortgage—even when the refinancing occurs shortly after the property's construction. The possibility that affordability requirements may be extended deters lenders because it appears to reduce the property's long-term income-producing potential. HUD is planning to resolve this uncertainty as Freddie Mac has requested.

A third factor that may have limited Freddie Mac's participation in the reinsurance program is its underwriting standards, which are set at a level that excludes many affordable multifamily mortgage loans. Program Plus, the multifamily product line that Freddie Mac introduced in 1994, requires a minimum debt service coverage ratio of 1.2 and a maximum loan-to-value ratio of 80 to 85 percent. In contrast, Fannie Mae's Targeted Affordable Housing product line allows a debt service coverage ratio as low as 1.1 and a loan-to-value ratio as high as 90 percent (or higher if a subordinate mortgage is part of a property's financing). This comparison is not intended to suggest that Freddie Mac should modify its underwriting standards to better accommodate the risk-sharing program, but to indicate that fewer affordable multifamily mortgages are eligible for purchase under Freddie Mac's reinsurance program than under Fannie Mae's.

## National Cooperative Bank and FHLB of Seattle Returned Their Units to HUD

The National Cooperative Bank (NCB) signed a risk-sharing agreement with HUD in September 1994, but no risk-sharing loans were ever approved because, according to a senior HUD official, HUD and the NCB have been unable to agree upon when a project legally becomes a cooperative under the terms of the risk-sharing agreement. The risk-sharing agreement prohibited the approval of any cooperative housing loans until the parties concurred on this point and amended the agreement accordingly. Because the bank's primary mission is to originate loans to cooperatives, including low-income housing cooperatives, this prohibition prevented the bank from using the reinsurance program. The NCB has verbally agreed to return its 2,000 units to HUD.

The Federal Home Loan Bank (FHLB) of Seattle did not participate in the reinsurance program because its member financial institutions (thrifts, commercial and savings banks and credit unions) did not express an interest in doing so. The FHLB of Seattle agreed to participate in the summer of 1994, after the acting director of its regulator, the Federal Housing Finance Board, encouraged the FHLBs to participate in the reinsurance program. The FHLB of Seattle agreed, knowing that customers in rural communities were having difficulty originating mortgages for affordable rental housing, primarily because there was no effective, efficient secondary market for loans of less than $2 million. But the FHLB did not survey its members to assess their interest in the program before signing a risk-sharing agreement with HUD in September 1994. Instead, it spent that time reviewing and analyzing the program's risks and resolving a legal uncertainty. When it subsequently surveyed its members, it found that they (1) perceived little need for risk-sharing insurance, since they considered their own underwriting standards adequate to ensure little or no loss; (2) wished to avoid involvement with FHA, whose programs they regarded as time-consuming and bureaucratic; and (3) recognized that the program's fees would increase their financing costs, making their loans less competitive. When none of its members expressed an interest in the reinsurance program, the FHLB took no further action until January 1998. At that time, it returned its 500 units to HUD for reallocation.

## More Recent Participants Have Not Had Time for Much Activity

It is generally too soon to determine how the second set of financial institutions—SONYMA, the FHLB of New York, and the two loan consortia—will use their risk-sharing units and how extensively they will participate in the reinsurance program. The program offers these institutions certain benefits that may encourage their participation.

SONYMA insures between 75 and 100 percent of the value of mortgage loans secured by properties located in New York State. Its risk-sharing agreement with HUD, signed in February 1997, provides SONYMA with 50-percent reinsurance for individual loans that it insures directly. This reinsurance benefits SONYMA by allowing it to double its reserve capacity and, at the same time, double the dollar value of the mortgage loans that it can insure for multifamily lenders throughout the state. According to a senior SONYMA official, the reinsurance could further benefit SONYMA by allowing it to obtain a higher credit rating, which, in turn, would lead to lower interest rates.

The FHLB of New York signed a risk-sharing agreement with HUD on January 5, 1998. This agreement provides the FHLB with 50-percent reinsurance for the portion of any eligible multifamily housing loan—called a loan participation[13]—that it purchases from a member financial institution. In July 1996, the Federal Housing Finance Board approved the FHLB's purchase of both single-family and multifamily housing loans through a pilot program known as the Community Mortgage Asset Program. The FHLB has proposed to use the reinsurance program to

[13]Instead of purchasing an entire loan originated by a member institution, the FHLB typically expects to purchase 80 percent of the loan while the member institution retains the balance and services the entire loan.

reinsure the multifamily loan participations that it purchases through this pilot program. To the extent that the added security provided through risk-sharing encourages the FHLB to finance additional affordable multifamily housing properties, it appears that the reinsurance program will (1) help increase liquidity to lenders that do not traditionally have access to the secondary market and (2) meet its objective of increasing multifamily lending.

As noted, CPC and CCRC are still negotiating risk-sharing agreements with HUD. Both institutions have extensive experience in affordable multifamily housing finance.

## Opportunities for Greater Participation Exist

Through its risk-sharing agreements with several major financial institutions, HUD has established a basis for encouraging greater participation in mortgage lending. If the program is made permanent or reauthorized for several years, the institutions and HUD could take several steps to expand participation. Some of these steps involve current participants; others involve bringing in new risk-sharing partners and broadening the program to include pooled as well as individual loans.

### Increasing the Participation of Government-Sponsored Enterprises Could Expand Mortgage Lending Nationwide

As noted, Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System operate nationwide. Thus, increasing their participation in the reinsurance program could increase mortgage lending for affordable housing throughout the country.

According to Fannie Mae, it is likely to resume its participation in the reinsurance program when it receives the 2,000 units that HUD has agreed to reallocate to it. In addition, if the program is made permanent or reauthorized for several years and the current limits on the number of available units are lifted, Fannie Mae expects to be able to use still more units. While Fannie Mae has not announced any plans for expanding its pool of DUS lenders, other lenders may have organizational ties to local banks that would facilitate their participation in the reinsurance program, much as Banc One Capital Funding Corporation’s affiliation with local lenders has advanced its risk-sharing business. Replicating Banc One Capital’s experience in other parts of the country could simultaneously increase the sale of affordable multifamily housing loans in the secondary market and diversify both the geographic location and the types of properties financed through the reinsurance program. Banks and thrifts, in particular, could increase their lending by taking advantage of the opportunity to terminate their credit support for well-performing loans after 3 years under Fannie Mae's modified risk supplement.

Overcoming the obstacles to Freddie Mac's participation could create further nationwide opportunities for expanding the reinsurance program. HUD has already said that it will consider at least two of the issues that Freddie Mac has cited as obstacles. As noted, HUD has agreed to assess the risks of reinsuring 10-year balloon mortgages. While amending Freddie Mac's risk-sharing agreement to include the purchase of 10-year balloon mortgages may make the majority of Freddie Mac's loans eligible for reinsurance, HUD may determine that potential increases in interest rates present an undue risk that it is unwilling to assume. However, because HUD has already determined that 18-year balloon mortgages do not present an undue risk, it could offer to amend Freddie Mac's or any other risk-sharing partner's agreement to allow for the use of reinsurance with 18-year balloon mortgages. In addition, if it agrees that the use of a short-term permanent loan[14] as a bridge between a construction loan and a long-term permanent loan does not convert the permanent loan into a refinancing loan with additional affordability requirements, it will alleviate Freddie Mac's concerns about the possible imposition of such requirements. A senior HUD official said that even if HUD agrees that the use of a short-term permanent loan does not convert the permanent loan to a refinancing loan, he believes that limits will have to be placed on the length of such short-term loans.

The Federal Home Loan Bank System, with its 6,504 member institutions in all 50 states, presents a major opportunity for expanding the reinsurance program while making minimal demands on HUD's resources. The 12 FHLBS, with close ties to their member institutions, would select these institutions for participation and monitor their performance. Although the Seattle FHLB's member institutions were not interested in the reinsurance program, the FHLB of New York may be able to demonstrate whether the program could be useful to other FHLBS. If the New York FHLB uses reinsurance, combined with its Community Mortgage Assistance Program, to purchase affordable multifamily loans from many types of member institutions, including smaller financial institutions that traditionally have not had access to Fannie Mae's or Freddie Mac's secondary market products, other FHLBS may decide to replicate the Community Mortgage Assistance Program and join the reinsurance program, thus expanding the program's geographic coverage. The Federal Housing Finance Board has also approved a proposal by the FHLB of

[14]Such loans are generally referred to as "mini-perm" loans.

Atlanta to purchase multifamily loans from a North Carolina loan consortium as a qualified investment for its own portfolio. While this initiative does not involve the reinsurance program, FHA's 50-percent reinsurance could be used as an incentive to encourage other FHLBS to purchase affordable multifamily loans from consortia operating in their regions.

## Involving Loan Consortia Could Increase Financing for Smaller Properties

Although HUD has not yet signed risk-sharing agreements with CPC and CCRC, these loan consortia represent another opportunity to expand participation in the reinsurance program. They are entities created by banks and thrifts to promote lending for affordable housing. Since the 1970s, they have financed the development and/or rehabilitation of affordable housing, particularly of multifamily rental properties, at both the city and the state level. Their loans have supported the development of smaller-size properties, most of which have fewer than 50 units. As noted in chapter 1, HUD has identified a nationwide need for financing for smaller properties. Thus, involving loan consortia in the reinsurance program could help to satisfy this need.

When HUD first established the reinsurance program, it believed that loan consortia would become involved, not as risk-sharing partners, but as lenders selling their loans to Fannie Mae and Freddie Mac. Both Fannie Mae and Freddie Mac identified particular consortia in their risk-sharing agreements as "special lenders" whose loans they would purchase to promote the program's goals. However, neither Fannie Mae nor Freddie Mac has purchased any risk-sharing loans from loan consortia. Fannie Mae noted that loan consortia have gained access to capital through other Fannie Mae sources.

Several factors make it difficult for loan consortia to sell their loans in the secondary market. Specifically, (1) their loan volumes are not large enough;[15] (2) their underwriting standards may not be compatible with Fannie Mae's and Freddie Mac's conventional standards; (3) their low net worth requires them to obtain letters of credit or other costly credit enhancements before they can sell their loans, and (4) their reserves are generally not adequate to meet Fannie Mae's and Freddie Mac's

[15]On average, their loans range in amount from $750,000 to $2.5 million. The total average loan volume estimated by the 10 loan consortia surveyed by GAO during 1996 was approximately $145 million. (CPC, the nation's largest loan consortium, was not included in the survey). See app. VII for the characteristics of the loans and properties financed by these 10 consortia.

requirements for long-term "credit support" from sellers under a loan pool purchasing arrangement.[16]

## Loan Pool Reinsurance Could Facilitate Consortia's Access to Secondary Markets

To help overcome the obstacles to their participation in the secondary markets, CPC and CCRC have proposed using risk sharing to reinsure pooled loans. Currently, HUD's risk-sharing reinsurance agreements apply only to individual loans, and HUD has no experience with loan pool insurance. However, the act authorizes loan pool insurance, and, according to a senior HUD official, HUD is not averse to experimenting with it as long as the credit risks are reasonable.

Loan pooling has several advantages that could facilitate the participation of loan consortia in the secondary markets. First, pooling aggregates loans, increasing their volume. Such aggregation is necessary, because of the complexities and costs associated with loan pool transactions. Second, pooling generally occurs after loans are seasoned—that is, some years after their origination, by which time they have acquired credit and property maintenance histories that can alleviate concerns about underwriting terms that differ from industry standards. Therefore, compared with newly originated loans, seasoned loans present less uncertainty and their performance is easier to predict. Third, losses can be more accurately projected for a pool of loans than for individual loans.

Loan pooling alone cannot overcome all of the obstacles limiting the participation of loan consortia in the secondary market. Risk-sharing reinsurance could, however, make pooled loans more attractive to purchasers. Freddie Mac, for example, decided not to purchase a consortium's pool of balloon loans because, according to a consortium official, (1) the consortium's net worth was too low and a letter of credit would have been too costly to acquire and (2) the consortium's cash reserves were not high enough to satisfy Freddie Mac's long-term credit support requirements. Had these loans been eligible for risk-sharing reinsurance—neither balloon mortgages nor loan pools are eligible under Freddie Mac's risk-sharing agreement with HUD—the reinsurance would have enhanced their credit and would have reduced Freddie Mac's reserve requirements for the loan consortia.

[16]Loan consortia are typically capitalized by pools of funds provided through short-term loans from their member financial institutions. These funding pools do not maintain the long-term reserves established by most state housing finance agencies and by Fannie Mae and Freddie Mac. Hence, they cannot be used to provide long-term credit support for loans sold in the secondary market.

Fannie Mae has experience with pooled loans, which it purchases through its Negotiated SWAP product line,[17] and it has proposed using the reinsurance program to reinsure loan pools. This proposal would appear to benefit loan consortia. However, Fannie Mae historically has not been interested in purchasing a loan pool from multiple lenders. Therefore, if a consortium could aggregate loans from its member lenders, or if several consortia could combine their loans, they would need to identify an "honest broker conduit" to sell the pool to Fannie Mae.

Despite the difficulties they have experienced in trying to sell loan pools in the secondary market, some loan consortia in our focus group believed that pooling, combined with risk-sharing reinsurance, would be an effective way for them to sell their loans. In general, representatives of 13 consortia said that participation in the risk-sharing program could have the following benefits (the numbers in parentheses indicate the number of consortia identifying each potential benefit): increase their sales of loans in the secondary market (12), increase their loan volumes (11), increase the size of their loans (9), and extend their loan amortization periods (8).

## Conclusions

Although the reinsurance program remains largely untested, Fannie Mae and Banc One Capital have demonstrated its potential to produce affordable multifamily housing efficiently and, in some instances, to produce smaller properties in rural markets, thereby helping to satisfy an unmet capital need. If HUD can resolve the obstacles to Freddie Mac's participation and negotiate risk-sharing agreements with the loan consortia, these institutions may also be able to use their risk-sharing units productively.

While HUD is considering the risks involved in Freddie Mac's request to use reinsurance with 10-year balloon mortgages, it could offer to amend the risk-sharing agreement of Freddie Mac—or of any other interested risk-sharing partner—to allow the use of reinsurance with 18-year balloon mortgages, making generally available an option that is currently limited to Fannie Mae. Because many properties with low-income housing tax credit financing have 18-year balloon mortgages, this action could increase the number of institutions eligible to combine reinsurance with tax credit financing and thus further both the reinsurance and the tax credit programs' affordable housing goals.

[17] In the Negotiated SWAP program, rather than purchasing one loan at a time, Fannie Mae purchases a pool of mortgage loans, and exchanges or "swaps" the loans for a mortgage-backed security.

Allowing the use of reinsurance with loan pools could help loan consortia and smaller lenders offset the limitations of low net worth and limited reserves that currently hamper their sales of loan pools in the secondary market. Because these lenders often finance smaller properties, facilitating their access to the secondary market could also help to satisfy the need HUD has identified for smaller affordable multifamily properties.

HUD's most recent risk-sharing partners may be able to demonstrate productive new uses of the reinsurance program. SONYMA officials appear to have a clear understanding of the program's benefits. The efforts of the Federal Home Loan Bank of New York also bear watching, not only because the reinsurance program, in combination with the Community Mortgage Assistance Program, may be able to increase liquidity to lenders that do not traditionally have access to the secondary market, but also because the Bank, as part of the Federal Home Loan Bank System with its over 6,500 member institutions, has an opportunity to establish a model for producing affordable multifamily housing that could be replicated nationwide.

Although the reinsurance program is still in the demonstration phase, we believe that it is conceptually sound, relying on reciprocal, market-driven risk-sharing agreements, and with more time and experience, activity in it may increase. If it is made permanent, as legislation has proposed, or if it is authorized for a certain number of years, both HUD and the participating financial institutions will have more incentive to commit resources to it.

## Recommendations

We recommend that the Secretary of Housing and Urban Development direct the Commissioner, Federal Housing Administration, to explore the feasibility of amending HUD's current risk-sharing agreements to (1) allow the use of reinsurance with 18-year balloon mortgages as is currently permitted in an agreement with Fannie Mae and (2) authorize the use of reinsurance with loan pools.

## Agency Comments

HUD agreed in written comments on a draft of this report (see app. IX) to offer to amend the risk-sharing agreements of the other participating entities to permit 18-year balloon mortgages with 30-year amortization periods. HUD also agreed, because of the potential to reach underserved and hard-to-serve markets, to explore the feasibility of amending current risk-sharing agreements to permit the use of reinsurance with loan pools, assuming that the actuarial soundness of the FHA insurance fund would be maintained.

# Risk-Sharing Limits HUD's Loss Exposure and Reduces Administrative Costs, but Information Systems and Oversight Need Improvement

HUD has derived significant benefits through risk-sharing, primarily by participating in the credit enhancement program. Specifically, it has generally limited its loss exposure for insured loans to half the outstanding loan amount and has substantially reduced the time taken to process applications for FHA insurance, compared with the time taken under its traditional mortgage insurance programs. The same benefits are potentially available to HUD through the reinsurance program, but, as discussed in chapter 3, activity in that program has been very limited. However, problems in the data system used to administer the credit enhancement program limit HUD's ability to accurately monitor the program and report on its status. Weaknesses in HUD's oversight could also jeopardize the program's benefits.

## Participation in the Risk-Sharing Demonstration Programs Limit Government's Exposure to Losses

One of the six goals of the risk-sharing programs is to ensure that other parties bear a share of the risk, in percentage amount and in position of exposure, that is sufficient to create strong, market-oriented incentives for the other participating parties to maintain sound underwriting and loan management practices. HUD has successfully met this legislative objective. Because most of the risk-sharing agreements require HUD's partners to share equally in any losses arising from loan defaults, HUD has limited its loss exposure while establishing economic incentives for its risk-sharing partners to perform their respective functions properly. HUD has further minimized its loss exposure by ensuring that its risk-sharing partners have sufficient capital to meet their obligations should any losses occur.

### Risk-Sharing Partners Assume Significant Risk

Compared with HUD's traditional multifamily insurance programs, the risk-sharing programs expose the federal government to substantially less risk of loss in the event of default. HUD's traditional programs generally hold the federal government responsible for 100 percent of any losses associated with defaults on federally insured loans. In contrast, the risk-sharing programs are generally holding the federal government responsible for 50 percent of any such losses. In the reinsurance program, all of the risk-sharing agreements signed to date divide the responsibility for any losses equally between the federal government and its risk-sharing partners. Thus, Fannie Mae is responsible for 50 percent of any losses for all of the 956 units in the 6 completed properties reinsured under the reinsurance program as of October 1997.

In the credit enhancement program, housing finance agencies can elect to assume as little as 10 percent of the loss exposure if they use HUD's underwriting standards,[1] but as of September 1997, 16 of the 21 agencies with closed loans had assumed 50 percent or more of the loss exposure for 87 of the 110 loans closed by that date. These loans accounted for about 85 percent of the 12,851 units in the 110 insured properties. Table 4.1 shows the percentage of risk assumed by the housing finance agencies for properties insured under the credit enhancement program through September 1997.

**Table 4.1: Percentage of Risk Assumed by Housing Finance Agencies for Insured Properties**

| Percentage of risk assumed by agency | Number of properties | Number of units | Percentage of units |
|---|---|---|---|
| 90 | 4 | 369 | 3 |
| 50 | 83 | 10,869 | 85 |
| 25 | 10 | 524 | 4 |
| 10 | 13 | 1,089 | 8 |
| **Total** | **110** | **12,851** | **100** |

Source: GAO's analysis of questionnaire data provided by housing finance agencies.

The opportunity to use their own underwriting standards has provided an incentive for most of the housing finance agencies to assume at least 50 percent of the loss exposure. As of September 1997, only 4 of the 21 agencies with closed loans had elected to assume a 10- or a 25-percent loss position on all, or most, of their closed loans. The New York Housing Finance Agency, for example, assumed only 10 percent of the risk of loss for each of the 4 loans it processed because, according to agency officials, the agency was already assuming the top loss position on these loans by supporting the financing of the insured properties through either grants or second mortgages.[2] In the officials' view, this other financing was more than adequate to absorb any losses if a default were to occur, and they did not believe that the federal government was in a serious risk position.

## Risk-Sharing Partners Have Financial Integrity

Besides requiring its risk-sharing partners to assume a significant portion of the risk of loss on insured loans, HUD has established criteria to ensure that its partners will be able to meet their financial obligations. The qualified financial institutions participating in the reinsurance program all

[1]Housing finance agencies electing to assume 50 percent or more of the risk exposure for losses (referred to as level I agencies) use their own underwriting standards. Agencies electing to assume less than 50 percent of this risk (level II) are required to use HUD's underwriting standards.

[2]These mortgages take a subordinate position to the first mortgage. This means that if any losses occur, the first mortgage, which is insured under the risk-sharing program, will be paid in full before any subordinate financing is paid.

have excellent credit ratings or track records in multifamily lending. Fannie Mae, Freddie Mac, and the FHLB System all have the highest ("AAA") credit rating. SONYMA has a "AA" credit rating and the National Cooperative Bank, which still has a risk-sharing agreement with HUD even though it has returned its allocated units, has an "A-" credit rating, according to the NCB's treasurer. Although two loan consortia told us that they have not been rated, each has had a long and successful history of multifamily lending. CCRC has made about $150 million in multifamily loans since 1989, and CPC has originated over $800 million in multifamily loans since 1972.

To participate in the credit enhancement program, a housing finance agency must either meet certain minimum credit standards for financial soundness established by a nationally recognized rating agency, such as Standard and Poor's or Moody's Investors Service, or have a dedicated reserve account with sufficient capital to meet the agency's outstanding obligations under the program. The minimum credit standards for an agency seeking acceptance into the program on the basis of a credit agency's evaluation are either (1) a "top tier" designation[3] or (2) an overall rating of "A" for the agency's general obligation bonds.[4] If an agency does not meet these criteria, HUD requires that the agency establish a dedicated reserve account of not less than $500,000 and add to that reserve 1 percent of the outstanding balance on all mortgages originated up to $50 million. For mortgages beyond this amount, additional but reduced reserves are required.

Our review of the eligibility standards met by the 32 housing finance agencies with risk-sharing agreements showed that 21 met the program's eligibility criteria on the basis of their credit rating from either Standard and Poor's or Moody's. The remaining 11 established dedicated reserve accounts. Appendix VIII shows the rating criteria that the housing finance agencies met to demonstrate their financial solvency.

[3]A top-tier rating reflects an agency's sound assets, stable earnings, and strong capital adequacy ratios. The rating also implies that the agency has capable management and is able to meet its mandate.

[4]As defined by Moody's, bonds rated "A" possess many favorable investment attributes and are to be considered as upper-medium-grade obligations. Factors giving security to principal and interest are considered adequate, but elements may be present that suggest a susceptibility to impairment sometime in the future.

## HUD Has Derived Administrative Benefits Through Its Participation in the Risk-Sharing Programs

Another goal established for the demonstration programs is to increase the efficiency, and lower the costs to the federal government, of processing and servicing multifamily housing mortgage loans insured by HUD. The programs have achieved this goal. By delegating its loan-processing responsibilities to its risk-sharing partners, HUD has been able to deliver multifamily insurance more expeditiously through the risk-sharing demonstration programs than through its traditional multifamily insurance programs. Furthermore, because HUD has also delegated the responsibilities for monitoring the performance of insured properties and for foreclosing on any properties in serious default, HUD will continue to accrue administrative benefits throughout the terms of the insured loans.

HUD has not formally assessed how much staff time it has saved through risk sharing. However, senior management within HUD pointed out, "it stands to reason" that the substantial reduction in HUD's responsibilities under risk sharing should result in substantial time savings for HUD. Estimates provided by the FHA Commissioner support this conclusion. For example, according to the Commissioner, one field office estimated that it takes about 480 staff hours to process an application for a traditional mortgage loan[5] through the firm commitment phase,[6] compared with about 80 staff hours under the risk-sharing program. Overall, HUD estimated that processing an application through the firm commitment stage can take as many as 540 hours under the traditional multifamily insurance programs and as few as 12 hours under the risk-sharing program. HUD further noted that the transfer of loan-processing and underwriting responsibilities to its risk-sharing partners has enabled its field offices to process projects through the firm commitment phase in 1 to 3 months, compared with 6 to 9 months under FHA's traditional multifamily insurance programs.

In addition, HUD estimated that under the traditional programs, its staff put in another 400 hours per loan before it provides the final endorsement.[7] They administer the construction loan, inspect the property, and certify the property's costs—all responsibilities that are delegated under the risk-sharing programs. Thus, according to HUD's estimate, loan processing takes about 80 hours under risk sharing, compared with about 880 hours

[5]Under section 221(d)(4). This program, used by for-profit developers, provides multifamily mortgage insurance for new construction and/or substantial rehabilitation.

[6]Phases in insuring a loan include the following: application received, firm commitment issued, initial endorsement provided, and final endorsement provided. In some instances, the application is withdrawn or the firm commitment expires.

[7]At this stage, when HUD provides the insurance, the property has been completed and occupied.

under the traditional programs—a 10-fold savings in staff time. While these estimates are not scientific, they are consistent with estimates provided by HUD staff in each of the five field offices we visited.[8]

The risk-sharing programs provide HUD with additional administrative benefits that start when an insured property becomes operational and continue throughout the life of the mortgage loan. These savings accrue to HUD because it delegates its asset management and property disposition responsibilities to its risk-sharing partners. While we did not attempt to quantify the staff time that HUD saves from delegating these responsibilities, we did explore the management implications of shifting them from HUD to its risk-sharing partners. According to HUD officials, most asset managers in its field offices are responsible for monitoring the financial and physical condition of about 60 multifamily properties. In some offices, they may be responsible for as many as 80 to 85 properties. In contrast, according to the executive directors and senior program managers from 11 active housing finance agencies participating in our focus groups, most asset managers at housing finance agencies are responsible for 25 to 30 properties. While there is no established standard for the optimal number of properties that an asset manager should oversee, the executive directors and risk-sharing program managers pointed out the obvious—the smaller the number of properties that an asset manager is responsible for overseeing, the more likely the manager will be familiar with the properties' performance characteristics, and the sooner the manager can identify and respond to potential problems, the less likely the property will incur carrying costs and physical decline.

## Information Systems Are Not Reliable

The data system that HUD created to manage the credit enhancement program—the Risk-Sharing Multifamily National System (RSS)—is largely unreliable and user unfriendly. A comparable system does not exist for the reinsurance program because activity in this program has been so limited. HUD relies instead on an automated spreadsheet to manage the reinsurance program. While recognizing the shortcomings of RSS, HUD maintained that its primary data system, known as F47, which it uses to monitor all insured multifamily loans, is reliable. However, we identified errors in this system for loans insured under both risk-sharing demonstration programs. These problems need to be resolved if HUD is to have an accurate database for monitoring and managing the programs.

[8]In Boston, Denver, Jacksonville, New York, and San Francisco.

## Credit Enhancement Program's Data System Is Flawed

HUD established RSS to monitor activity under the credit enhancement program. This system, HUD officials said, was designed for HUD headquarters to (1) track the number of units allocated to housing finance agencies, (2) monitor the progress of projects through specific phases toward completion,[9] and (3) provide program managers with financial information on completed properties. However, the system was not designed to be a single comprehensive point of reference for monitoring and managing the credit enhancement program. Rather, because HUD field offices are responsible for collecting data from participating housing finance agencies within their jurisdictions, HUD headquarters expected that the field offices would create their own information systems to oversee projects applying for and receiving insurance under the program.

RSS has met its first objective of providing HUD headquarters with accurate data on the number of units allocated to housing finance agencies. However, the system has generally not met the other two objectives, even though the Director of HUD's Office of Multifamily Housing Development emphasized the importance of reliable data in a December 1996 memorandum to the field offices. This memorandum stated that despite substantial progress under the credit enhancement program, "reliable data to substantiate this achievement [remain] a major program deficiency." In addition, the memorandum identified significant discrepancies between the data in RSS and information available to HUD headquarters from other sources. These sources indicated, for example, that firm approval letters had been signed for properties that did not appear in RSS. Such problems persist today, even though the memorandum advised that "increased attention be given to the availability of timely and reliable data," given the intense interest in the new partnership between HUD and the housing finance agencies shown by congressional, industry, and other observers.

HUD headquarters and field officials have acknowledged that RSS was designed quickly and, in the rush to develop and implement the system, certain basic requirements were overlooked. Specifically, software was provided to housing finance agencies and HUD field offices with little, if any, training or documentation. Although a manual was provided, the software was difficult to use. In addition, the software did not come with a data dictionary, a basic requirement for a data system, needed to ensure the data's reliability. Not having a data dictionary has precluded the consistent reporting of data from the housing finance agencies.

[9]Application received, firm commitment issued, initial endorsement provided, final endorsement provided, or application withdrawn or firm commitment expired if appropriate.

Officials from the seven housing finance agencies we visited and from the eight other agencies participating in our focus group on the credit enhancement program discussed the problems they had encountered in using RSS. The officials were virtually unanimous in concluding that the software for the system is user unfriendly. Almost all of them noted, for example, that the software does not contain an edit function. Consequently, if a user makes an error in entering data, he or she has to start entering the data all over again to correct the error. The officials also noted that the software could not generate paper copies for users to verify the data they had entered.

To work around RSS' limitations, some agencies began using alternative software. At the time of our review, officials at the Florida Housing Finance Agency were using spreadsheet software to make necessary edits and to print information. They entered the same data elements that RSS requires and sent a paper copy of their spreadsheet to the appropriate HUD field office. The HUD field office, in turn, reentered the data into RSS before transferring the data to HUD headquarters for inclusion in the master RSS database.

Officials at the Massachusetts Housing Finance Agency also observed that RSS is not user friendly because it requires the continuous, sequential entry of all data at one time. Thus, to add or change a data element, the person entering the data has to restart the program and reenter the data previously entered in every data field. These officials said they would prefer to selectively add and delete or reenter data elements without having to reenter all of the elements for a particular project. Officials from the New York Housing Finance Agency identified the same problem, commenting that they would be likely to enter new information as it became available.

To the housing finance agencies, the lack of a data dictionary posed serious concerns about the reliability of the data entered into the system. For instance, the Florida Housing Finance Agency developed its own data dictionary for the required data elements. However, as agency officials pointed out, their interpretation of data elements might differ from other agencies' interpretations. Officials from the Montgomery County Housing Finance Agency in Maryland were also concerned about the difficulty of interpreting certain required data elements without a data dictionary. For example, they showed us a $2.4 million item for one property that they reported under the "local grant" category when, they said, they could just as easily have reported it under the "loans and subsidies" category. In effect, without a data dictionary for clarification, they arbitrarily decided where to report this item.

Finally, officials from several housing finance agencies expressed concern because they are required to report over 50 data elements on a property's financial and physical condition; however, they were not aware that any use was being made of this information. Our discussions with HUD headquarters officials confirmed that these data have not been used to summarize the program's results or to evaluate the program. Moreover, we found that for all loans from California and Massachusetts, these data elements had not been entered into RSS. HUD field office and headquarters staff told us that this problem exists, in part, because HUD field offices have no incentive to transfer final data on closed loans into RSS, given that similar data are required to be reported in HUD's Multifamily Insurance System. This system, known as F47, should contain data on all of HUD's insured multifamily properties, including those insured under both the credit enhancement and the reinsurance programs. HUD management uses this system for budgeting and assessing the attainment of production objectives.

Our visits to five HUD field offices generally confirmed the problems noted by the housing finance agencies. In addition, one field office noted that HUD headquarters has occasionally taken actions such as increasing or reallocating risk-sharing units among housing finance agencies without informing the servicing HUD field offices. Such actions limit the field offices' ability to monitor the unit allocations available to housing finance agencies.

Because F47 is supposed to contain financial and other data on all FHA-insured properties, HUD headquarters officials tended to minimize the problems associated with RSS. They noted that data on a risk-sharing loan become part of F47's database when two events occur—when the closing memorandum (HUD Form 290) is signed by the authorized HUD field staff and when a check is received by HUD for the first payment on the loan's insurance premium. Within a few days of these two events—independent of the credit enhancement program's administrative processes—data on the risk-sharing loan should become part of the F47 system.

To test the reliability of the data on risk-sharing loans in the F47 system, we compared the information in the system as of November 1997 with our data on the 110 loans closed by housing finance agencies as of September 1997 and the 6 loans closed by Fannie Mae as of October 1997.

We noted errors in both cases. Specifically, the F47 system reported 106 loans closed by the housing finance agencies and 2 loans closed by Fannie Mae. A senior HUD headquarters official attributed these omissions to servicing problems in HUD field offices. According to this official, problems have occurred in documenting the first payment of the insurance premium and in transferring the closing memorandum to HUD headquarters. Because FHA insurance is not recorded on a property until these two actions have been completed, such problems have delayed the entry of data into the F47 database.

## Alternatives to RSS Are Available

Executive directors and risk-sharing program managers from several housing finance agencies indicated that, in place of RSS, they would prefer a reporting system that relied on personal-computer-based software. Such a system with a data dictionary, they agreed, would provide program mangers at all levels with consistent, easily accessible data for program evaluations. In addition, they agreed that state-of-the-art spreadsheet or database software would provide user-friendly editing and reporting capabilities that would also enhance the reliability of the data.

According to HUD headquarters officials, the problems associated with RSS, a stand-alone system, should be resolved in the broader context of ongoing efforts to overhaul and fully integrate all of HUD's management information systems. Currently, HUD is installing a personal-computer-based software suite departmentwide. This suite, called HUDWARE II, includes word processing, spreadsheet, database, and graphics/report software packages. HUD is training its staff in the use of the new software as it is installed in headquarters and the field. We found that HUD field offices were using the new spreadsheet packages to partially fulfill their monitoring requirements under the credit enhancement program. A senior HUD headquarters program official also told us that suite software such as HUDWARE II would provide sufficient capacity to monitor and report on the risk-sharing program. Managers at all levels could consistently use such software for program oversight functions.

## HUD Recognizes That Programs' Future Expansion Requires Effective Administrative Controls

Because the risk-sharing demonstration programs delegate virtually all critical loan-processing and administrative functions to HUD's risk-sharing partners, it is imperative that HUD (1) establish procedures for ensuring that its partners are carrying out their responsibilities in accordance with the programs' regulations and risk-sharing agreements and (2) monitor its partners to ensure that these procedures, regulations, and/or agreements are being followed. HUD has established reasonable administrative controls for overseeing the programs; however, it is somewhat premature to assess HUD's application of these controls, given the programs' limited activity to date. Nevertheless, we did observe some problems with HUD's implementation of these controls. HUD is aware of these problems and plans to address them.

### HUD Has Established Controls for Oversight

Procedures for implementing the credit enhancement demonstration program are contained in a June 1995 handbook. According to these procedures, HUD field offices have the primary responsibility for ensuring that housing finance agencies comply with handbook's requirements for loan underwriting, asset management, and, if necessary, property disposition. The handbook requires the field offices to make at least one annual on-site review of each participating housing finance agency to assess the agency's compliance with the handbook's requirements. This on-site visit is to include a review of a sample of loan files to validate compliance with agreed-upon underwriting criteria. The handbook further requires HUD headquarters to provide "remote monitoring" of housing finance agencies to ensure that they continue to meet the program's eligibility criteria and maintain either an "A" credit rating or the required dedicated reserves. The handbook also requires that housing finance agencies submit semiannual reports to HUD headquarters that include the status (current, delinquent, workout, or foreclosure) of all insured loans. Finally, agencies are required to notify HUD headquarters monthly when a mortgage is in default (30 days past due) until it either becomes current or an application for an initial claim payment is made.

HUD has not drafted a regulatory handbook for administering the reinsurance program. Rather, the procedures for HUD's oversight of the participating financial institutions are specified in each risk-sharing agreement. According to these agreements, HUD headquarters, rather than HUD field offices, is responsible for monitoring the performance of participating financial institutions. This monitoring includes receiving and reviewing semiannual reports from the participating institutions showing the unpaid principal balance on each risk-sharing loan and its status. While the agreements also require the participating entity to provide HUD with any records it deems necessary to carry out its review functions, HUD headquarters is not required to conduct on-site reviews of the financial institutions.

## Review of Oversight Disclosed Some Problems

Because the demonstration programs are still evolving, and participation by many of HUD's risk-sharing partners has been limited, we did not conduct a comprehensive evaluation of how well HUD field offices and headquarters are carrying out their oversight responsibilities. However, we did discuss with officials at five HUD field offices the procedures they are using to ensure that housing finance agencies comply with the handbook's requirements for the credit enhancement program. These five field offices oversee housing finance agencies that account for about 60 percent of the units reserved through September 1997 under the credit enhancement program. Our review disclosed some inconsistencies in the field offices' procedures for on-site monitoring, documentation of housing finance agencies' performance, and communication and resolution of identified problems with housing finance agencies.

HUD headquarters officials, with a broader perspective, confirmed that HUD field offices have been inconsistent in reviewing housing finance agencies to ensure that they are complying with the program's regulations and procedures. Moreover, headquarters officials agreed that they have not developed a systematic process for ensuring (1) that HUD headquarters has received and reviewed the semiannual reports required from housing finance agencies on the status of their closed loans or (2) that housing finance agencies continue to meet the program's eligibility criteria. We contacted the housing finance agencies in California, Colorado, Florida, and Massachusetts, which account for about 60 percent of the closed loans as of September 1997, to inquire whether they were complying with the semiannual reporting requirements. Officials at the California and Florida agencies told us that they had neglected to send in the required reports. According to a senior official at the California Housing Finance Agency, one of the agency's insured loans had been in default since October 1996. Furthermore, the California Housing Finance Agency did not notify the HUD field office of the default until October 1, 1997, at which time the payments for loan principal, interest, real estate taxes, and property insurance were over $457,000 in arrears. As we pointed out in chapter 2, HUD headquarters officials were not aware of this default until we brought it to their attention in February 1998. However, according to the senior California official, the agency has notified HUD that it will hold HUD harmless on this loan because of extenuating circumstances. The official also said that the agency is withdrawing the loan from the risk-sharing program. We found that, for overseeing the reinsurance program, HUD headquarters had received the semiannual reports required from Fannie Mae.

HUD management is aware of the oversight problems as well as the importance of ensuring that its risk-sharing partners comply with the programs' procedures, regulations, and/or risk-sharing agreements. According to headquarters officials, HUD plans to transfer the responsibility for overseeing both the credit enhancement and the reinsurance programs to a newly established quality assurance unit that is to be created by realigning HUD field office staff. The creation of this unit is part of HUD's ongoing initiative to transform the way the Department administers all of its programs. The quality assurance unit would be responsible for overseeing all lenders participating in the risk-sharing programs and in FHA's other insurance programs. According to headquarters officials, the unit's responsibilities could include validating the status of housing finance agencies' qualifications, including the agencies' financial solvency; reviewing agencies' underwriting practices; and reviewing the semiannual reports on the agencies' portfolios insured under the credit enhancement program, including the original mortgage amount, outstanding loan principal balance, and status of all loans. In addition, headquarters officials are also considering institutionalizing certain periodic and cyclical tasks, such as annual reviews of housing finance agencies' financial statements and annual requests to Moody's and Standard and Poor's for agencies' credit ratings.

## Conclusions

Whether or not the Congress permanently authorizes the risk-sharing demonstration programs, HUD program managers will need consistent and reliable data on the units allocated to HUD's risk-sharing partners and on the progress of these units towards completion. Furthermore, asset management and property disposition issues may arise over the life of the programs that may require data on properties' financial and physical characteristics. This broad range of information will be needed to monitor and accurately evaluate the overall performance of the risk-sharing programs and their individual projects. The credit enhancement program's current data system (RSS) does not provide reliable information, and servicing problems have led to omissions in F47.

HUD has not yet selected the system that will support the information and evaluation needs of the credit enhancement program's future managers. Adequately addressing the shortcomings of the current data system, especially the lack of a data dictionary, is, however, imperative as designers planning the new system identify the needs of users at all levels. HUD has indicated that it is redesigning F47.

HUD will also need to ensure that its risk-sharing partners in both demonstration programs are carrying out their responsibilities under HUD's regulations and/or their risk-sharing agreements, since activity is likely to increase if the Congress either extends the programs or makes one or both of them permanent. Although the programs are still relatively new, HUD has not executed some of its oversight responsibilities. While HUD has outlined an approach for addressing the current oversight problems and for monitoring the performance of its risk-sharing partners in the future, it is too early to tell whether this approach will be successful. However, correcting the current oversight problems to ensure that the programs are being properly administered should, in our view, be a priority for HUD.

## Recommendations

To ensure that the risk-sharing demonstration programs' managers have consistent and reliable data to meet their statutory and regulatory obligations, we recommend that the Secretary of Housing and Urban Development take steps to correct current flaws in the information systems supporting the programs. We recommend that, in correcting the flaws in the data system supporting the credit enhancement program, the Secretary direct the system's designers and the program's managers to examine the near-term suitability of using spreadsheets and databases commonly contained in suite software within the context of the long-term data needs of a growing universe of projects, giving careful consideration to the requirements of all users of the system.

We further recommend that the Secretary give priority to implementing a comprehensive monitoring system to ensure that the Department's risk-sharing partners are complying with the demonstration programs' procedures, regulations and/or risk-sharing agreements, including the requirements for timely reporting on the status of insured loans.

## Agency Comments

HUD agreed in its written comments on a draft of this report (see app. IX) with our concerns about the flaws in the information systems supporting the risk-sharing demonstration programs and is planning to implement a monitoring system to ensure that its risk-sharing partners are complying with the programs' requirements, including the requirements for timely reporting. More specifically, HUD said that it is already pilot-testing a new Development Application Process that will track mortgage insurance applications from their submission through to endorsement. HUD said that until data on the risk-sharing projects can be incorporated into this system, it will develop spreadsheets to make the current systems more user friendly and to simplify data input for its risk-sharing partners. Also, to facilitate monitoring, compliance, and timely reporting, HUD said that it would develop an Internet system to provide guidance and solicit verification of its records and the required reports from its risk-sharing partners.

# Allocations and Reservations of 42,000 Units by Housing Finance Agencies With Risk-Sharing Agreements as of September 1997

| Housing finance agency | Number of units allocated | Number of units reserved for completed properties[a] | Number of units reserved for properties in pipelines[b] | Number of unallocated units | Percentage of total allocation reserved |
|---|---|---|---|---|---|
| District of Columbia | 160 | 0 | 160 | 0 | 100 |
| Florida | 7,002 | 2,511 | 4,491 | 0 | 100 |
| Illinois | 1,470 | 324 | 1,146 | 0 | 100 |
| Maryland | 575 | 212 | 363 | 0 | 100 |
| Maryland-Montgomery County | 2,217 | 700 | 1,517 | 0 | 100 |
| Michigan | 950 | 0 | 950 | 0 | 100 |
| Minnesota | 810 | 196 | 614 | 0 | 100 |
| Missouri | 630 | 340 | 290 | 0 | 100 |
| New Jersey | 1,123 | 0 | 1,123 | 0 | 100 |
| Oregon | 720 | 113 | 607 | 0 | 100 |
| Puerto Rico | 250 | 0 | 250 | 0 | 100 |
| Rhode Island | 595 | 68 | 527 | 0 | 100 |
| New Mexico | 925 | 341 | 568 | 16 | 98 |
| Kentucky | 745 | 232 | 479 | 34 | 95 |
| California | 8,435 | 3,177 | 4,696 | 562 | 93 |
| Connecticut | 610 | 0 | 569 | 41 | 93 |
| Maine | 150 | 140 | 0 | 10 | 93 |
| Virginia-Fairfax County | 370 | 330 | 0 | 40 | 89 |
| Massachusetts | 2,148 | 895 | 803 | 450 | 79 |
| Wisconsin | 1,010 | 194 | 528 | 288 | 71 |
| New Hampshire | 600 | 263 | 144 | 193 | 68 |
| Colorado | 4,310 | 1,885 | 992 | 1,433 | 67 |
| New York State | 3,015 | 505 | 1,042 | 1,468 | 51 |
| Pennsylvania | 690 | 0 | 306 | 384 | 44 |
| South Dakota | 235 | 0 | 90 | 145 | 38 |
| Idaho | 800 | 278 | 0 | 522 | 35 |
| Pennsylvania-Philadelphia | 400 | 115 | 0 | 285 | 29 |
| Montana | 175 | 32 | 10 | 133 | 24 |
| Alaska | 0 | 0 | 0 | 0 | 0 |
| Indiana | 300 | 0 | 0 | 300 | 0 |
| Louisiana | 280 | 0 | 0 | 280 | 0 |
| New York City | 300 | 0 | 0 | 300 | 0 |
| **Total** | **42,000** | **12,851** | **22,265** | **6,884** | **84** |

(Table notes on next page)

Note: Data in this table reflect activity reported by state and local agencies as of September 1997 and include only the 42,000 units authorized as of March 1996. Although additional units were authorized in July 1997, we did not include these units because the agencies had not had time to use them when we were conducting our audit work. Appendix II includes the units authorized in July 1997.

[a]"Completed properties" are those with closed loans. Insurance has been issued for these properties, and they are occupied.

[b]"Properties in the pipeline" are those for which an agency has reserved units. They may include those for which the agency (1) has not submitted paperwork to HUD, (2) has submitted paperwork but not received firm approval letters from HUD, or (3) has received firm approval letters but not yet closed the loans.

Source: GAO's analysis of data provided by HUD.

# Allocation of 49,500 Units to Housing Finance Agencies With Risk-Sharing Agreements as of October 1997

| Housing finance agency | Number of units allocated as of Sept. 1, 1997 | Number of units allocated at the end of fiscal year 1997 | Total number of units allocated as of Oct. 6, 1997 |
|---|---|---|---|
| California | 8,435 | 1,000 | 9,435 |
| Florida | 7,002 | 2,200 | 9,202 |
| Colorado | 4,310 | 850 | 5,160 |
| Massachusetts | 2,148 | 1,222 | 3,370 |
| Maryland - Montgomery County | 2,217 | 50 | 2,267 |
| New York State | 3,015 | –995 | 2,020 |
| New Jersey | 1,123 | 850 | 1,973 |
| Illinois | 1,470 | 300 | 1,770 |
| Oregon | 720 | 550 | 1,270 |
| New Mexico | 925 | 250 | 1,175 |
| Minnesota | 810 | 350 | 1,160 |
| Kentucky | 745 | 280 | 1,025 |
| Wisconsin | 1,010 | 0 | 1,010 |
| Michigan | 950 | 0 | 950 |
| Missouri | 630 | 189 | 819 |
| Idaho | 800 | 0 | 800 |
| Connecticut | 610 | 150 | 760 |
| Rhode Island | 595 | 150 | 745 |
| Pennsylvania | 690 | 0 | 690 |
| New Hampshire | 600 | 75 | 675 |
| Maryland | 575 | 0 | 575 |
| Virginia - Fairfax County | 370 | 175 | 545 |
| Pennsylvania - Philadelphia | 400 | 100 | 500 |
| Puerto Rico | 250 | 54 | 304 |
| Indiana | 300 | 0 | 300 |
| Louisiana | 280 | 0 | 280 |
| South Dakota | 235 | 0 | 235 |
| Montana | 175 | 0 | 175 |
| District of Columbia | 160 | 0 | 160 |
| Maine | 150 | 0 | 150 |
| Alaska | 0 | 0 | 0 |
| Florida - Dade County | 0 | 0 | 0 |
| New York City | 300 | –300 | 0 |
| **Total** | **42,000** | **7,500** | **49,500** |

Source: GAO's analysis of data provided by HUD.

# Location of Units Reserved for Completed and Pipeline Properties as of September 1997

| Housing finance agency | Total number of units | Location of units | | | Percentage of units | | |
|---|---|---|---|---|---|---|---|
| | | Urban | Suburban | Rural | Urban | Suburban | Rural |
| AK | 0 | 0 | 0 | 0 | [a] | [a] | [a] |
| CA | 7,873 | 3,659 | 3,296 | 918 | 46.5 | 41.9 | 11.6 |
| CO | 2,877 | 1,519 | 663 | 695 | 52.8 | 23.1 | 24.2 |
| CT | 569 | 535 | 34 | 0 | 94.0 | 6.0 | 0.0 |
| DC | 160 | 160 | 0 | 0 | 100.0 | 0.0 | 0.0 |
| FL | 7,002 | 4,290 | 2,712 | 0 | 61.3 | 38.7 | 0.0 |
| ID | 278 | 278 | 0 | 0 | 100.0 | 0.0 | 0.0 |
| IL | 1,470 | 399 | 1,071 | 0 | 27.1 | 72.9 | 0.0 |
| IN | 0 | 0 | 0 | 0 | [a] | [a] | [a] |
| KY | 711 | 315 | 117 | 279 | 44.3 | 16.4 | 39.3 |
| LA | 0 | 0 | 0 | 0 | [a] | [a] | [a] |
| MA | 1,698 | 851 | 815 | 32 | 50.1 | 48.0 | 1.9 |
| MD | 575 | 575 | 0 | 0 | 100.0 | 0.0 | 0.0 |
| MD-MC | 2,217 | 391 | 1,826 | 0 | 17.6 | 82.4 | 0.0 |
| ME | 140 | 140 | 0 | 0 | 100.0 | 0.0 | 0.0 |
| MI | 950 | 750 | 66 | 134 | 78.9 | 6.9 | 14.1 |
| MN | 810 | 327 | 483 | 0 | 40.3 | 59.7 | 0.0 |
| MO | 630 | 630 | 0 | 0 | 100.0 | 0.0 | 0.0 |
| MT | 42 | 0 | 0 | 42 | 0.0 | 0.0 | 100.0 |
| NH | 407 | 0 | 407 | 0 | 0.0 | 100.0 | 0.0 |
| NJ | 1,123 | 719 | 326 | 79 | 64.0 | 29.0 | 7.0 |
| NM | 909 | 687 | 0 | 222 | 75.6 | 0.0 | 24.4 |
| NYC | 0 | 0 | 0 | 0 | [a] | [a] | [a] |
| NYS | 1,547 | 599 | 741 | 207 | 38.7 | 47.9 | 13.4 |
| OR | 720 | 647 | 0 | 73 | 89.9 | 0.0 | 10.1 |
| PA | 306 | 0 | 275 | 31 | 0.0 | 90.0 | 10.0 |
| PA-PH | 115 | 115 | 0 | 0 | 100.0 | 0.0 | 0.0 |
| PR | 250 | 250 | 0 | 0 | 100.0 | 0.0 | 0.0 |
| RI | 595 | 451 | 144 | 0 | 75.7 | 24.3 | 0.0 |
| SD | 90 | 90 | 0 | 0 | 100.0 | 0.0 | 0.0 |
| VA -FC | 330 | 0 | 330 | 0 | 0.0 | 100.0 | 0.0 |
| WI | 722 | 395 | 285 | 42 | 54.6 | 39.5 | 5.9 |
| **Total** | **35,116** | **18,772** | **13,592** | **2,752** | | | |
| **Percent of total** | **100.0%** | **53.5%** | **38.7%** | **7.8%** | | | |

(Table notes on next page)

Note: MD-MC is Montgomery County, Maryland; PA-PH is Philadelphia, Pennsylvania; and VA-FC is Fairfax County, Virginia.

[a]Not applicable.

Source: GAO's analysis of questionnaire data provided by housing finance agencies.

# Type of Construction for Units Reserved for Completed and Pipeline Properties as of September 1997

| Housing finance agency | Total units | Type of construction | | | | Percentage of units by type of construction | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | Acquisition | New | Rehab | Refinance | Acquisition | New | Rehab | Refinance |
| AK | 0 | 0 | 0 | 0 | 0 | [a] | [a] | [a] | [a] |
| CA | 8,899 | 0 | 4,960 | 2,913 | 1,026 | 0.0 | 55.7 | 32.7 | 11.5 |
| CO | 1,851 | 0 | 575 | 1,210 | 66 | 0.0 | 31.1 | 65.4 | 3.6 |
| CT | 569 | 0 | 142 | 427 | 0 | 0.0 | 25.0 | 75.0 | 0.0 |
| DC | 160 | 0 | 51 | 109 | 0 | 0.0 | 32.0 | 68.0 | 0.0 |
| FL | 7,002 | 0 | 6,501 | 501 | 0 | 0.0 | 92.8 | 7.2 | 0.0 |
| ID | 278 | 0 | 278 | 0 | 0 | 0.0 | 100.0 | 0.0 | 0.0 |
| IL | 1,470 | 0 | 922 | 548 | 0 | 0.0 | 62.7 | 37.3 | 0.0 |
| IN | 0 | 0 | 0 | 0 | 0 | [a] | [a] | [a] | [a] |
| KY | 711 | 0 | 416 | 153 | 141 | 0.0 | 58.5 | 21.6 | 19.9 |
| LA | 0 | 0 | 0 | 0 | 0 | [a] | [a] | [a] | [a] |
| MA | 1,698 | 0 | 667 | 991 | 40 | 0.0 | 39.3 | 58.4 | 2.4 |
| MD | 575 | 0 | 0 | 575 | 0 | 0.0 | 0.0 | 100.0 | 0.0 |
| MD-MC | 2,217 | 269 | 521 | 0 | 1,427 | 12.1 | 23.5 | 0.0 | 64.4 |
| ME | 140 | 140 | 0 | 0 | 0 | 100.0 | 0.0 | 0.0 | 0.0 |
| MI | 951 | 0 | 898 | 53 | 0 | 0.0 | 94.4 | 5.6 | 0.0 |
| MN | 810 | 0 | 0 | 810 | 0 | 0.0 | 0.0 | 100.0 | 0.0 |
| MO | 630 | 0 | 340 | 290 | 0 | 0.0 | 54.0 | 46.0 | 0.0 |
| MT | 42 | 0 | 42 | 0 | 0 | 0.0 | 100.0 | 0.0 | 0.0 |
| NH | 407 | 0 | 263 | 144 | 0 | 0.0 | 64.6 | 35.4 | 0.0 |
| NJ | 1,123 | 0 | 1,101 | 22 | 0 | 0.0 | 98.0 | 2.0 | 0.0 |
| NM | 909 | 211 | 698 | 0 | 0 | 23.2 | 76.8 | 0.0 | 0.0 |
| NYC | 0 | 0 | 0 | 0 | 0 | [a] | [a] | [a] | [a] |
| NYS | 1,547 | 0 | 1,206 | 341 | 0 | 0.0 | 78.0 | 22.0 | 0.0 |
| OR | 720 | 0 | 477 | 243 | 0 | 0.0 | 66.3 | 33.7 | 0.0 |
| PA | 306 | 0 | 306 | 0 | 0 | 0.0 | 100.0 | 0.0 | 0.0 |
| PA-PH | 115 | 0 | 63 | 52 | 0 | 0.0 | 54.8 | 45.2 | 0.0 |
| PR | 250 | 0 | 0 | 250 | 0 | 0.0 | 0.0 | 100.0 | 0.0 |
| RI | 595 | 0 | 47 | 548 | 0 | 0.0 | 8.0 | 92.0 | 0.0 |
| SD | 90 | 0 | 90 | 0 | 0 | 0.0 | 100.0 | 0.0 | 0.0 |
| VA-FC | 330 | 0 | 120 | 0 | 210 | 0.0 | 36.4 | 0.0 | 63.6 |
| WI | 722 | 120 | 222 | 280 | 100 | 16.6 | 30.7 | 38.8 | 13.9 |
| **Total** | **35,117** | **740** | **20,907** | **10,459** | **3,011** | | | | |
| **Percent of total** | **100.0%** | **2.1%** | **59.5%** | **29.8%** | **8.6%** | | | | |

(Table notes on next page)

Note: MD-MC is Montgomery County, Maryland; PA-PH is Philadelphia, Pennsylvania; and VA-FC is Fairfax County, Virginia.

[a]Not applicable.

Source: GAO's analysis of questionnaire data provided by housing finance agencies.

# Units in Completed Properties, by Size, as of September 1997

| Housing finance agency | Number of units in size category: 400 or more | 200-399 | 100-199 | 50-99 | Under 50 |
|---|---|---|---|---|---|
| California | 500 | 1,146 | 830 | 510 | 191 |
| Colorado | | 200 | 986 | 447 | 252 |
| Florida | | 2,511 | | | |
| Idaho | | 200 | | 78 | |
| Illinois | | 227 | | 97 | |
| Kentucky | | | | 84 | 148 |
| Massachusetts | | 224 | 349 | 290 | 32 |
| Maryland | | 212 | | | |
| Maryland - Montgomery County | | 311 | 236 | 153 | |
| Maine | | | 140 | | |
| Minnesota | | | | 148 | 48 |
| Missouri | | | 244 | 96 | |
| Montana | | | | | 32 |
| New Hampshire | | 263 | | | |
| New Mexico | | | 120 | 164 | 57 |
| New York | | | 422 | 83 | |
| Oregon | | | 113 | | |
| Pennsylvania - Philadelphia | | | | 115 | |
| Rhode Island | | | | 60 | 8 |
| Virginia - Fairfax County | | 210 | 120 | | |
| Wisconsin | | | 120 | 58 | 16 |
| **Total** | **500** | **5,504** | **3,680** | **2,383** | **784** |

Note: MD-MC is Montgomery County, Maryland; PA-PH is Philadelphia, Pennsylvania; and VA-FC is Fairfax County, Virginia.

Source: GAO's analysis of questionnaire data provided by housing finance agencies.

# Income Levels Served by Completed Units in the Credit Enhancement Program as of September 1997

| Housing finance agency | Number of units reserved | Income level targeted: Units targeted to over 60% of area's median income | Units targeted to 60% or less of area's median income | Units targeted to 50% or less of area's median income | Percentage of units meeting affordability requirements |
|---|---|---|---|---|---|
| California | 3,177 | 949 | 1,490 | 738 | 70 |
| Colorado | 1,885 | 915 | 486 | 484 | 51 |
| Florida | 2,511 | 1,169 | 1,015 | 327 | 53 |
| Idaho | 278 | 59 | 146 | 73 | 79 |
| Illinois | 324 | 45 | 240 | 39 | 86 |
| Kentucky | 232 | 0 | 190 | 42 | 100 |
| Massachusetts | 895 | 452 | 5 | 438 | 50 |
| Maryland | 212 | 0 | 64 | 148 | 100 |
| Maryland - Montgomery County | 700 | 94 | 574 | 32 | 87 |
| Maine | 140 | 35 | 77 | 28 | 75 |
| Minnesota | 196 | 79 | 78 | 39 | 60 |
| Missouri | 340 | 93 | 182 | 65 | 72 |
| Montana | 32 | 0 | 30 | 2 | 100 |
| New Hampshire | 263 | 210 | 0 | 53 | 20 |
| New Mexico | 341 | 132 | 150 | 59 | 61 |
| New York | 505 | 171 | 219 | 115 | 66 |
| Oregon | 113 | 0 | 0 | 113 | 100 |
| Pennsylvania - Philadelphia | 115 | 0 | 75 | 40 | 100 |
| Rhode Island | 68 | 0 | 66 | 2 | 100 |
| Virginia - Fairfax County | 330 | 0 | 330 | 0 | 100 |
| Wisconsin | 194 | 48 | 40 | 106 | 75 |
| **Total** | **12,851** | **4,451** | **5,457** | **2,943** | **65** |
| **Percent of total** | **100%** | **35%** | **42%** | **23%** | |

Source: GAO's analysis of questionnaire data provided by housing finance agencies.

# Profile of Selected Loan Consortia's Multifamily Loan Portfolios

**Table VII.1: Characteristics of Loan Consortia's Multifamily Loan Portfolios**

| Loan consortium | Year began multifamily finance | Average annual loan volume | Increased or decreased loan volume | Average loan size | Number of units |
|---|---|---|---|---|---|
| Chicago Community Investment Corporation | 1983 | $30 million | Decreased | $750,000 | 21-50 |
| California Community Reinvestment Corporation | 1989 | $20 million | Decreased | $1.8 million | 21-50 |
| Central Florida Community Reinvestment Corporation | 1991 | $5-6 million | Decreased | $2 million | Over 100 |
| Hawaii Community Reinvestment Corporation | 1991 | $10 million | Decreased | $2.5 million | 51-100 |
| Nevada Community Reinvestment Corporation | 1992 | $5 million | Increased | $2 million | 21-50 |
| New Hampshire Community Reinvestment Corporation | 1995 | $5.5 million | Increased | $1 million | 21-50 |
| Network For Oregon Affordable Housing | 1991 | $10 million | Same | $1.25 million | 21-50 |
| Savings Associations Mortgage Company (SAMCO) | 1971 | $35 million | Decreased | $2.5 million | 51-100 |
| Tampa Bay Community Reinvestment Corporation | 1993 | $7 million | Increased | $1.5 million | Over 100 |
| Washington Community Reinvestment Association | 1992 | $16 million | Decreased | $1.5 million | 21-50 |

Table VII.2: Additional Characteristics of Loan Consortia's Multifamily Loan Portfolios

| Loan consortium | Location of project | Type of project | Type of Financing | Loan Performance |
|---|---|---|---|---|
| Chicago Community Investment Corporation | Urban | Rehab | Adjustable | 1% loss on total portfolio |
| California Community Reinvestment Corporation | Urban, suburban, rural | New construction | Fixed | Very-low default rate |
| Central Florida Community Reinvestment Corporation | Urban | New construction and rehab | Fixed | No charge-offs, no delinquencies |
| Hawaii Community Reinvestment Corporation | Urban | New construction | Balloon | No delinquencies |
| Nevada Community Reinvestment Corporation | Urban | New construction | Fixed | No charge-offs |
| New Hampshire Community Reinvestment Corporation | Suburban | New construction | Fixed | Too early to determine |
| Network For Oregon Affordable Housing | Urban, suburban, rural | New construction | Fixed | No charge-offs |
| Savings Associations Mortgage Company (SAMCO) | Urban, suburban, rural | All types | Adjustable | Less than 1% loss on delinquencies |
| Tampa Bay Community Reinvestment Corporation | Urban | Acquisition and refinance | Adjustable | No charge-offs, no delinquencies |
| Washington Community Reinvestment Association | Urban, suburban, rural | New construction | Fixed and adjustable | No charge-offs |

Note: The members of the loan consortia were asked to state their average loan volume for 1994-96. They were then asked if they expected their 1997 loan volume to be the same as the previous 3-year average, to increase, or to decrease from that loan volume.

Source: GAO's analysis of questionnaire data provided by members of the loan consortia.

# Indicators of Financial Soundness of Housing Finance Agencies

| Housing finance agency | Risk level[a] | Rating agency[b] | Required reserve account[c] |
|---|---|---|---|
| Alaska | I | Moody's | No |
| California | I | Standard and Poor's | No |
| Colorado | I | Moody's | No |
| Connecticut | Both[d] | Standard and Poor's | No |
| District of Columbia | II | Not rated | Yes |
| Fairfax County, Virginia | I | Not rated | Yes |
| Florida | I | Not rated | Yes |
| Idaho | I | Moody's | No |
| Illinois | Both[d] | Moody's | No |
| Indiana | Both[d] | Moody's | No |
| Kentucky | II | Moody's | No |
| Louisiana | Both[d] | Not rated | Yes |
| Maine | Both[d] | Moody's and Standard and Poor's | No |
| Maryland | Both[d] | Moody's | Yes |
| Massachusetts | Both[d] | Standard and Poor's | No |
| Michigan | I | Standard and Poor's | No |
| Minnesota | I | Standard and Poor's | No |
| Missouri | I | Standard and Poor's | No |
| Montana | II | Moody's | Yes |
| Montgomery County, Maryland | Both[d] | Moody's | No |
| New Hampshire | I | Moody's | No |
| New Jersey | Both[d] | Standard and Poor's | No |
| New Mexico | II | Not rated | Yes |
| New York City | Both[d] | Standard and Poor's | No |
| New York State | Both[d] | Not rated | Yes |
| Oregon | Both[d] | Not rated | Yes |
| Pennsylvania | Both[d] | Standard and Poor's | No |
| Philadelphia, Pennsylvania | II | Not rated | Yes |
| Puerto Rico | II | Not rated | Yes |
| Rhode Island | Both[d] | Standard and Poor's | No |
| South Dakota | Both[d] | Not rated | Yes |
| Wisconsin | Both[d] | Not rated | Yes |

(Table notes on next page)

[a]Level I: The housing finance agency assumes 50 to 90 percent of the risk and may use its own underwriting standards and loan terms.
Level II: The housing finance agency uses underwriting standards and loan terms and conditions approved by HUD. The agency assumes 25 percent of the risk of loss if the loan-to-value ratio is greater that 75 percent. The agency assumes either 10 percent or 25 percent of the risk of loss, at its option, when loan-to-value ratio is less than 75 percent.

[b]The housing finance agency (1) has received the “top tier” designation from Standard and Poor’s or another nationally recognized rating agency, (2) has received an overall “A” rating from a nationally recognized agency or (3) can otherwise demonstrate its capacity to HUD by establishing a dedicated reserve account of liquid assets of not less than $500,000.

[c]The housing finance agency must maintain an account with an initial amount of not less than $500,000. Thereafter, the agency must deposit at each loan closing, and thereafter maintain, additional money as specified in the regulations—essentially, 1 percent of mortgage amounts up to $50 million, plus 75 basis points of mortgage amounts between $50 million and $150 million, plus 50 basis points for mortgage amounts over $150 million.

[d]The risk-sharing partner can use level I or level II procedures to provide FHA insurance under its risk-sharing agreement.

Source: HUD, New Products Division.

# Comments From the Department of Housing and Urban Development

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

APR 3 1998

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

Ms. Judy England-Joseph
Director, Housing and Community
Development Issues
United States General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Ms. England-Joseph:

Enclosed is the Office of Housing's comments on the March 19, 1998, draft report entitled FHA's Risk Sharing Programs Offer Alternatives for Financing Affordable Multifamily Housing.

Thank you for your consideration and the opportunity to comment. If you have any questions please contact Joseph E. Malloy at (202) 708-3000.

Sincerely,

Annie D McCulloch for

Art Agnos
Acting General Deputy Assistant
Secretary for Housing

Enclosure

FHA COMMENTS
on the
GAO's Draft Report to Congressional Requesters

*FHA's Risk Sharing Programs Offer Alternatives for Financing Affordable Multifamily Housing*

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This is in response to the GAO recommendations in its report *FHA's Risk Sharing Programs Offer Alternative for Financing Affordable Multifamily Housing*. That report recommends that:

1. The Commissioner, Federal Housing Administration ...explore the feasibility of amending HUD's current risk-sharing agreements with qualified financial institutions...to allow the use of reinsurance with: (a) 18-year balloon mortgages and (b) loan pools.

2. (T)hat the Secretary (a) correct current flaws in the data systems supporting the risk-sharing demonstration programs and (b) give priority to implementing a comprehensive monitoring system to ensure compliance and timely reporting.

---

We agree with the recommendations provided in the report.

Recommendation 1(a): explore amending current risk sharing agreements to allow the use of 18-year balloon mortgages.

> On November 25, 1997, the Department and Fannie Mae executed an amendment to their risk-sharing agreement to allow 18-year balloon mortgages. While no balloon mortgages have yet to be reinsured, with the precedent set by that amendment we will extend the offer to the other participating entities to modify their agreements to permit 18-year balloon mortgages with 30-yerar amortization periods.

Recommendation 1(b): explore the feasibility of amending current risk sharing agreements to reinsure loan pools.

> Because of the potential to reach under served and hard to serve markets, we will explore the reinsurance of loan pools with the current participating risk sharing partners keeping in mind that we must maintain the actuarial soundness of the FHA insurance fund.

Recommendation 2(a): correct current flaws in the data systems supporting the risk-sharing demonstration programs.

> A comprehensive system for the acceptance, tracking and management of mortgage insurance applications from submission through to endorsement is currently in pilot operation in seven offices and planned for national implementation September 1998. That system, the Development Application Process (DAP), will provide source data to the insurance-in-force system which is currently being redesigned and expected to be operational September 1998. While the DAP may not handle risk sharing in its initial implementation, risk sharing projects will be included in later releases. In the interim, we will develop spreadsheets to the improve

*April 2, 1998*

the user friendliness of the current systems and simplify data input for our risk-sharing partners.

We will develop an intranet system for internal tracking, management and coordination with the field offices and outstationed staff.

Recommendation 2(b) give priority to implementing a comprehensive monitoring system to ensure compliance and timely reporting.

To facilitate monitoring, compliance and timely reporting, we will develop an internet system to provide guidance and solicit verification of our records and the required reports from our risk-sharing partners. We will develop an internal intranet based system to provide oversight guidance and report compliance with programmatic requirements for HUD staff.

# Major Contributors to This Report

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