

Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance Fund Fiscal Year 2010

U.S. Department of Housing and Urban Development
November 15, 2010





Secretary's Foreword

I am pleased to present to Congress my second annual report on the financial status of the Federal Housing Administration (FHA) Mutual Mortgage Insurance (MMI) Fund, which contains the FHA's single-family forward and reverse mortgage portfolios. Though the economic recovery remains fragile, all indications are that the Fund remains sound. At the close of FY 2010, the MMI Fund holds more than \$33 billion in liquid assets, which are readily available to pay insurance claims. The FY 2011 book, which just opened, is anticipated to provide \$6 billion of additional security to the Fund under the base-case forecast. New loan guarantees are generating sufficient net income that, going forward, the MMI Fund is positioned to withstand even a near-term repeat of the 2007-2009 house-price declines. The Fund contributed net revenue to the taxpayer and performed better than was expected in last year's report.

FHA and Ginnie Mae have proven to be extremely resilient throughout the financial and housing market crisis of the past three years. I am proud of what these two agencies of HUD have done and continue to accomplish. They act as catalysts to private sector activity; they do not replace that activity. FHA and Ginnie Mae saved hundreds of thousands of jobs for lenders, real estate agents, home builders, and appraisers—along with the many other workers involved in housing markets. These two agencies provide continuous access to the capital markets for mortgage credit in all areas at all times. This liquidity function assures that housing markets continue to operate which, in turn, has mitigated the magnitude of the current housing downturn.

The importance of FHA and Ginnie Mae to housing markets today is seen most clearly in home purchase activity. FHA guarantees are supporting one-in-five home purchases in the U.S. today. In terms of actual home-purchase mortgage loans, FHA guaranteed close to 40 percent of those originated in the past year. A recent Federal Reserve Board analysis on Home Mortgage Disclosure Act reporting indicates that Ginnie Mae guarantees covered more than 50 percent of all home-purchase loans in 2009. But we are committed to stepping back from this role and supporting the return of private capital to the market.

The contraction of conventional, private sources of loan guarantees has meant a dramatic increase in the credit quality of loans coming to FHA. As housing markets continue to be stressed and attempt to stabilize in cities across the country, FHA is taking on business that is resulting in a portfolio of historically high credit quality. These new loan guarantees, and the

mortgage insurance premiums that they generate, are providing net income that can be used both to offset claim expenses on the earlier books and to start rebuilding FHA's capital position. The quality of recent originations increased the economic value of the MMI Fund by almost \$9 billion and the actuaries predict an additional increase of \$28 billion by 2016. While we need to continue to carefully manage risk, the report shows the MMI Fund remaining self-sufficient in every scenario tested by the actuaries.

We are cognizant of our responsibility to the communities that depend on us, and to the American taxpayers, to prudently manage this risk. Under the leadership of Federal Housing Commissioner, David Stevens, Chief Risk Officer, Bob Ryan, and Deputy Assistant Secretary for Single Family Housing, Vicki Bott, the FHA team is continually evaluating all aspects of single family insurance operations and tightening risk controls to make sure that we remain in the business of *sustainable* homeownership. Their leadership has led to significant changes in underwriting guidelines and premium rates, increased standards for lender qualifications and performance, and heightened attention to loan servicing quality to significantly strengthen the MMI Fund.

This Administration has a deep commitment to FHA's role in facilitating the recovery of the housing market and to its mission of providing access to homeownership for first-time homebuyers and underserved populations. After 76 years, FHA remains a stabilizing force in the housing market and an important door to homeownership in the United States.



Shaun Donovan
Secretary
United States Department of Housing and Urban Development

TABLE OF CONTENTS

I. INTRODUCTION 1

A. FHA ACTIVITY IN FISCAL YEAR 2010 1

 1. First-Time Homebuyers 5

 2. Minority Homebuyers 6

 3. Refinance Volumes 7

 4. Home Equity Conversion Mortgage (HECM) 7

B. ASSISTING BORROWERS WITH FINANCIAL DIFFICULTIES 8

II. THE FINANCIAL STATUS OF THE MMI FUND..... 10

A. CURRENT FINANCIAL STATUS..... 10

 1. Account Balances..... 10

 2. Core Insurance Operations in FY 2010 11

B. ASSESSMENT OF THE INDEPENDENT ACTUARIAL STUDIES 12

 1. Principal Findings 13

 2. Principal Drivers of the Actuarial Assessment 15

 3. Other Measures of Financial Health 19

 4. Credit Quality of Future Books..... 20

 5. HECM’s Future..... 22

 6. Credit Losses in the Current Portfolio 22

 7. Credit Quality of the 2004-2008 loan cohorts 23

 8. Continuing Influence of Seller-Funded Downpayment Assistance (SFDPA) loans 24

 9. Impact of Income Disruptions 25

C. RISKS TO THE ACTUARIAL FORECAST 27

 1. Economic Forecast Risk 27

 2. Alternative Scenarios and their Implications for Capital Resources and the Capital Ratio..... 28

 3. Other Risk Factors 33

III. ACTIONS TAKEN TO STRENGTHEN THE FUND FOR THE FUTURE..... 34

A. A COMPREHENSIVE FOCUS ON RISK MANAGEMENT 34

B. UNDERWRITING AND PRICING 34

 1. Streamline Refinancing..... 34

 2. Minimum Borrower Credit Quality 36

 3. Appraisal Standards 36

 4. Single-Family Premiums 36

 5. HECM Changes 37

C. MANAGING COUNTERPARTY RISK 38

 1. Origination and Underwriting..... 38

 2. Indemnification Against Potential Loss..... 39

 3. Loan Servicing..... 39

 4. IT Infrastructure 40

IV. THE CONTINUING ROLE OF THE FHA..... 40

FIGURES AND TABLES

Figure 1. FHA Single-Family Shares of Mortgage Originations3
Figure 2. FHA Share of Home Purchase Activity by Fiscal Year and Month3
Figure 3. FHA Single-Family Purchase Loan Endorsements in FY 2010, by State.....4
Figure 4. FHA Single-Family Refinance Endorsements in FY 2010, by State4
Figure 5. FHA Reverse Mortgage (HECM) Endorsements in FY 2010, by State5
Figure 6. FHA Single-Family Recapture Rates by Fiscal Year7
Figure 7. FHA Endorsements of Reverse Mortgages (HECM), by Fiscal Year8
Figure 8. Alternative Forecasts of Annual House Price Growth Rates15
Figure 9. Comparing the Assumed Credit Characteristics of the FY 2010 Book in the FY 2009 Actuarial Study with Actual Characteristics.....18
Figure 10. MMI Fund Capital Resources and Capital Reserves Over Time.....19
Figure 11. Future Business Assumptions Used in the Single-Family Actuarial Study.....22
Figure 12. Estimated Value of Each Book-of-Business^a23
Figure 13. Base Case and Alternative House Price Scenarios28
Figure 14. Capital Resource Estimates Under Alternative Economic Scenarios, FY 2010-2017.....30
Figure 15. Capital Ratio Estimates Using Alternative Economic Scenarios, FY 2010-201730
Figure 16. Capital Ratio Estimates and NPV of the FY 2010 Book Under Alternative Economic Scenarios.....33

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Table 1. FHA Single-Family Mortgage Insurance Endorsements2
Table 2. FHA Single-Family Insurance Endorsements for First-time Homebuyers5
Table 3. Racial Distribution of FHA FY 2010 Endorsements by Loan Purpose6
Table 4. FHA Insurance as a Share of Home-Purchase Loans^a in 2009 by Race and Type6
Table 5. FHA Single-Family Insurance: New 90-Day Delinquencies, Foreclosure and Claims9
Table 6. FHA Single-Family Foreclosure Avoidance, by Fiscal Year9
Table 7. FHA Single-Family Insurance MMI Fund Balances by Quarter, FY 2008 – FY 201011
Table 8. FHA MMI Fund Financing Account Insurance Operations Cash Flows in FY 2010.....12
Table 9. Independent Actuarial Assessments for FY 2010.....14
Table 10. FHA Premium Structure: Upfront and Periodic Rates for 30-Year, Fixed-Rate, Purchase and Refi18
Table 11. MMI Fund Capital Resource and Capital Ratio – Base Case Actuarial Estimates, FY 2010 - 2016.....20
Table 12. FHA Single-Family Insurance Endorsements for First-time Homebuyers25
Table 13. FHA Single-Family Insurance New 90+ Day Delinquencies by Reason for Delinquency.....26
Table 14. Peak-to-Trough House Price Declines Under Alternative Economic Forecasts29
Table 15. Projected End-of-Year MMI Fund Capital Ratios by Economic Scenario31
Table 16. FHA Single-Family Insurance Early Payment Delinquency Rates by Product Type and Month.....35

I. Introduction

The Mutual Mortgage Insurance (MMI) Fund is a system of accounts which are used to manage the single-family mortgage insurance programs of the Federal Housing Administration (FHA). The FHA resides within the U. S. Department of Housing and Urban Development (HUD) and provides federally-insured loan guarantees for mortgages issued by private lenders. Its insured portfolio includes mortgages on single-family residential properties, apartments, hospitals, assisted-living facilities, and nursing homes. As an agency, the FHA oversees an insured portfolio of over \$1 trillion, of which the MMI Fund programs represent \$907 billion. In FY 2010 alone, MMI Fund loan guarantees represented 43 percent of all federal direct loans and guarantees.¹

MMI Fund programs are unique among federal direct loan and guarantee programs as they are required to be self-supporting. Since its inception in 1934, the MMI Fund has been self-supporting; it has never required a direct appropriation from the Congress to continue insurance operations. The findings of independent actuarial reviews performed at the close of FY 2010 state that the MMI Fund remains actuarially sound, though there are significant risks to the near-term financial outlook. Actuarial soundness refers to the balance of insurance risk and premium rates today. New insurance premiums from newly insured loans are expected to continue rebuilding the Capital Reserve Account in FY 2011. That account has been substantially depleted over the past two years to finance dedicated loss reserves for outstanding books-of-business. Those funds have not been spent; they have simply been moved to the Financing Account, which is obligated to hold all dedicated loss reserves for outstanding books-of-business. The total capital resources of the MMI Fund, which is the combined sum of the Capital Reserve and Financing Account, have actually grown by over \$5 billion in the past two years. The contribution of individual books-of-business to the stability of the MMI Fund changed with FY 2009. The FY 2009 book is in actuarial balance while those from 2000 through 2008 are expected to result in net losses for the Fund. The new FY 2010 book, however, is expected to both pay for itself and contribute toward paying losses on pre-2009 books of business. The FY 2011 book is expected to be equally valuable as the FY 2010 book.

This report details FHA's significant role in supporting the U.S. housing market today, the financial assessment of the independent actuaries, and the many steps that HUD has already taken to ensure the FHA remains a stable force in the broader U.S. housing finance system.

A. FHA ACTIVITY IN FISCAL YEAR 2010

The FHA served more than 1.1 million homebuyers in FY 2010, and helped 882,000 of those households become homeowners for the first time. This was the second time the FHA assisted more than 1 million homebuyers in a single year. The first was in 1987. Now, as then, the FHA

¹ Per the FY 2011 President's Budget, *Federal Credit Supplement*, excluding special expenditures of the U.S. Treasury under economic stabilization programs, and excluding Ginnie Mae security guarantees (which would double count loan guarantees).

is providing essential access to mortgage credit at a time when severe housing recessions across the country have curtailed private sources of credit in the housing sector for many borrowers.

In total, the FHA insured \$319 billion of single-family mortgages in FY 2010, representing 1.75 million households. These aggregate volumes are second only to the volume of FHA activity in FY 2009.

Table 1. FHA Single-Family Mortgage Insurance Endorsements					
Time Period	Number of New Insurance Cases				
	Forward Mortgages^a				Reverse Mortgages (HECM)^b
	Home Purchase	Refinance from Conventional Loan	FHA-to-FHA Refinance	All Forward Loans	
<i>Fiscal Year</i>					
2000	763,063	30,352	38,131	831,546	6,637
2001	730,106	43,802	188,644	962,552	7,789
2002	787,093	61,100	319,985	1,168,178	13,048
2003	602,452	59,499	556,983	1,218,934	18,084
2004	540,313	53,939	298,169	892,421	37,790
2005	328,542	31,958	117,849	478,349	43,082
2006	293,258	58,226	48,420	399,904	76,280
2007	261,165	104,578	36,600	402,343	107,368
2008	591,323	349,132	91,129	1,031,584	112,015
2009	995,103	468,769	367,426	1,831,298	114,641
2010	1,105,711	304,318	251,195	1,661,224	78,757
<i>Fiscal Year Quarters</i>					
2009Q1	261,430	122,162	25,645	409,237	27,651
2009Q2	182,634	120,053	97,856	400,543	30,190
2009Q3	228,752	118,727	143,318	490,797	28,686
2009Q4	322,737	108,021	100,666	531,424	28,114
2010Q1	304,929	86,575	96,157	487,661	24,729
2010Q2	245,881	88,393	67,987	402,261	20,278
2010Q3	289,777	65,655	31,038	386,470	15,266
2010Q4	268,996	64,965	57,259	391,220	18,484

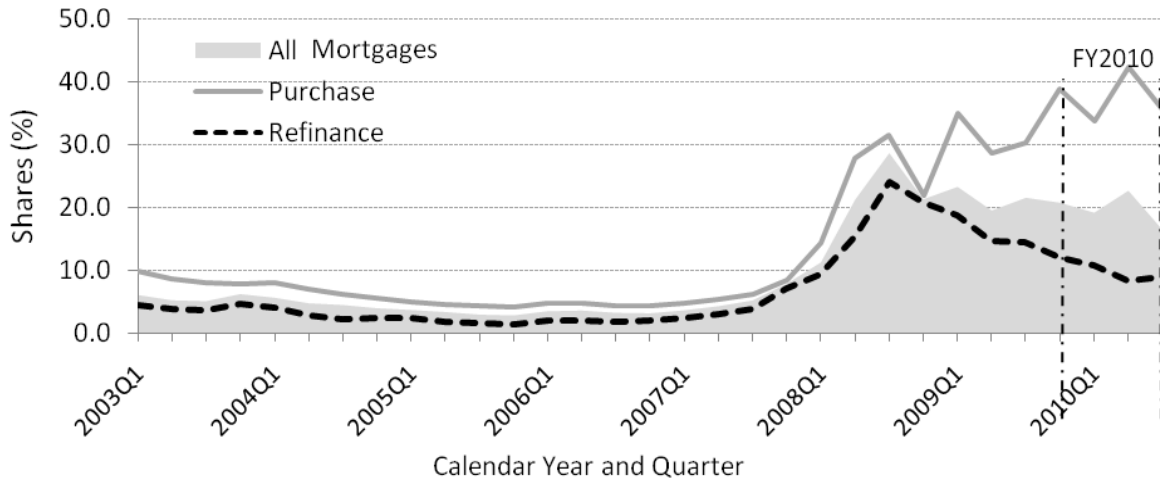
^aStarting in 2008Q4, these counts include 203(K) purchase-and-rehabilitation loans and 234(C) condominium loans.

^bThe FHA reverse-mortgage insurance program is called Home Equity Conversion Mortgage (HECM). Starting in FY 2009, all new HECM endorsements are in the Mutual Mortgage Insurance Fund. Previous endorsements, by law, remain in the General and Special Risk Insurance Fund.

Source: U.S. Department of HUD, Office of Housing/FHA.

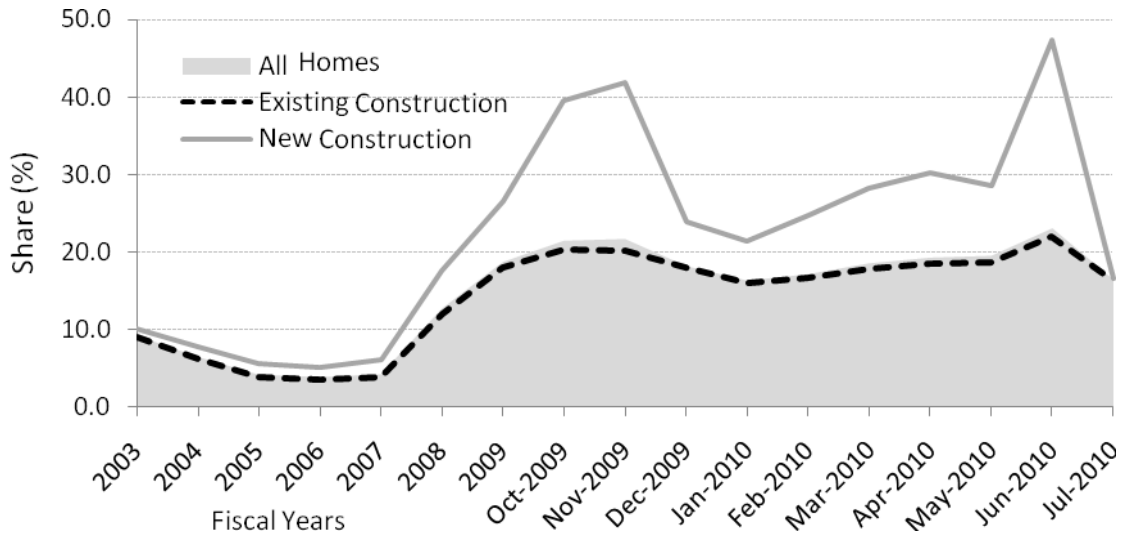
The impact of the FHA in supporting housing and mortgage markets can be seen in national market shares and in state-level activity concentrations. Data now available through July of this year show that one of every five U.S. home purchases in FY 2010 relied upon FHA insurance. The rate was three in every ten for purchases of newly constructed homes. Among mortgage originations, the FHA insured 38 percent of all home-purchase loans and 9 percent of all refinance loans during the 9 month period ending in June 2010.

Figure 1. FHA Single-Family Shares of Mortgage Originations



Source: Analysis by U.S. Department of HUD/FHA; market data from the Mortgage Bankers Association on dollar volumes and from First American Core Logic on average mortgage amounts.

Figure 2. FHA Share of Home Purchase Activity by Fiscal Year and Month



Source: Analysis by U.S. Department of HUD/FHA; market data on home sales from the National Association of Realtors and the U.S. Bureau of the Census.

Figure 3. FHA Single-Family Purchase Loan Endorsements in FY 2010, by State

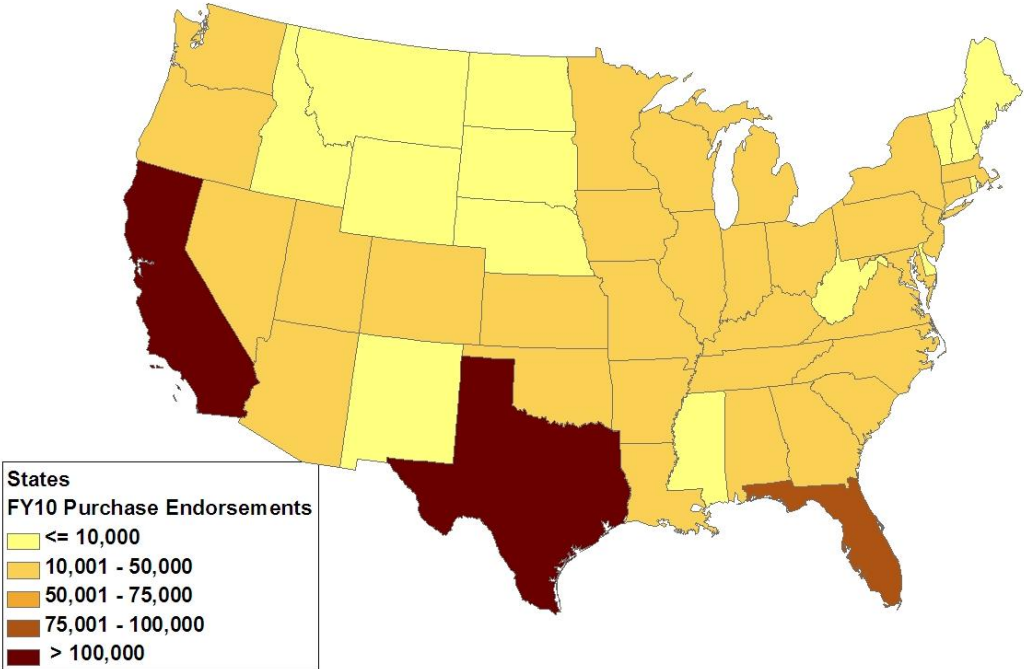


Figure 4. FHA Single-Family Refinance Endorsements in FY 2010, by State

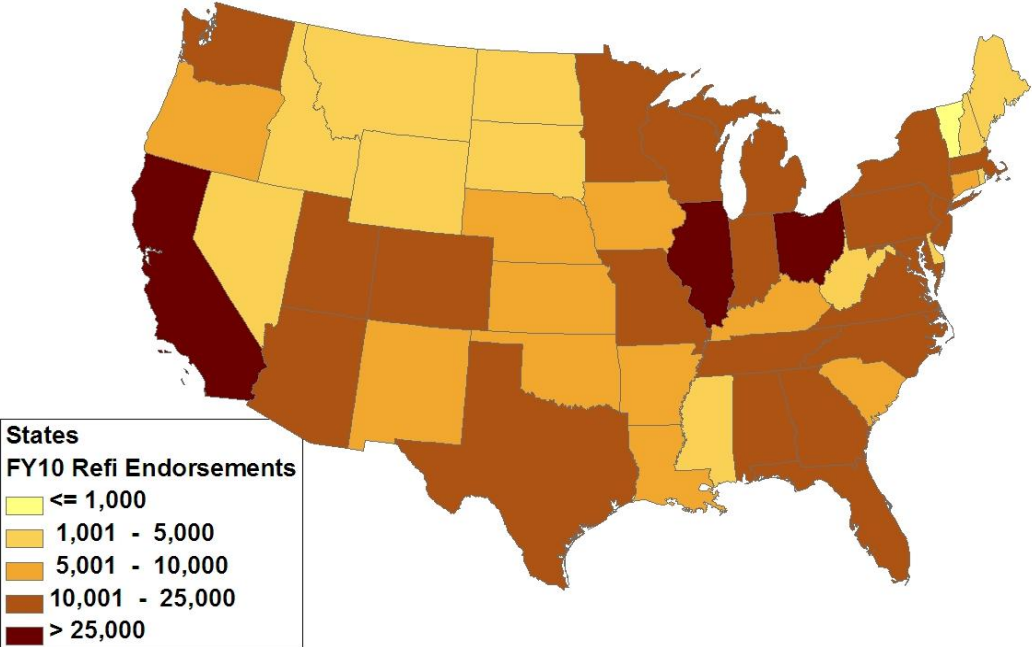
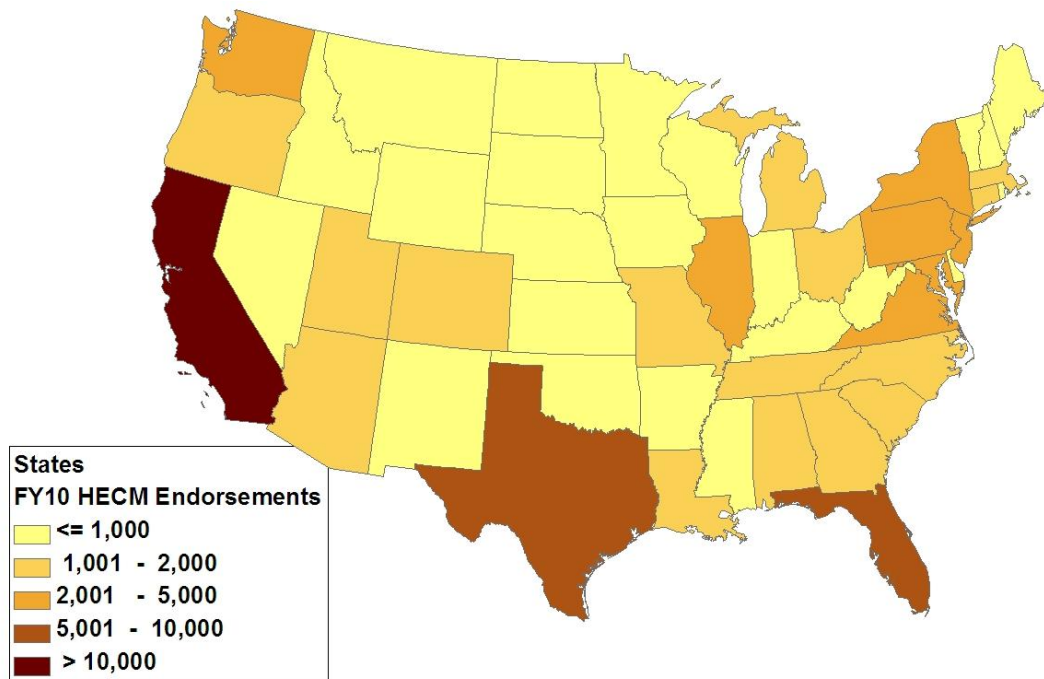


Figure 5. FHA Reverse Mortgage (HECM) Endorsements in FY 2010, by State



FHA’s largest presence today is in California and Texas. In California, FHA’s presence among single-family (non-HECM) mortgage originations nearly disappeared during the housing boom. In FY 2000, FHA insured over 100,000 home-purchase loans in California, but by FY 2006 that amount had fallen to just 2,600, with an additional 1,800 refinance endorsements. In both FY 2009 and 2010 FHA insured more than 130,000 home purchase loans and over 30,000 refinance loans each year in California. In Texas, FHA endorsements fell in half from 2005 – 2007, but increased back to more than 105,000 home purchase loans in FY 2010, with all single-family and HECM endorsements totaling nearly 135,000.

1. First-Time Homebuyers

This year, FHA insured mortgages for over 882,000 first-time homebuyers.

Fiscal Year	Number of First-Time Homebuyers Served	Average Home Price
2000	684,998	100,730
2001	643,640	107,203
2002	683,581	114,105
2003	521,724	116,920
2004	454,241	121,081
2005	280,082	117,823
2006	248,884	120,538
2007	221,470	126,428
2008	492,282	156,414
2009	781,680	168,867
2010	882,097	167,782

2. Minority Homebuyers

FHA provided significant support in FY 2010 for minority homebuyers and for minority homeowners seeking to refinance their properties and lower their monthly housing costs. Among borrowers who disclosed their race, 30 percent of home purchase loan endorsements, 20 percent of refinance loans, and 25 percent of HECM loans were for minorities. In the broader housing market, FHA is playing a large role in facilitating homeownership by minority homebuyers. The 2009 Home Mortgage Disclosure Act (HMDA) data suggests that FHA insured mortgages for 60 percent of all African American and Hispanic/Latino homebuyers in the U.S. that year. During the height of the recent housing boom in 2005 and 2006, FHA insured just ten percent of African American and six percent of Hispanic/Latino home-purchase loans.

Race or Ethnicity	Loan Purpose		
	Home Purchase	Refinance	HECM
African American	9.47%	8.27%	15.10%
Asian	3.98	2.34	1.52
Hispanic/Latino	14.42	7.40	7.97
Native American	0.37	0.43	0.35
White	65.54	71.83	72.79
Unknown	6.23	9.72	2.27
All	100.00%	100.00%	100.00%

Source: U.S. Department of HUD/FHA.

Race or Ethnicity	Number	Shares by Type of Loan (each row adds to 100%)			
		Conventional ^b	FHA	VA ^c	USDA Rural Development ^c
All Borrowers	3,317,726	50.32%	38.35%	6.92%	4.40%
African American	177,794	22.10	60.07	13.64	4.20
Asian	179,695	73.72	23.49	2.24	0.54
Hispanic/Latino	281,680	29.27	60.74	5.88	4.11
Native American	11,128	42.11	43.00	9.09	5.80
White	2,299,398	52.71	35.62	6.55	5.12
Not disclosed	280,928	56.48	33.66	7.94	1.92
Mixed - White and minority co-borrowers	87,103	45.40	39.31	12.77	2.52

^aLoan data only for owner-occupied homes.

^bConventional loans include those originated for sale to Fannie Mae or Freddie Mac, and all loans without any federal government guarantee.

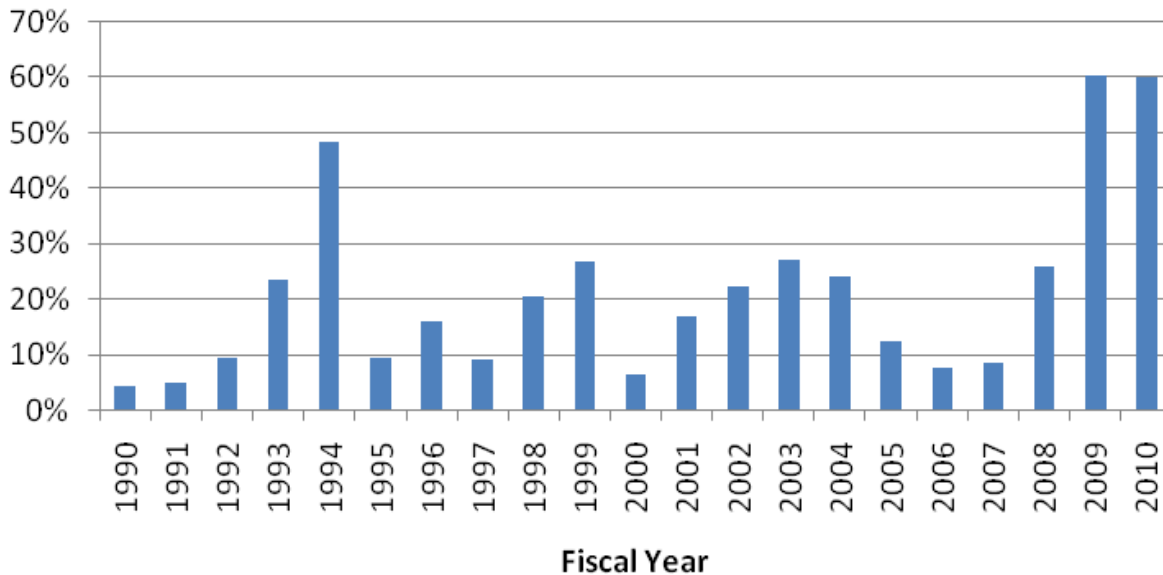
^cLike FHA, the VA and USDA provide government loan guarantees.

Source: U.S. Department of HUD/FHA; Analysis of 2009 Home Mortgage Disclosure Act (HMDA) data. HMDA data provided by the Federal Financial Institutions Examination Council.

3. Refinance Volumes

The FY 2010 book-of-business was also characterized by significant savings on refinance transactions, and by high rates of loan payoffs returning to the FHA as new refinance transactions. FHA-insured borrowers who refinanced with the FHA in FY 2010 saved an average of \$127 per month. In the last six months of the year the savings were over \$140.² The rate at which borrowers return to the FHA after a loan payoff is referred to as a “recapture” rate. The recapture rate of 60 percent during FY 2010 nearly matched the historic level seen in FY 2009.³ These loans continue to contribute insurance premiums to the MMI Fund and the lower monthly payments generally make them of lower risk than the loans they replace.

Figure 6. FHA Single-Family Recapture Rates by Fiscal Year



Source: U.S. Department of HUD/FHA.

4. Home Equity Conversion Mortgage (HECM)

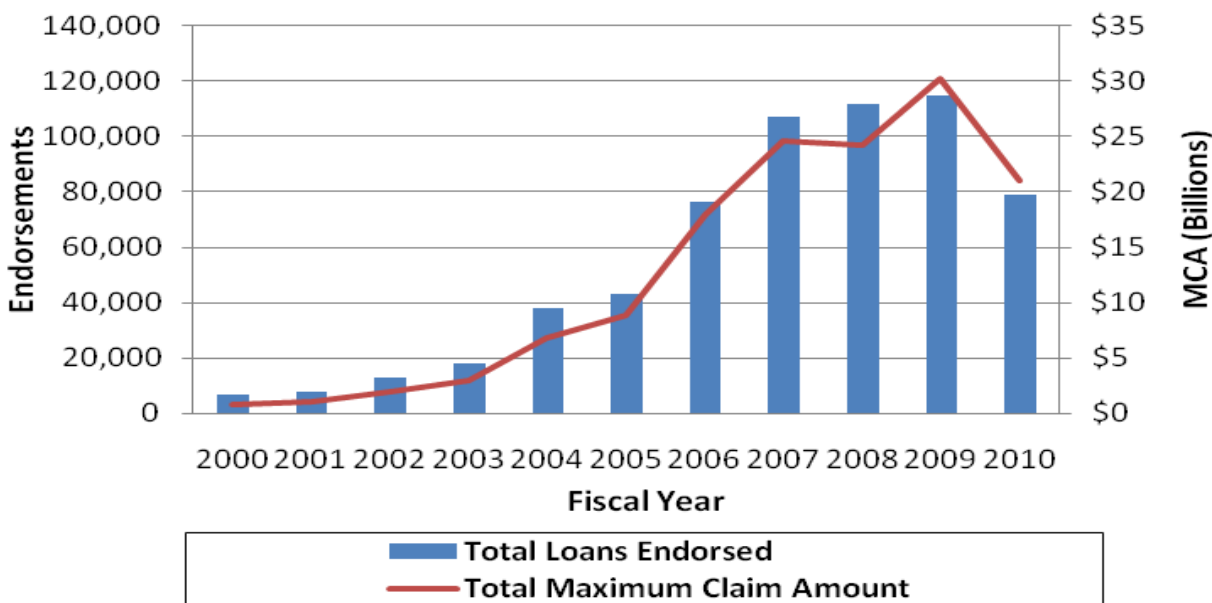
FHA’s reverse mortgage product, which supports senior homeowners, is known as the Home Equity Conversion Mortgage (HECM). HECM insurance endorsements declined in FY 2010 by over 30 percent to 78,757 loans. This marked the first measurable decline in the 21-year history of the program. The decline is most likely due to the reduction in equity take-out limits imposed in October 2009. This reduction was designed to enable the FY 2010 book-of-business to break-even under the conservative out-year house-price-growth assumptions of the President’s Budget.

² FHA does not know the terms of previous loans in the case of convention-to-FHA refinance transactions. Thus, we can only report of monthly savings for FHA-to-FHA refinance transactions.

³ Loans that are not “recaptured” do not necessarily represent conventional market refinancing, especially in today’s economy. Many may be selling their homes. If they purchase a new home with an FHA-insured mortgage they are not counted here as recaptures. Recapture rates decrease for older vintages of loans. The FY 2006 book represents the mean expectation, from which the recapture rate these past two years has been just over 60 percent. Older books have lower recapture rates and more recent books have higher recapture rates. The FY 2008 book, in particular, had a 90 percent recapture rate among FY 2009 payoffs, and a 98 percent recapture rate for payoffs in FY 2010.

Further discussion on the economic performance of HECM and additional changes to the reverse mortgage product offerings are provided in later sections of this report.

Figure 7. FHA Endorsements of Reverse Mortgages (HECM), by Fiscal Year



Source: U.S. Department of HUD/FHA; Maximum Claim Amount represents the maximum that FHA will pay to a lender on assignment of a HECM loan in the future, or else in losses on a pre-assignment termination.

B. ASSISTING BORROWERS WITH FINANCIAL DIFFICULTIES

FY 2010 continued to be a challenging environment for supporting existing homeowners facing financial difficulties. New 90-day delinquencies reached an all-time high of nearly 52,000 in January of this year before starting to taper off. That was nearly double the rate of two years earlier and it led to an historic-high number of foreclosure starts in March (27,600).⁴ At the same time, interventions to preserve homeownership are also at an all-time high. In FY 2010, FHA’s loan servicers provided over 301,000 assisted cures through repayment plans, loan modifications, and partial claims.⁵ Another 155,000 homeowners are currently working with their loan servicers on home-retention workouts, and many are already in repayment plans. An additional 20,200 homeowners were able to avoid foreclosure by selling their home through a preforeclosure (short) sale of the mortgage, or a voluntary deed transfer, with FHA paying the loss. On net, in the course of FY 2010, there were nearly three completed loss mitigation actions for each

⁴ January is also the peak month for new 90-day delinquencies. The seasonally-adjusted rate for January 2010 is 44,000. Firms servicing FHA-insured loans must either have a documented work-out plan or else initiate foreclosure proceedings by the end of the sixth month of delinquency, for loans uncured by that point.

⁵ Partial claims are used by HUD to bring loans current after several months of delinquency, or when the borrower needs a reduction in the loan balance to bring payments in-line with reduced income. The latter is the new FHA Home Affordable Modification Plan (HAMP) option which was just authorized by the Congress in 2009. In either case, funds expended to cure the delinquency are secured by a lien on the property, which is payable when the property is sold or refinanced. With a partial claim, there are no monthly payment obligations of the borrower against the new promissory note secured by the lien.

foreclosure claim paid by HUD. Thus, among all defaulted borrowers who were unable to cure the situation on their own, only 27 percent experienced foreclosure and eviction.

Year and Quarter	New 90- Day Delinquencies	Foreclosure Starts	Foreclosure Claims Paid
2007Q1	44,259	26,138	13,048
2007Q2	46,991	20,982	12,238
2007Q3	62,802	22,524	12,011
2007Q4	78,643	25,027	13,059
2008Q1	67,559	31,296	14,658
2008Q2	67,929	26,549	14,078
2008Q3	92,033	31,279	14,033
2008Q4	122,367	36,001	14,666
2009Q1	111,451	44,806	16,046
2009Q2	108,001	48,056	18,115
2009Q3	146,712	55,435	20,339
2009Q4	152,884	60,861	20,655
2010Q1	124,579	69,766	24,699
2010Q2	104,108	59,558	23,627
2010Q3	131,036	50,082	29,976

Source: U.S. Department of HUD/FHA.

Fiscal Year of Complete Action	Assisted Cures^a	Other Foreclosure Avoidance Actions^b
2001	49,446	3,686
2002	90,706	4,445
2003	77,920	5,542
2004	89,239	6,214
2005	131,384	5,825
2006	123,181	5,769
2007	185,856	3,961
2008	233,130	4,176
2009	194,491	8,736
2010	301,502	20,819
Open Actions ^c	154,761	20,959

^aAssisted Cures include all delinquency reinstatements using any repayment plans, modifications, partial claims (including HAMP actions).

^bOther Foreclosure Avoidance Actions include preforeclosure (short) sales and voluntary deed transfers (deeds-in-lieu).

^cOpen Actions represent situations where loan servicers are actively working with borrowers on cures or Other Actions, as-of September 30, 2010. Not all of these Open Actions will be successful in either curing the default or otherwise avoiding foreclosure.

Source: U.S. Department of HUD/FHA.

II. The Financial Status of the MMI Fund

A. CURRENT FINANCIAL STATUS

The MMI Fund operates with two primary sets of financial accounts.⁶ All business transactions related to insurance operations are maintained in a series of Financing Accounts at the U.S. Department of Treasury (U.S. Treasury). Secondary reserves for unexpected claim expenses are maintained in a separate Capital Reserve Account, which is also held at the U.S. Treasury. FHA's MMI Fund programs, like all federal government direct-loan and loan-guarantee programs operate with what is called "permanent and indefinite budget authority," which provides direct access to the U.S. Treasury for any funds needed to pay extraordinary claim obligations. Thus, FHA programs are never in any jeopardy of lacking sufficient funds to pay insurance claims. That would be true even in the absence of a Capital Reserve Account.

1. Account Balances

At the end of FY 2010, the MMI Fund had \$33.3 billion in cash and investments. Of that total, \$28.9 billion was in the Financing Accounts and \$4.4 billion in the Capital Reserve Account. The combined balance is \$1.5 billion higher than it was at the end of FY 2009 and \$5.1 billion higher than at the end of FY 2008. The combined balance is referred to as the capital resources of the MMI Fund. They represent liquid assets available for cash needs. FHA can use these to pay for any required claim expenses without a special request of the U.S. Treasury.

Of note, Table 7 reflects significant movement of funds from the Capital Reserve Account to the Financing Accounts during both FY 2009 and FY 2010. Those fund transfers were conducted as a part of the annual budget re-estimate process, in order to place monies into dedicated loss reserve accounts to pay future expected insurance claims on outstanding loan guarantees. Upon completion of the FY 2010 actuarial review, the independent actuaries now estimate the amount of required loss reserves to be \$28.9 billion. The calculations used to arrive at that figure subtract projections of future claim expenses from the sum of future premium revenues and property recoveries on outstanding business, without consideration for the value of new insurance written in the future. This loss reserve methodology is not commonly used in the private sector, but it is the construct adopted by the federal government for booking loss reserves in the annual financial statements.⁷

⁶ There are two additional sets of accounts that are independent of the insurance operations, and for which funds are directly appropriated by the Congress each year. The most important is the set of Program Accounts which cover all personnel and administrative expenses. Last is the Liquidating Account, which represents remaining cash flows each year on pre-1992 insurance endorsements. The year 1992 marks implementation of the Federal Credit Reform Act of 1990 and introduction of the Financing Accounts.

⁷ The Financing Account balances nearly exactly equaled the actuarial assessment of newly required loss reserve amounts on September 30, 2010. This is primarily because the new actuarial projections are in-line with the projections used for the budget re-estimate which was booked in May 2010, and which transferred monies from the Capital Reserve Account to the Financing Account for this purpose. Official loss reserve requirements are determined as part of the annual budget re-estimate process overseen by the Office of Management and Budget (OMB). The actuarial assessments form the basis for loss reserves booked in FHA's annual financial statements. They appear as the Loan Guarantee liability item.

**Table 7. FHA Single-Family Insurance MMI Fund Balances by Quarter, FY 2008 – FY 2010^a
(billions)**

Fiscal Year	Quarter Ending in	Capital Reserve Account ^b	Financing Account ^c	Total Capital Resources ^d
2008	September	\$19.3	\$9.0	\$28.2
2009	December	19.6	9.3	28.9
2009	March	19.9	9.7	29.6
2009	June	10.0	20.9	30.9
2009	September	10.7	21.1	31.8
2010	December	11.4	21.2	32.6
2010	March	12.0	20.2	32.2
2010 ^e	June	3.5	29.6	33.1
2010	September	4.4	28.9	33.3

^aOnly September 2008 and 2009 represent audited figures.

^bThis is an on-budget account that records net receipts provided by FHA to the federal budget, over time. Balances are held in cash and U.S. Treasury securities. The securities earn interest for FHA.

^cThis is a series of off-budget cash accounts used to manage insurance operation collections and disbursements.

^dTotal Capital Resources is the sum of Capital Reserve and Financing Account balances, and it represents the sum of cash and investments at the U.S. Treasury that can be immediately liquidated into cash. It does not represent total assets of the MMI Fund.

^eUnder requirements of Federal Credit Reform accounting, \$9.8 billion was transferred in May 2010 from the Capital Reserve Account to the Financing Account, as part of the annual budget re-estimate process. Those transferred amounts became earmarked funds to cover possible future net claim losses. If they are not needed, they will be transferred back to the Capital Reserve Account in a future budget re-estimate.

Source: U.S. Department of HUD/FHA; October 2010.

2. Core Insurance Operations in FY 2010

Core insurance operation cash flows are the net of collections (insurance premiums, property sale receipts, and other income) minus disbursements (insurance claims, property maintenance, and other expenses). While total capital resources increased by \$1.5 billion, actual core insurance operations had a net outflow of \$271 million in FY 2010. The improvement in capital resources came principally from interest earnings being greater than net core insurance operation outflows. At the same time, core insurance operations performed much better than predicted in last year's independent actuarial study. The study predicted that FHA would pay out \$2 billion more in insurance claims than actually occurred. This prediction was based on forecasts that housing markets would experience more substantial declines in FY 2010. In fact, housing markets were more stable than anticipated, resulting in claim expenses being substantially lower than forecasted. Additionally, in April, FHA increased the upfront premium rate charged on new insurance endorsements, which helped to minimize the net cash outflow on core insurance operations.

	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Fiscal Year Totals
Collections					
Premiums	\$ 2,418	\$ 1,898	\$ 2,465	\$ 2,507	\$ 9,289
Property Sale Receipts	1,086	1,093	1,493	1,347	5,020
Other	12	10	14	10	46
Total	3,516	3,002	3,972	3,865	14,355
Disbursements					
Claims ^b	\$ (2,764)	\$ (3,407)	\$ (3,479)	\$ (4,440)	\$ (14,090)
Property Maintenance	(115)	(117)	(161)	(142)	(535)
Other	-	-	-	-	-
Total	(2,879)	(3,524)	(3,640)	(4,582)	(14,625)
Net Operations Cash Flow	\$ 637	\$ (523)	\$ 332	\$ (717)	\$ (271)

^aThese are unaudited figures; totals may not equal due to rounding.

^bClaim payments listed include conveyance, preforeclosure sale, note sales, and loss mitigation actions.

Source: U.S. Department of HUD/FHA.

B. ASSESSMENT OF THE INDEPENDENT ACTUARIAL STUDIES

The National Housing Act requires that HUD contract for an independent actuarial study of the MMI Fund each year.⁸ For FY 2010, separate contractors were again employed to analyze the forward- and reverse-mortgage portfolios.⁹ Their written reports are available online in the Office of Housing Reading Room at www.hud.gov.¹⁰

The actuarial studies use statistical models to predict claim, loss-on-claim, and prepayment rates for current and future books-of-business. The models are built using historical information on insurance endorsements and performance, and are applied to outstanding loan guarantees using commercially available economic forecasts of house prices and interest rates. The projections are translated into cash flows for premium revenues (and refunds), claim payments and recoveries, and additional expenses for loss mitigation default interventions. The discounted present value of those cash flows becomes the principal output of the actuarial studies. MMI Fund capital resources plus the present value of future cash flows equals the “economic net worth” of the MMI Fund, as defined by the National Housing Act.¹¹ This process is repeated for each of the next six years by adding projected volumes and composition of new business each year, projecting their cash flows, and then reassessing the economic net worth of the MMI Fund at the end of each year.

⁸ See, 12 USC 1708(a)(4).

⁹ The contractors are the same as for FY 2009: Integrated Financial Engineering, Inc. for Single-Family forward loans and IBM for Home Equity Conversion (reverse) Mortgages (HECM).

¹⁰ See, <http://www.hud.gov/offices/hsg/hsgroom.cfm>.

¹¹ See, 12 USC 1711(f)(4). The statute refers only to capital resources (liquid assets) and the present value of future cash flows. The actuarial studies, however, include value of properties in inventory and net accounts receivable and payable in their calculation of capital resources rather than in the present value of future cash flows. This is because they do not predict these items, but rather take their values from the values used by FHA in its annual financial statements.

Economic net worth indicates what additional resources are immediately available for paying extraordinary claim expenses, above those already anticipated in the present-value-of-future-cash-flow calculations. Those calculations are for the next 30 years and are not a direct measure of any immediate issues related to cash needs for expected near-term claim payouts.

1. Principal Findings

Because FHA has, since 1983, relied more on upfront premium charges than on annual insurance premiums over time, the present value of future cash flows on outstanding business is a negative number.¹² Therefore, economic net worth is smaller than the amount of capital resources. At the end of FY 2010, the actuarial estimate of the capital resources of the MMI Fund (net asset position) is \$33.6 billion, and the estimated present value of future cash flows is \$28.9 billion, for a final economic net worth calculation of \$4.7 billion.¹³ That value is \$1.1 billion higher than the estimate made at the end of FY 2009.

The two portfolios of the MMI Fund—forward (single-family) and reverse (HECM) mortgages—have fundamentally different performance dynamics and are analyzed separately. They also have separate accounting within both the Capital Reserve and Financing Accounts. Table 9 shows that \$1.75 billion was transferred to the HECM Financing Account during FY 2010 to facilitate a budget re-estimate for the FY 2009 HECM book-of-business. Because HECM only joined the MMI Fund portfolio with FY 2009 insurance endorsements, it did not have time to build its own dedicated capital reserves prior to the current economic disruption.¹⁴ Thus, the transfer was effectively of funds that had been contributed to the Capital Reserve Account by the single-family program. The remaining negative economic net worth for HECM (\$503 million) is a result of actuarial projections that the FY 2010 book will itself not break even.

The final economic net worth calculation (\$4.7 billion) is measured against active insurance-in-force (\$931 billion) to calculate the statutory capital ratio. The ratio reflects minimal change from last year, at 0.50 percent today, compared to 0.53 percent for FY 2009. The decline is a direct result of new projections that FY 2009 and FY 2010 HECM endorsements will not perform as well as predicted in the FY 2009 actuarial study. The single-family portfolio on its own shows an improvement over last year, with its implied stand-alone capital ratio rising from 0.42 percent to 0.79 percent had \$1.75 billion of funds not been transferred from the single-family accounts to the HECM accounts this year.

¹² This changes for FY 2011 with the introduction of new premium schedules for both single-family and HECM loans that rely more upon ongoing/periodic premium assessments than has been the case in the past.

¹³ Because the actuarial studies must complete their data analysis before the end of the fiscal year they do not have the exact capital resources as of September 30. Principally, they are estimating insurance operations cash flows for the last several months of the fiscal year. This is why the actuarial estimate of capital resources is \$300 million higher than the end-of-year balances shown in Table 5. Because all of the actuarial assessments involve estimates—including end-of-year insurance-in-force, we do not make any adjustments to their numbers when reporting the calculated capital ratio.

¹⁴ HECM books prior to FY 2009 are within the General and Special Insurance Fund of FHA. That Fund does not have a capital reserve requirement and, thus, net income from loan guarantees is simply swept by Treasury as federal receipts. Indeed, the same is actually done for MMI Fund programs only, to facilitate the capital reserve requirement; Treasury credits those receipts against the designated Capital Reserve Account. FHA then earns interest on that Account as the Treasury recognizes that it is using MMI Fund receipts in lieu of publicly issued debt to finance government operations.

Table 9. Independent Actuarial Assessments for FY 2010

	FY 2009 Summary ^a	FY 2010		
		Single Family	HECM ^b	MMI Fund
Beginning-of-Year Positions^c				
Cash		\$ 21,123	\$275	\$ 21,398
Investments		10,252	376	10,628
Properties and Mortgages ^d		2,291	-	2,291
Other Assets and Receivables		50	2	52
Total Assets		33,716	653	34,369
Liabilities (Accounts Payables)		(3,255)	-	(3,255)
Capital Resources at Beginning of Year	\$30,719	\$ 30,461	\$653	\$ 31,114
FY 2010 Activity				
Net Gain from Investments		\$1,850	\$141	\$1,991
Net Insurance Income		(511)	500	(11)
Net Change in Value of Property Inventory		500	-	500
Transfer to HECM Financing Account		(1,748)	1,748	-
Capital Resources at End-of-Year		\$ 30,552	\$3,042	\$ 33,594
Actuarial Calculations^e				
Present Value of Future Cash Flows on Outstanding Insurance	\$ (27,078)	\$ (25,392)	\$ (3,545)	\$ (28,937)
Economic Net Worth	\$ 3,641	\$ 5,160	\$ (503)	\$ 4,657
Capital Ratio Calculations				
End-of-year Amortized Insurance-in-Force ^g	\$ 684,708	\$ 879,875	\$ 51,397	\$ 931,273
Capital Ratio ^h	0.53%	0.59%	-0.98%	0.50%

^aData in this column are from the FY 2009 Actuarial Reviews of the Single-Family and HECM programs of the MMI Fund.

^bHECM amounts appear small because HECM is only included in the MMI Fund starting with FY 2009 insurance endorsements.

^cBeginning of year positions are from FHA's audited FY 2009 financial statements.

^dAt present, there are no assigned mortgages from HECMs in the MMI Fund (FY 2009 endorsements).

^eActuarial calculations for Single-Family and HECM come from the respective FY 2010 Actuarial Reviews.

^gAmortized Insurance-in-Force represents outstanding loan balances for forward loans and maximum claim amounts for HECM.

^hThe National Housing Act (12 USC 1711(f)) defines the capital ratio calculation as being the ratio of economic net worth to outstanding loan balances.

Source: U.S. Department of HUD/FHA; HUD Accounting systems, and the FY 2009 and FY 2010 independent actuarial study final review reports.

By law, HUD must maintain a capital ratio of at least two percent for the combined MMI Fund portfolio.¹⁵ The current housing crisis has put the MMI Fund in a position where the ratio has fallen below the mandated level. This has precipitated significant administrative actions at HUD to both protect the ratio from falling below zero, and to assure that a two percent ratio can again be achieved in a reasonable amount of time. Those actions are discussed later in this report.

¹⁵ See, 12 USC 1711 (f).

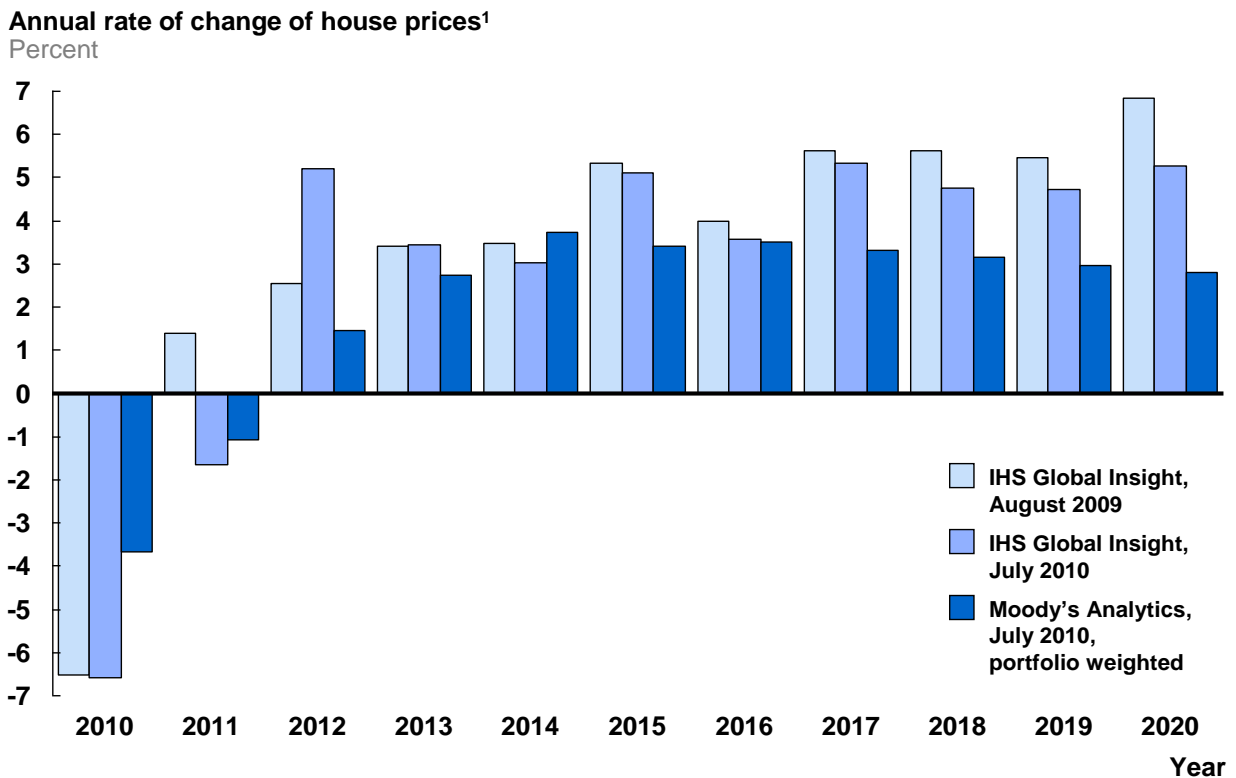
2. Principal Drivers of the Actuarial Assessment

The actuarial study details many factors that cause this year’s estimate of economic net worth to differ from last year’s estimate. There are both positive and negative effects that, together, produce the \$1 billion increase in economic net worth this year. Below is a summary of the most important drivers.

a) House Price Forecast (-\$8.5 billion)

The largest negative influence on economic net worth is the use of a more conservative house price forecast. This year, the actuarial assessments switched from using national house price forecasts by IHS Global Insight to local-area forecasts provided by Moody’s Analytics. Though Global Insight’s recent forecasts are more conservative than were its forecasts last year, Moody’s has a significantly more conservative view of the long-term prospects for housing in the U.S. The long-term (2020 and thereafter) rate of growth in home prices predicted by IHS Global Insight is over 5 percent per year. Moody’s local-area predictions, as applied to FHA’s current insured portfolio, yield a long-term growth rate of under 3 percent per year. The switch to this more conservative house price forecast series has an impact on economic net worth of -\$7.6 billion.

Figure 8. Alternative Forecasts of Annual House Price Growth Rates



Source: U.S. Department of HUD/FHA; Forecasts provided by IHS Global Insight and Moody’s Analytics are for the Federal Housing Finance Agency all transactions house price index; IHS Global Insight forecasts are at the national level; Moody’s forecasts are at the metropolitan area level and weighted according to FHA insurance-in-force, July 2010.

An additional house-price-related effect is a discount for home maintenance risk on the HECM portfolio. That adds an additional -\$940 million to the -\$7.6 billion mentioned above. Home maintenance risk has to do with the impact of length-of-stay in the home on the likelihood that senior homeowners will under-invest in their property, relative to other owners and properties in the local market. This under-investment could be due to lack of maintenance or to not investing in upgrades that become standard features in homes over time. In either case, it becomes more pronounced for seniors who are in their homes for more than 10 years after taking out a HECM loan. That point starts the time period in which the basic actuarial risk of HECM comes into play in a measurable way. With HECM, FHA is insuring against the accruing loan balance being greater than the property value when each senior leaves their home. That risk becomes greater as HECM loans season to 10, 15, and 20 years.

b) Model Improvements (-\$3.59 billion)

The actuarial models have many component parts and improvements are undertaken each year. Those improvements yield both positive and negative effects on economic net worth calculations. This year, the change with the greatest effect is a significant update to the loan performance forecast equations for single-family, streamline refinance loans. The new equations both mark-to-market the value of properties at time of loan origination and pick-up risk characteristics from the former loans to apply to the new loans. This has significant negative value this year because the forecasts now account for negative characteristics of the large volume of streamline refinance loans insured in FY 2009 and FY 2010. Those characteristics include large house-price declines on many properties, between the time of the original loan and the refinance action, and continuing risks associated with borrowers that initially used seller-funded downpayment assistance or who had low credit scores at the time the original FHA-insured loan was underwritten.¹⁶

With HECM, model improvements that led to lower economic net worth included: use of house-price dispersion measures to enhance estimates of the probability that any loan could be “underwater” at time of termination; forecasting borrower mobility as a function of home value relative to area median value (a proxy for borrower income and wealth); and gender-specific mortality risk (rather than using the time-trend shape of the female mortality for all borrowers).

One model improvement with a measurable positive value (\$2 billion) was a switch to loan-level cash-flow generation on the HECM portfolio, rather than generating cash flows from aggregations of claim (loan assignment) and termination rates by book-of-business. Using portfolio averages last year led to unrealistic results regarding longevity of older seniors who take out HECM loans. That then inferred too high a probability of incurring losses at time of loan termination. Calculating cash flows from loan-level probabilities of loan termination corrects the problem.

¹⁶ Some borrowers use the streamline refinance option multiple times. The actuarial contractor then traced each streamline origination and endorsement back to the first fully-underwritten loan, for which a property appraisal would be available.

c) Economic Value of the FY 2009 and 2010 Book of Business (+\$8.1 billion)

For the single-family portfolio, the underlying credit quality of newly insured loans increased throughout FY 2009 and FY 2010. As a result, the FY 2009 actuarial study—which locked-in its assumptions before the end of the year—based its performance forecasts on an underwriting quality for these books that was worse than the actual credit composition of the book. For the FY 2010 book, the change from predicted to actual quality is significant. The share of loans with credit scores of 680 or better is 12 percentage points higher, with a dramatic decrease in the share of loans with scores in the 600-639 range, and a virtual disappearance of those with credit scores below 600. The difference in the present value of future cash flows is +\$5.2 billion and the difference in performance during FY 2010 of the FY 2009 and FY 2010 books adds another \$2.9 billion. These decomposition results reflect the improvement in economic value compared to last year's predictions before the change in house price forecasts mentioned above. Therefore, the improvement in credit quality over what had been predicted put the FY 2009 and FY 2010 books into a much better position when imposing the more conservative out-year house price forecasts.

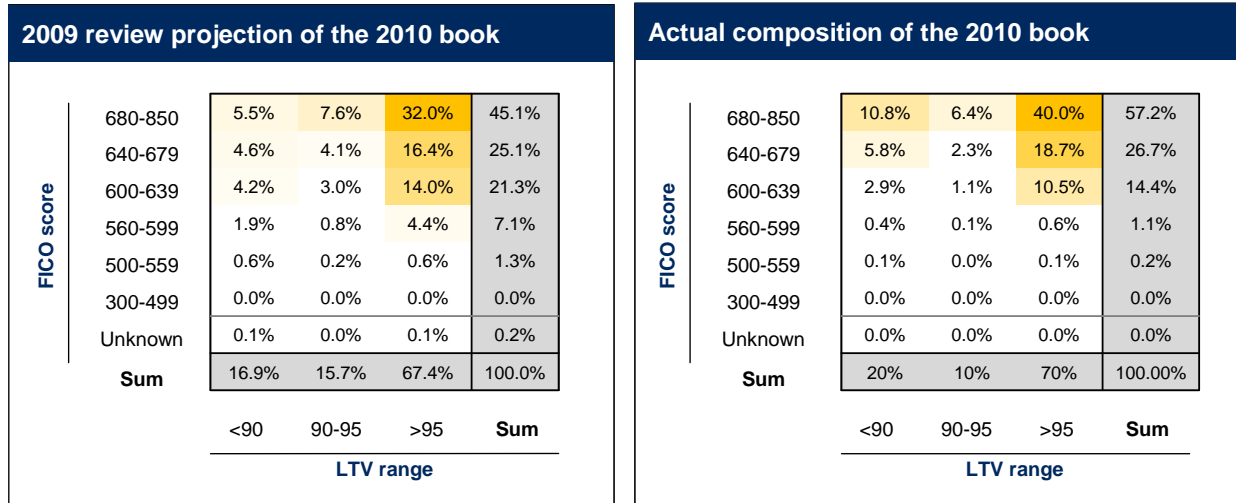
d) Premium Rate Changes (\$612 million; \$8.1 billion by FY 2016)

HUD raised the upfront premium rate on FHA single-family loans in April 2010. This was a stop-gap measure until Congress approved higher annual premium rates, which occurred in August 2010. Effective October 2010, HUD has implemented a new premium structure that increases the annual insurance premium rates while decreasing the upfront insurance premium rate. The value of having the higher upfront premium charge (2.25 versus 1.75 percent) for the last six months of FY 2010 was \$612 million. The value of the new premium structure for FY 2011, with less reliance on the upfront premium and more reliance on the periodic charge, is predicted by the actuaries to be worth \$6.9 billion by FY 2016. The new higher premium rates on HECM loans that were also introduced in October 2010, together with the benefits of the lower loan balances for HECM Saver loans, are estimated to be worth \$3.2 billion by FY 2016.

Figure 9. Comparing the Assumed Credit Characteristics of the FY 2010 Book in the FY 2009 Actuarial Study with the Actual Characteristics

Percent of 2010 loan volume, by FICO and LTV^a
Percent

High Volume
 Low Volume
 Sum



^a The decomposition is drawn only from 30 year purchase and fully underwritten refinances; streamline refinances do not capture FICO data at endorsement; HECM is excluded

Source: IFE Group and U.S. Department of HUD/FHA .

Table 10. FHA Premium Structure Effective October 4, 2010 Upfront and Periodic Rates^a for 30-Year, Fixed-Rate, Purchase and Refinance Loans^b			
Credit Scores	LTV Ratios		
	<= 90%	> 90% & ≤ 95%	> 95% & ≤ 96.5% ^c
≥ 500 & < 580	100/85		
≥ 580	100/85	100/85	100/90

^aRates are shown here as up-front/annual. All Premiums are stated in basis points (0.01 percent). Periodic premiums are expressed as the annual-rate but are charged monthly. The upfront premium is charged against the initial loan balance and the annual/monthly premiums are assessed against the mid-year outstanding loan balance.

^bLoans with terms of 15-years or less are charged the same upfront premium rates. They have no periodic premiums if the LTV ratio is less than 90 percent. Current regulations allow for a 25-basis point annual rate charge for 15-year loans with LTV ratios of 90 or above.

^cRefinance loans can have LTV ratios up to 97.75%.

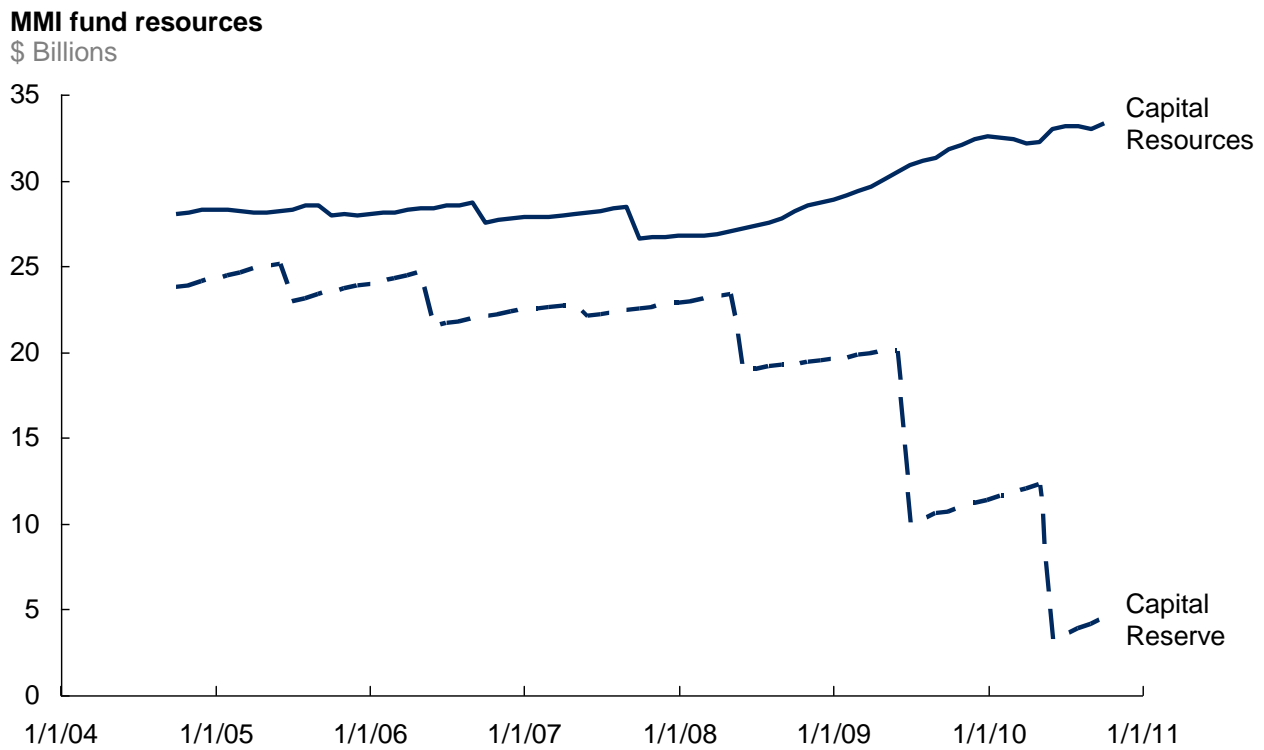
Source: U.S. Department of HUD/FHA.

3. Other Measures of Financial Health

a) Total Capital Resources

The capital ratio focuses exclusively on residual reserves and not total reserves. Total capital resources of the MMI Fund—the combined balances of the Financing and Capital Reserve Accounts— provide a more holistic picture of FHA funds available to cover losses from insured loans. While the Capital Reserve has been declining over the past few years, total capital resources have increased. FHA has simply moved more funds into dedicated loss reserves to be prepared for future contingencies. At the same time, FHA’s core insurance operations outperformed last year’s actuarial projections by \$5.5 billion. The actuarial projections were for capital resources to decline by \$4 billion in FY 2010, when in fact they rose by \$1.5 billion.

Figure 10. MMI Fund Capital Resources and Capital Reserves Over Time



Source: U.S. Department of HUD/FHA.

a) Short-Term Loss Reserves

Private sector financial services firms typically reserve for expected credit losses over one- and two-year time horizons. Were FHA to book such reserves today, rather than those required under federal accounting rules, the implied capital ratio would be higher. A one-year loss reserve for net credit expenses (after property recoveries) would be \$20.6 billion and a two-year reserve would be \$28.7 billion. The implied MMI Fund capital ratio in each case would be 1.39 and 0.52 percent, respectively.¹⁷ The similarity of two-year reserve results with the capital ratio based on a

¹⁷ This analysis does not include any net credit losses on HECM loans. HECM loans in the MMI Fund start with FY 2009 endorsements and so they are still too young for any measurable credit losses to occur.

thirty-year loss reserve is because the actuarial projections expect the majority of net claim expenses from legacy books-of-business to occur in the next two years.

b) Ongoing Insurance Operations

The capital ratio calculation is a measure of the ability of MMI Fund resources available today, along with expected future revenues from outstanding insurance contracts, to pay for expected future net claim expenses on the insured loans. It presumes a business “wind-down” with no new insurance endorsements starting October 2010. However, FHA is not in a wind-down mode, as the calculation assumes. This understanding is important because the actuarial projections suggest that new insurance written in FY 2011 and beyond, as well as FY 2010, should provide net income for the MMI Fund under a very wide range of possible economic conditions. Much of that income will be available to pay expected future claims on earlier books of business.

The capital ratio front-loads all expected future losses from existing business into a present expense, without any consideration of the possibility that revenues on future business could also be available when those net claim expenses actually occur. With new business assumptions added, capital resources of the MMI Fund the base-case expectation is that capital resources will fall to just under \$30 billion at the end of FY 2011, but then start to grow and reach \$42 billion five years later. The implied capital ratios go from roughly one percent next year to 2.9 percent five years later.

Components (bil \$)	2010	2011	2012	2013	2014	2015	2016
Capital Resources	\$ 33,594	\$ 29,931	\$ 31,041	\$ 33,651	\$ 35,453	\$ 38,510	\$ 42,067
Economic Net Worth	4,657	11,052	15,562	21,204	26,551	32,342	38,508
Insurance in Force	931,273	1,112,874	1,253,957	1,338,012	1,337,054	1,330,344	1,346,729
Capital Ratio	0.50%	0.99%	1.24%	1.58%	1.99%	2.43%	2.86%

Source: U.S. Department of HUD/FHA; Analysis from estimates of the independent actuarial studies for FY 2010.

4. Credit Quality of Future Books

For last year’s actuarial study, FHA provided demand forecasts which assumed that, absent any policy changes, the return of a more normal functioning mortgage market would result in the credit quality of FHA single-family loans being similar to the quality of loans insured in 2007, though incorporating the underwriting restrictions put in place by FHA as they were at the beginning of FY 2010.¹⁸ Indeed, the years 2002-2007 were all very much similar in that FHA was being adversely selected by the conventional market. Even absent loans with seller-funded downpayment assistance, FHA had very large shares of loans with low credit scores. Those loans have extremely high sensitivities to economic downturns, which has been evident in their high default and claim rates over the past three years. It is now unlikely, however, that the future composition of single-family books-of-business could look like they did in 2007. First, FHA has,

¹⁸ Between FY 2007 and FY 2010 HUD eliminated use of seller-funded downpayment assistance, established a credit-score threshold of 500 for loans with LTVs above 90 percent, and returned to a former policy of a maximum LTV ratio of 85 percent for cash-out refinance loans.

over the past year, put in place credit policies that will prevent insurance of new loans with the historically highest credit risks. Those policies include tighter controls on loans that do not receive “accept” decisions from the FHA TOTAL scorecard used in major automated underwriting systems, credit-score floors, and net tangible benefit requirements on streamline refinance actions. Additionally, it is assumed that the broad change in product mix available in the market to less aggressive products will continue, reducing the likelihood of adverse selection in the FHA portfolio. The combined result is that future insurance books will be better than had been predicted last year.

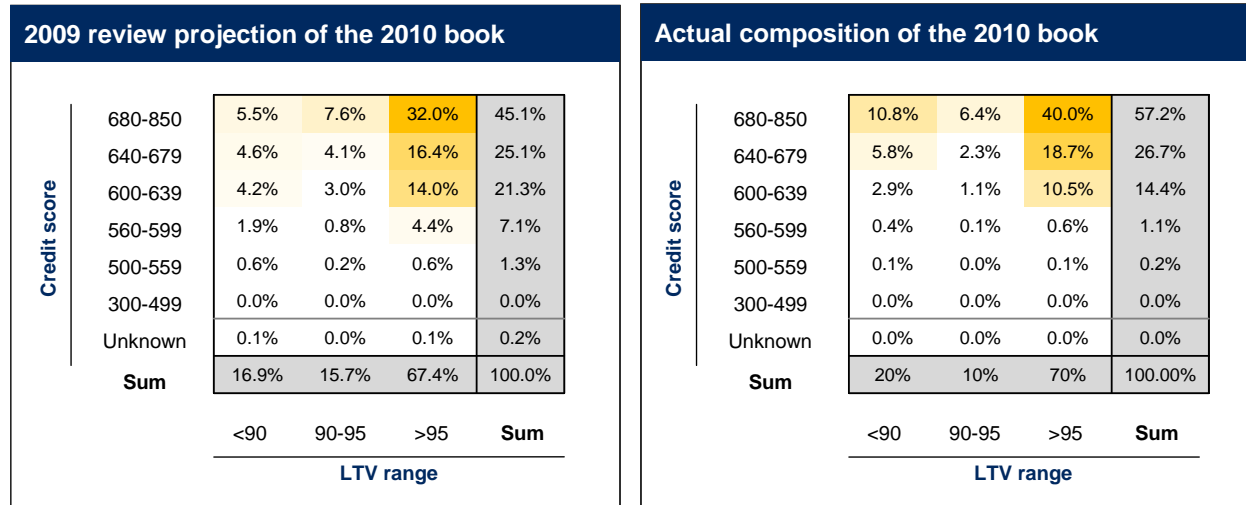
This year, the projections of future-book credit quality provided to the actuaries suggest that a fully recovered conventional mortgage market could move FHA into a position that looks more like the mid-1990s. Those books were very similar to the composition of loans coming to FHA in mid FY 2009. They had lower concentrations of high credit score borrowers than is seen today, but they also lacked high concentrations of low credit-score borrowers. The new composition assumptions include the new credit-score floors that just went into effect, as well as a recognition that new restrictions on manually-underwritten loans will restrict volumes of those loans.¹⁹

¹⁹ Those restrictions, which limit allowable payment ratios and require cash reserves, will also improve the credit quality of those loans which are insured. HUD only provided the actuaries with the composition shares and did not request that they attempt to make any manual changes to their forecasts to measure any improved credit quality from manually underwritten loans.

Figure 11. Future Business Assumptions Used in the Single-Family Actuarial Study, Last Year and This Year

Percent of 2010 loan volume, by FICO and LTV^a
Percent

■ High Volume
□ Low Volume
■ Sum



^a The decomposition is drawn only from 30 year purchase and fully underwritten refinances; streamline refinances do not capture FICO data at endorsement; HECM is excluded

Source: U.S. Department of HUD/FHA; The 2009 actuarial study assumptions represent the composition of CY 2007 endorsements, using FY 2010 underwriting policies; the 2010 actuarial study assumptions represent the composition of CY 1995-1996 endorsements, using FY 2011 underwriting policies.

5. HECM’s Future

HECM loans are different from single-family loans in that credit risk only manifests itself after a considerable period of time. Loans are originated with limits on the equity take-out allowance in order to provide a significant equity cushion against any short-term economic disruptions. Also, HECM borrowers do not have monthly mortgage payments and so the portfolio is mostly insensitive to income disruptions in the larger economy.

Starting in FY 2011, the actuarial estimates are that each new HECM book will generate net income for the MMI Fund, and that the HECM portfolio will itself be providing more than two percent capital—per the statutory definition—in just two more years. This is even with the more conservative out-year house-price forecasts being used in this year’s projections. HUD is able to do this primarily because of changes that went into effect in October 2010. Increased premium rates and the introduction of the lower-equity-take-out HECM Saver option should provide significant protections against negative outcomes on HECM loans in future books-of-business.

6. Credit Losses in the Current Portfolio

Within the confines of the current economic environment, major sources of current and expected credit losses to the MMI Fund can be grouped into three categories: the credit quality of the 2004-2008 books, the continuing influence of loans with seller-funded downpayment assistance (SFDPA), and the impact of income disruptions on defaults and claims.

7. Credit Quality of the 2004-2008 loan cohorts

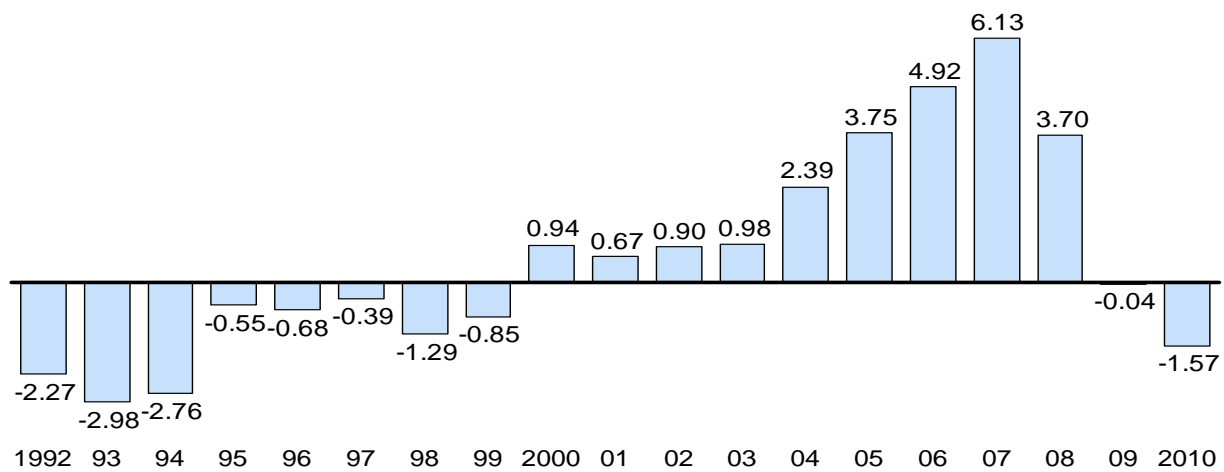
All of the annual books-of-business from 2000 through 2008 are expected to result in net losses over the life of the loan guarantees, but the largest losses will be from the 2004-2008 books. One way to compare books-of-business is through something akin to the credit subsidy rate calculations used in the federal budget. A credit subsidy rate is the net present value (NPV) of all cash flows over the life of the loan guarantees, divided by the dollar amount of the loans insured. We provide such calculations here using to-date experience grafted to the future projection of the current actuarial studies.²⁰ These summary NPV calculations show that the largest rates of loss are associated with 2004 to 2008 books, with the absolute largest being 2007. The FY 2007 book has an expected lifetime losses of more than six cents for every dollar insured. Already, that book has a to-date claim rate comparable to the worst books from the early 1980s. Those earlier books have cumulative claim rates that have exceeded 20 percent.

The FY 2007 book came in at the very end of the expansion of subprime mortgage originations, which created the worst adverse selection for FHA, it had low credit scores and high rates of seller-funded downpayment assistance, and loans also were originated at the cusp of the economic recession.²¹

While the projected NPV for the FY 2008 book is smaller than that for FY 2007, the larger size of the FY 2008 book means that actual dollar losses from that book will be greater than those from the FY 2007 book.

Figure 12. Estimated Value of Each Book-of-Business^a

Subsidy Rate, by Loan Origination Year
Percent



^aValue is defined as the net present value of all insurance cash flows, over the 30-year life of each book, divided by the dollar amount of loan insured. Discount rates are the official budget discount rates as determined by OMB for each book year (budget cohort).

²⁰ With budget credit subsidy rate calculations, however, receipts are negative values and expenses are positive values. Thus, negative net present value calculations in the budget world are good as they indicate positive net receipts (negative outlays).

²¹ The U.S. Bureau of Labor Statistics reports that the national unemployment rate began to rise in July 2007, and peaked in October 2009.

Source: U.S. Department of HUD/FHA; Analysis based on historical data and future projections from the independent actuarial studies.

8. Continuing Influence of Seller-Funded Downpayment Assistance (SFDPA) loans

Loans with SFDPA have claim rates that are up to three times those of other FHA single-family loans. The FY 2009 actuarial study noted that the net capital ratio would still have been above the statutory requirement of two percent if FHA had never insured those loans. FHA's estimated economic net worth would have been \$10.4 billion higher in FY 2009 were it not for SFDPA loans. The actuary's estimate in the FY 2010 study is now that the SFDPA loans have a net cost of \$13.6 billion. That cost, however, may be understated because it only includes insured loans that have not refinanced with FHA.

Of the over 1 million loans insured with SFDPA from 1998 to 2009, almost 500,000 are still active. However, an additional 145,000 paid-off but re-entered the MMI Fund portfolio as streamline refinance loans. Nearly one-in-ten of those loans (14,000) have already gone to claim.

To date, FHA has experienced over \$5.5 billion in losses from the over 121,000 SFDPA loans that have resulted in insurance claims. An additional \$600 million in losses has been incurred on the subsequent refinance loans that have been claimed, making total to-date losses more than \$6 billion.

Taken together, the sum of home purchase loans with SFDPA, and refinance loans from that portfolio, account for \$157 billion of actively insured loan balances today. That represents 17 percent of all active insurance in the MMI Fund. Of the original SFDPA loans still active, 34 percent are in serious delinquency. Another 12 percent of the refinance loans are in serious delinquency. This suggests significant additional claims and losses will occur over the next two years. If one-in-three of these loans results in an insurance claim, with current loss-on-claim rates of 54 percent, the expected two-year losses could be an additional \$7.5 billion beyond the \$6.1 billion already incurred.²²

Loans with SFDPA were primarily an issue with first-time homebuyers. Today, first-time homebuyers are again providing their own funds for downpayments at rates seen before growth of SFDPA. Those first-time homebuyers not providing their own funds for a downpayment are relying primarily on family gifts. Such gifts were used to facilitate twenty-eight percent of first-time home purchases in FY 2010, which is the highest rate seen since FHA started recording sources of downpayment funds in 1998. From a risk perspective, this is fundamentally different from what happened in previous years with SFDPA. With SFDPA there was strong evidence that downpayments were effectively being financed in the mortgage via higher home sale prices.²³ Family gifts, however, are not tied to the property sale transaction, they represent real cash investment in the property, and there is a sustained relationship with the donor that reduces foreclosure risk.

²² The actuarial estimates do account for the differential risk of SFDPA loans that refinance within the context of valuing the streamline refinance portfolio. Those value estimates were not included in the \$13.6 billion net cost of SFPDA loans stated in their written report.

²³ U.S. General Accountability Office, *Additional Action Needed to Manage Risks of FHA-insured Loans with Downpayment Assistance*, GAO-06-24, November 2005. Available at: <http://www.gao.gov/new.items/d0624.pdf>.

Fiscal Year	Number of Homebuyers Served	Average Home Price	Downpayment Source Shares				
			Own Funds	Family Gifts	Nonprofit Organization ^a	Government Agency	Employer
2000	684,998	100,730	73.73%	21.77%	1.94%	2.47%	0.09%
2001	643,640	107,203	75.62	16.81	5.37	2.10	0.10
2002	683,581	114,105	72.98	14.83	9.78	2.31	0.09
2003	521,724	116,920	61.65	16.21	19.03	2.99	0.12
2004	454,241	121,081	51.61	16.53	28.18	3.55	0.13
2005	280,082	117,823	45.61	15.14	34.33	4.79	0.12
2006	248,884	120,538	45.49	13.90	34.19	6.28	0.13
2007	221,470	126,428	44.39	12.76	36.67	6.05	0.12
2008	492,282	156,414	48.96	12.95	34.55	3.44	0.10
2009	781,680	168,867	70.11	22.69	5.72	1.34	0.14
2010	882,097	167,782	70.72	27.54	0.23	1.37	0.14

^aThe small percentage in FY 2009 represents insurance endorsements of loans originated prior to the ban on October 1, 2008. The element left in FY 2010 represents true charitable gifts from nonprofit organizations not using funds from property sellers.

Source: U.S. Department of HUD/FHA.

9. Impact of Income Disruptions

Credit losses on the 2004-2008 books, and on loans with SFDPA, are magnified in the current economic environment. The primary force behind the increase in 90-day delinquencies over the past three years has been income disruptions. In the most recent quarter, lenders reported either unemployment or reduction-in-income as the primary reason for 49 percent of all new 90-day delinquencies. This figure rises to 57 percent when excluding borrowers for whom the primary reason for delinquency could not be ascertained due to lack of contact. Three years earlier, at the start of the recession, the corresponding shares of new 90-day delinquencies attributed to income disruptions were 28 and 32 percent. The rise in these shares alone accounts for over 213,000 serious delinquencies in the past three years. A conservative estimate would be that thirty percent of these ultimately result in insurance claims, and with an average cost of \$70,000. That yields net claim losses directly attributable to higher levels of income disruption in the economic recession of \$4.5 billion.

Total losses due to income disruptions are likely higher than \$4.5 billion, as homeowners who would have had income disruptions in earlier periods, but who could have found new employment within a short period of time, cannot recover in the current economic environment. Credit losses from earlier books of business, with lower credit scores and higher rates of SFDPA usage, have been exacerbated by increased frequency of income disruptions. Putting risk controls on the portfolio, such as those recently instituted in FY 2010, minimizes the increase in claim rates not only during normal economic times but, especially during periods of economic disruption when the financial soundness of the MMI Fund is at stake.

Table 13 shows that income disruption as a share of primary reasons for new 90-day delinquencies peaked in the first quarter of FY 2010 (2009Q4). The absolute number of new 90-day delinquencies on FHA-insured loans peaked in January 2010. In addition, new 90-day delinquencies have declined year-over-year for 2010Q2 and 2010Q3. Focusing on year-over-year changes removes the normal cyclical nature of delinquencies, whereby they tend to fall in the first two quarters of the year and then rise in the last two quarters. This downward trend should continue as long as job losses in the economy do not worsen.²⁴

Year and Quarter	New 90+ Day Delinquencies	Reduction of Income	Unemployment	Excessive Obligations	Death or Illness of Principal Borrower or family	Marital Difficulties	No Contact	Other ^a
2007Q1	44,259	22.63%	3.76%	28.30%	8.44%	3.89%	12.70%	20.29%
2007Q2	46,991	22.42	4.65	29.22	8.41	3.85	12.77	18.68
2007Q3	62,802	23.17	4.94	27.20	8.39	3.69	13.30	19.30
2007Q4	78,643	25.12	5.47	25.76	9.07	3.72	13.83	17.03
2008Q1	67,559	26.42	5.83	25.29	8.45	3.61	13.70	16.71
2008Q2	67,929	27.67	6.51	22.94	8.36	3.82	13.95	16.74
2008Q3	92,033	29.36	6.84	21.99	7.80	3.51	14.42	16.09
2008Q4	122,367	32.52	7.29	19.56	7.17	3.23	14.04	16.20
2009Q1	111,451	35.73	8.59	16.98	6.42	3.01	13.45	15.82
2009Q2	108,001	38.56	9.27	14.98	6.21	3.19	12.49	15.31
2009Q3	146,712	39.66	9.36	14.37	6.29	3.08	11.84	15.40
2009Q4	152,884	41.42	9.29	13.95	6.69	3.23	11.87	13.56
2010Q1	124,579	41.31	9.17	13.99	6.72	3.24	13.18	12.38
2010Q2	104,108	40.44	9.92	14.82	7.55	3.66	14.16	9.45
2010Q3	131,036	38.75	10.05	16.04	7.71	3.55	14.30	9.59

^a The Other category includes reasons such as: abandonment of property, distant employment transfer, neighborhood problems, property problems, inability to sell or rent property, military service, business failure, casualty loss, energy environment cost, servicing problems, payment adjustment, payment dispute, transfer of ownership pending, fraud, and incarceration.

Source: U.S. Department of HUD; per monthly delinquency status reports provided by loan servicers to FHA; October 2010.

²⁴ The U.S. Bureau of Labor Statistics reports that the national unemployment rate peaked in October 2009, and that one significant measure of movement toward stability is also showing improvement. That measure is the (seasonally adjusted) number of new unemployment insurance claimants from mass layoffs. It peaked in May 2009 and is now down to levels last seen in April 2008.

C. RISKS TO THE ACTUARIAL FORECAST

1. Economic Forecast Risk

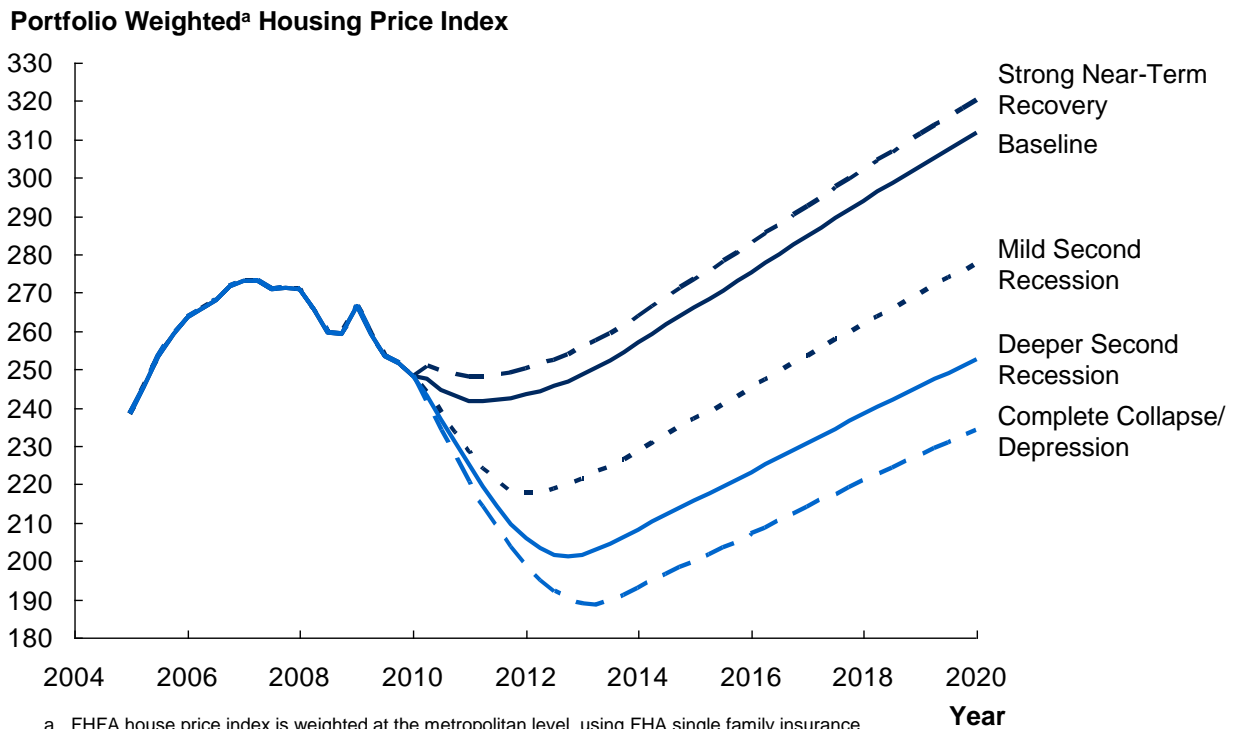
The premier risk to the economic net worth and financial soundness of the MMI Fund is forecast risk. Moving to Moody's Analytics as provider of the independent economic forecast used in this year's actuarial studies provided an opportunity to adopt a new approach to economic sensitivity analysis. In the past, actuarial contractors created their own sensitivity analyses for house prices and interest rates that were not tied to the base-case forecast. Moody's, however, provides as part of its standard forecast package alternative scenarios matched to points along the distribution of possible economic outcomes. Their base-case scenario represents the median or 50th percentile event. That means there is an even chance that the actual economic events of the next five to ten years could be either better or worse than the base case projection. However, what is important for sensitivity analysis for the economic net worth calculations is that the magnitude of deviations from the base-case are larger for worse outcomes than they are for better outcomes.

Using the Moody's alternative forecasts helps to understand the range of possible future outcomes. Moody's produces four short-run scenarios which the actuarial contractors adapted to create long-run scenario distinctions. The adaptation was that, once each scenario's house price forecast reaches its minimum point (or trough), it is only permitted to grow at annual rates equivalent to those in the base-case forecast. Otherwise, because Moody's provides multiple short-run variations around its base-case long-run forecast, there is a natural convergence under all scenarios to the base-case house price values within ten years.

Each of the Moody's alternative scenarios has its own, individual interest rate path, which is also used in the sensitivity analysis. However, here we focus on the house price paths as they have the largest effects on portfolio valuation.²⁵ Figure 13 shows the various house price paths used for the sensitivity analysis of the single-family and HECM portfolios.

²⁵ The actuarial model for single-family loans does not include direct measures of unemployment. Such measures are noisy with respect to direct influences on default and claim rates and have not proved useful in the current actuarial model. At the same time, the Moody's house-price forecasting equations at the local level are built as functions of local economic dynamics, which include labor market measures.

Figure 13. Base Case and Alternative House Price Scenarios



a FHFA house price index is weighted at the metropolitan level, using FHA single family insurance volumes as of July 2010

Source: Analysis by the U.S. Department of HUD/FHA using Moody's Analytics' forecasts of the FHFA HPI at the metropolitan level and FHA single-family insurance volumes as of July 2010 for the weighting factors to arrive at national portfolio house price growth rates and indices.

In addition to the four Moody's alternative forecasts, the single-family actuarial study added a fifth sensitivity analysis using interest rate fluctuations. This was intended to add some of the realism associated with fluctuations in loan payoff rates as interest rates move from quarter to quarter. The base-case Moody's forecast envisions smooth movements in interest rates over time, whereas, in actuality, they can have sizable jumps within short periods of time. Therefore, the actuarial study used random fluctuations in interest rates around the base-case trend—provided by Moody's Analytics—to create this additional sensitivity run.

2. Alternative Scenarios and their Implications for Capital Resources and the Capital Ratio

Home prices across the nation peaked in mid-2007. Every economic scenario thus has an implied peak-to-trough house-price forecast. The peak-to-trough changes in each of the five Moody's scenarios are shown in Table 14.²⁶

²⁶ Note that all house price indices referenced here are the Federal Housing Finance Agency House Price Index, all transactions, at various levels of geography. As these are the series used to estimate the statistical models of loan performance, forecasts of the same series are the appropriate data to use in forecasting future portfolio performance.

Economic Scenario	Peak-to -Trough House Price Change^a	Forecast Period House Price Change^b	Trough is Equivalent to Price Level in Fiscal Year
Base-case	-16.7%	-2.80%	2004
Strong Near Term Recovery	-14.6	-0.40	2005
Mild Second Recession	-25.1	-12.56	2003
Deeper Second Recession	-30.7	-19.16	2002
Complete Collapse / Depression	-35.0	-24.19	2001

^aAll historic price indices and future forecasts are for the FHFA House Price indices, all transactions, at the metropolitan level. Nationwide, the FHFA indices peaked in 2007. For the purpose of measuring forecast period changes, forecasts are presumed to begin in 2010Q3.

^bThe actuarial studies were performed before the end of FY 2010 using actual forecast data that began in 2010Q2. As such, these forecast period declines begin in 2010Q2.

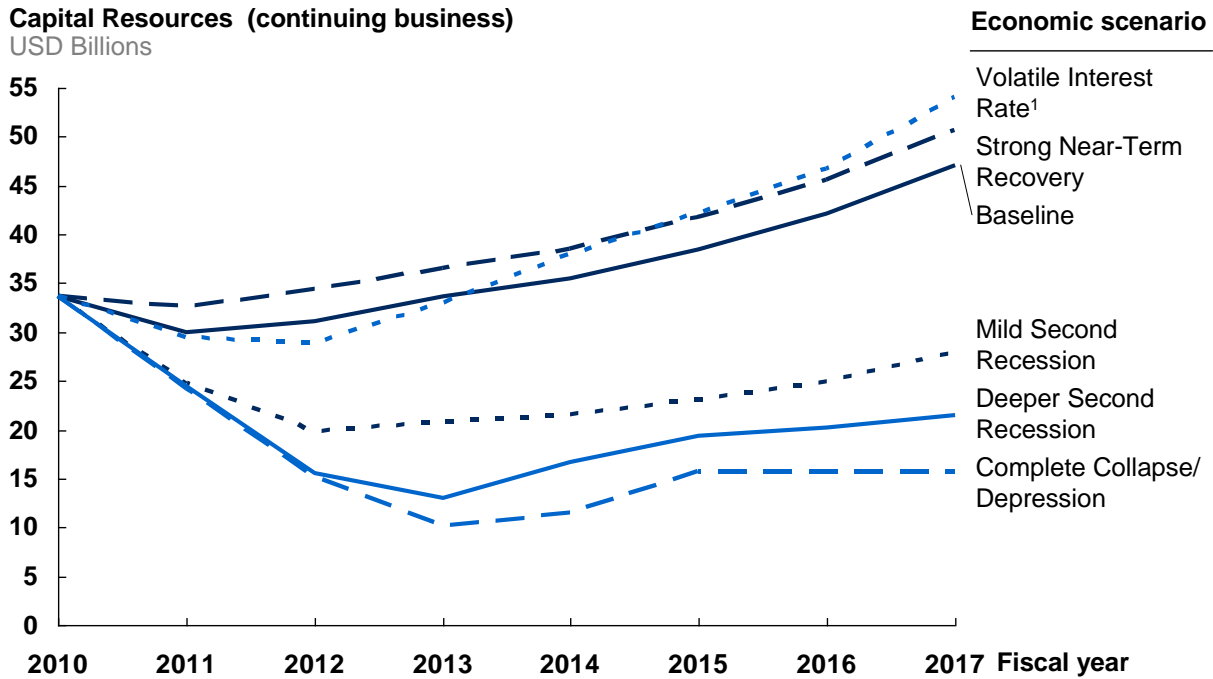
Source: U.S. Department of HUD/FHA; Analysis using metropolitan-level house price forecasts from Moody's Analytics and FHA single-family insurance volumes as of July 2010.

Only one of the Moody's alternatives, the Strong Near-Term Recovery, produces a better outcome than under the base-case. That scenario supposes that home prices have reached their trough and are ready to rise again. Moody's suggest that this is a 90th percentile outcome, meaning there is a 10 percent chance that the economy will actually start to improve immediately and by as much (or more) as suggested in this scenario.

The other three alternative scenarios all envision the possibility that home prices could fall more than in the base-case forecast. The worst scenario, the Complete Collapse / Depression, envisions a peak-to-trough price decline affecting the FHA portfolio of 35 percent. Moody's suggests that this scenario represents the 4th percentile event, reflecting a small chance that price declines could be even worse.

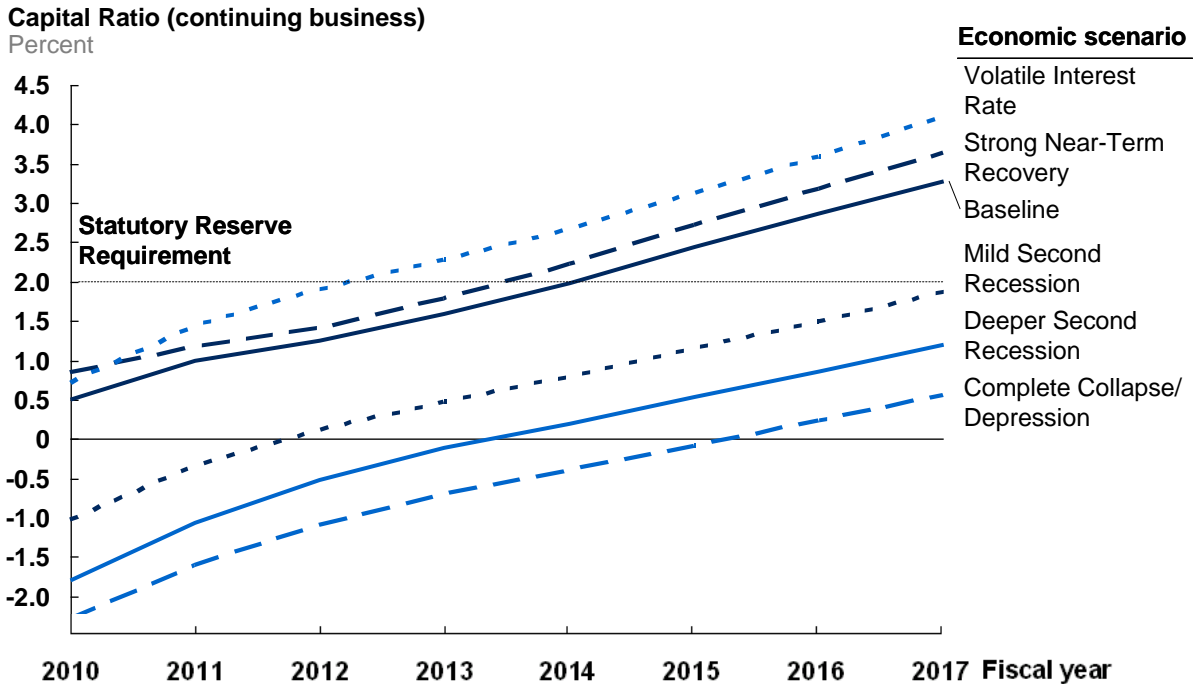
Because FHA is not in a wind-down mode, but will continue to issue new insurance endorsements, what matters under each of these prospective scenarios is how capital resources and the implied capital ratio will fare over time. Such comparisons are shown in Figures 14 and 15. The two metrics to focus on in these figures are how close capital resources could possibly come to zero at the worst point in the credit cycle, and how long it would take to rebuild a two percent capital ratio (without additional policy changes).

Figure 14. Capital Resource Estimates Under Alternative Economic Scenarios, FY 2010-2017



Source: U.S. Department of HUD/FHA; Analysis of the results of the independent actuarial studies for FY 2010.

Figure 15. Capital Ratio Estimates Using Alternative Economic Scenarios, FY 2010-2017



Source: U.S. Department of HUD/FHA; Analysis of the results of the independent actuarial studies for FY 2010.

The base-case expectation shown in Figures 14 and 15 predicts capital resources will likely fall approximately \$3 billion in FY 2011, but then rise at a strong pace thereafter. The capital ratio

nearly reaches two percent in FY 2014 (1.99 percent) and exceeds two percent in FY 2015 (2.43 percent). Under the Near-Term Recovery, capital resources fall only slightly in FY 2011 (to \$32.5 billion) and the capital ratio exceeds two percent in FY 2014.

On the downside, Moody’s Recession and Depression scenarios suggest that, under those economic paths, high net claim losses in the near term would cause capital resources to fall measurably, though they would still remain safely above zero. In the Mild Second Recession scenario, capital resources fall to \$19.8 billion, in the Deeper Second Recession they fall to \$13.0 billion, and in the Depression scenario they fall to just under \$10 billion. In each of those three scenarios there are no prospects of building to a two percent capital ratio over the next seven years without some additional administrative actions to either stem losses or else increase revenues.

In the Volatile Interest Rate scenario, capital resources fall by more than they do in the base case (to \$28.9 billion), but the two percent capital ratio is reclaimed a bit faster, cleanly reaching two percent in FY 2013.

Table 15. Projected End-of-Year MMI Fund Capital Ratios by Economic Scenario

Fiscal Year	Base-Case	Strong Near Term Recovery	Mild Second Recession	Deeper Second Recession	Complete/ Collapse Depression	Volatile Interest Rates ^a
2010	0.50%	0.83%	-1.03%	-1.80%	-2.29%	0.70%
2011	0.99	1.16	-0.35	-1.07	-1.62	1.44
2012	1.24	1.41	0.11	-0.53	-1.11	1.90
2013	1.58	1.77	0.47	-0.12	-0.70	2.26
2014	1.99	2.21	0.79	0.20	-0.41	2.66
2015	2.43	2.70	1.14	0.52	-0.10	3.11
2016	2.86	3.18	1.49	0.85	0.22	3.58
2017	3.28	3.63	1.85	1.19	0.56	4.09

^aThe Volatile Interest Rates are only applied to the single-family insurance and not to HECMs
 Source: U.S. Department of HUD/FHA; Analysis of results from the independent actuarial studies.

Though not detailed in last year’s Annual Report to Congress, the briefing accompanying the report showed results of a Depression scenario having a peak-to-trough decline in home prices that matches the current Moody’s Depression scenario.²⁷ Last year, the results were that the MMI Fund capital resources could go negative, and that the low point would be at close to -\$10 billion in FY 2013. Notably, this year’s actuarial results produce a low-point of +\$10 billion rather than -\$10 billion, suggesting that FHA’s capital resources will not go negative in this most stressed scenario. There are several reasons for this significant improvement. First, is the improved credit quality of the FY 2009, FY 2010, and (projected) future books-of-business which leads to fewer expected losses. Next, this year’s analysis includes the increases in insurance premiums

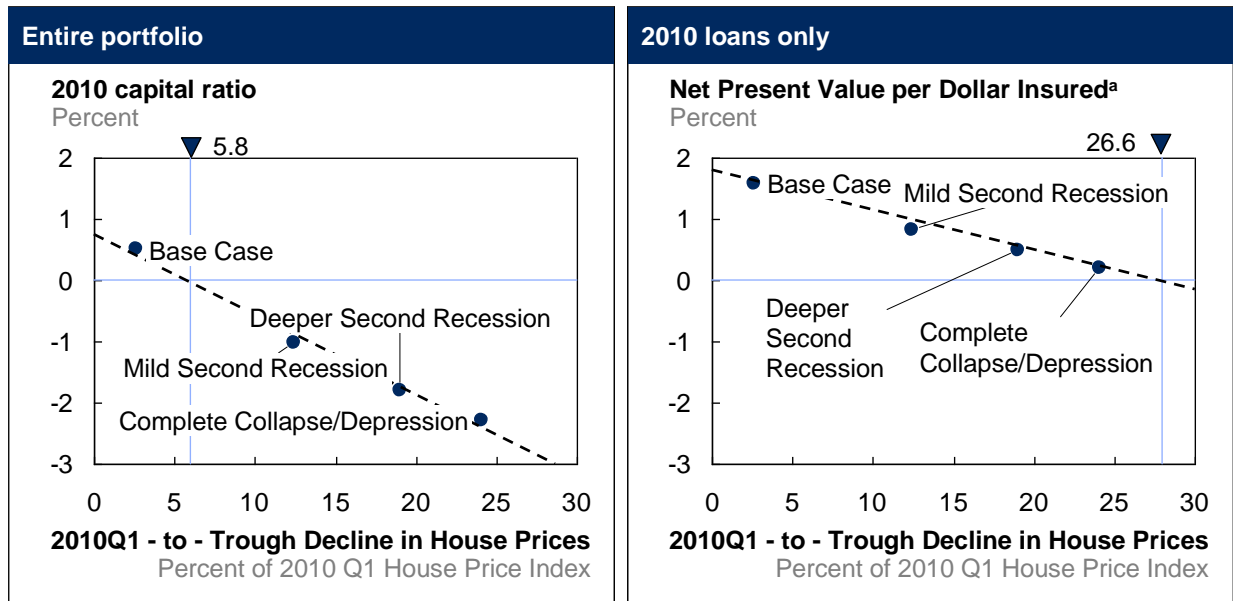
²⁷ Briefing available in HUD’s press briefing archives at:
http://portal.hud.gov/portal/page/portal/HUD/press/press_releases_media_advisories/2009/HUDNo.09-214

that were implemented beginning in April 2010, which generates additional revenues. Third, the new Moody's Depression scenario is comprehensive and includes further declines in interest rates. That helps the value of the MMI Fund by reducing the present value of future net claim expenditures, especially for HECM loans. The Depression scenario that was used last year did not include any reduction of interest rates from base-case levels, but only simulated further declines in home values.

Sensitivity analysis performed in the actuarial studies suggests that the economic net worth of the Fund today is highly sensitive to future house price movements. In the base-case scenario, home prices are predicted to have a further decline of 2.8 percent before reaching a low point in mid-FY 2011. As shown in Figure 16, if home prices were instead predicted to decline by 5.8 percent during the early forecast period, the economic net worth of the portfolio today would be zero. Thus, all of the alternative economic scenarios that use larger home price declines than the base-case result in negative estimates of economic net worth.

The FY 2010 book, however, is extremely resilient and could sustain a severe decline in house prices before exhibiting a negative lifetime NPV. Even in the Moody's Depression scenario, where the FY 2010 book would itself sustain immediate house price declines of 24 percent, the value of the book remains positive, though by a small margin. As noted in Figure 16, it would take nearly a 27 percent house price decline in the initial forecast period to cause the value of the FY 2010 book to drop to zero. The FY 2009 book is not as strong, and has a base-case value that is close to zero. That book would have negative expected NPV with a (future) decline in home prices of just 4 percent. The lack of any margin of error for the FY 2009 book is principally because that book is shouldering a substantial amount of the original credit risk of the FY 2006 – 2008 books via streamline refinancing into that book. Streamline refinance loans are not newly underwritten and so represent a mixture of credit quality from previous books. The base-case NPV of the FY 2009 book without streamline refinance loans is 0.61 percent of the value of loans insured. With the streamline refinance loans added, that falls to just 0.06 percent.

Figure 16. Capital Ratio Estimates and NPV of the FY 2010 Book Under Alternative Economic Scenarios



a NPV as of origination of the loan, divided by the insurance-in-force at origination

Source: U.S. Department of HUD/FHA; Analysis of results of the independent actuarial studies.

3. Other Risk Factors

In addition to economic forecast risk, actual results could vary from base case estimates if other fundamental assumptions do not hold true. One of those assumptions, which we have already discussed, is the projected value of higher credit quality loans in future books-of-business. For the past two years, actual credit quality has come in better than initially anticipated. For the future, the speed at which the conventional market will lower credit restrictions put in place during 2008 and 2009, and the extent to which the conventional market will attract better quality loans from FHA, remains a risk factor. If conventional market recovery occurs faster than anticipated in our demand forecasts, the capital ratio will not rise at the rate anticipated in the base-case. Additionally, if FHA insurance volumes on new books-of-business are smaller than anticipated, the capital ratio will not rise as per the base-case forecast since those books are expected to generate net income for the MMI Fund.

In the current economic environment, there is the potential for change in the rate of cures on delinquent loans, which impacts the share of loans going to foreclosure and insurance claim. Additionally, there is the potential for an increased rate of foreclosure completion on those cases where the loan servicer has already taken the first legal action toward foreclosure. Historically, only between 50 and 60 percent of foreclosure initiations actually end with the final auction and FHA taking possession of the property. There is some evidence today that the foreclosure completion rate may be rising above 60 percent. Alternately, given the improved credit quality of recently insured borrowers, the overall foreclosure completion rate in the portfolio could also decline assuming recently insured borrowers would have increased capacity to cure a delinquency.

Lastly, various states and lenders have imposed or are considering foreclosure moratoria of varying lengths of time. Today, the potential impact of these moratoria on delinquency transitions and rates of cure compared to foreclosure rates for FHA-insured loans is unclear.

III. Actions Taken to Strengthen the Fund for the Future

A. A COMPREHENSIVE FOCUS ON RISK MANAGEMENT

One key to maintaining the financial health of the MMI Fund is effective and ongoing monitoring and management of risk exposures within the portfolio. That includes more than just credit risk on new and outstanding loan guarantees and extends to counterparty risk, operations risk, and key personnel risk. As an important step toward developing a risk-management culture within FHA, HUD has now established a new Office of Risk Management and Regulatory Affairs (RMRA). RMRA now oversees monthly risk briefings with each program office – single-family, multifamily, and health care—and is engaged in risk reviews of all policy changes and initiatives. The Office also provides extensive analysis and reports on portfolio positions and valuations to senior management at HUD. It now oversees the annual independent actuarial studies and provides analysis of new policy initiatives. As the new Office completes its staffing plan, it will be more involved in defining risk tolerances, risk-response decisions, and risk-mitigation actions.

B. UNDERWRITING AND PRICING

Over the past year, HUD has made many changes to underwriting policies and premium rates for MMI Fund loans. Additional changes became effective in the beginning of FY 2011. A discussion of selected changes is below.

1. Streamline Refinancing

Streamline refinance loans persistently have higher rates of early-payment delinquencies than do other loans. The actuarial projections are that streamline loans endorsed for insurance over the past three years will perform worse than will fully-underwritten purchase and refinance mortgages. To assure that lenders are not simply “churning” portfolios to earn origination fees, or otherwise increasing risk to FHA by improper use of the streamline program, HUD issued rules requiring a number of new risk controls including:²⁸

- Requiring a net tangible benefit to borrower;
- Demonstration that the borrower has been making on-time payments to their initial FHA-insured mortgage;
- Prohibiting streamline refinancing for loans in which the borrower seeks to increase the loan balance (and thus increase risk exposure to FHA);

²⁸ See, Mortgagee Letter 2009-32, *Revised Streamline Refinance Transactions*, September 18, 2009. (All mortgagee letters are available at: <http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/>.)

- Reporting of credit scores to HUD so that FHA has an updated assessment of the borrowers' credit risk position;
- Certification of borrower employment and validation of assets needed for closing; and
- Limits on the combined loan-to-value ratio where second mortgages are re-subordinated in the refinance transaction (rather than being paid off).

Table 16. FHA Single-Family Insurance Early Payment Delinquency Rates^a by Product Type and Month of Loan Origination				
Month of Origination	Purchase Loans	Fully Underwritten Refinance	Streamline Refinance	All Loans
2007				
8	2.59	2.06	3.33	2.45
9	2.51	1.66	2.48	2.21
10	2.47	1.64	2.95	2.14
11	2.47	1.96	2.95	2.28
12	2.59	1.84	2.65	2.26
2008				
1	2.58%	1.73%	2.77%	2.23%
2	2.27	1.62	2.91	2.11
3	2.17	1.76	3.69	2.17
4	1.95	1.88	4.59	2.14
5	1.74	1.93	5.84	2.03
6	1.81	2.20	6.43	2.08
7	1.70	2.39	7.53	2.04
8	1.46	2.09	5.80	1.72
9	1.34	1.84	4.71	1.60
10	1.08	1.67	4.58	1.46
11	1.09	1.55	5.11	1.40
12	1.05	1.42	2.93	1.44
2009				
1	1.06%	1.01%	2.27%	1.39%
2	0.94	0.77	2.23	1.22
3	0.78	0.78	2.45	1.18
4	0.62	0.62	2.20	1.06
5	0.56	0.60	2.25	1.05
6	0.55	0.57	2.48	0.93
7	0.50	0.67	2.17	0.81
8	0.42	0.55	1.92	0.66
9	0.34	0.55	1.48	0.57
10	0.31	0.71	1.15	0.54
11	0.29	0.36	1.07	0.46
12	0.42	0.32	1.26	0.56
2010				
1	0.38	0.32	0.97	0.43
2	0.37	0.40	1.06	0.43

^a Early Payment Delinquencies are defined here as a 90-day delinquency within the first six months of required mortgage payments. The first payment-due month is the second month after loan closing. Thus, these rates indicate the percent of loans experiencing a 90-day delinquency within 7 months of loan closing.

Source: U.S. Department of HUD/FHA; October 2010.

2. Minimum Borrower Credit Quality

A mortgage loan is typically the largest debt liability that any household will manage. Sustainable homeownership requires that households have a successful track-record of managing other debt obligations before assuming this responsibility. While HUD does not want to unduly restrict access to homeownership opportunities, it also recognizes there are thresholds that indicate when managing a mortgage liability is too great and the chance of failure too high. As a result, HUD has instituted minimum credit score thresholds for insurance eligibility, which are based on the borrower's initial investment in the home. For those able to make a 10 percent investment (or greater), the minimum credit score is 500; for those making a smaller investment, the minimum is now 580.²⁹

For borrowers without traditional credit histories, HUD has now imposed risk controls involving maximum permissible payment ratios and cash reserves' requirements.

3. Appraisal Standards

The high-LTV-ratio lending supported by FHA is dependent upon valid assessments of property value. HUD has made two principal changes over the past year to bring new risk controls into the appraisal process. First, HUD limited the types of situations for which a lender may order a second property appraisal, to avoid "shopping" to get around identified property deficiencies.³⁰ Second, HUD reduced the appraisal-validity period from six months to the industry-standard of four months.³¹

4. Single-Family Premiums

Recent changes to FHA insurance premium rates was an immediate response to improve the finances of the MMI Fund, in order to provide additional protection against the possibility of higher-than-expected claim losses over the next few years. In April 2010, the upfront premium rate was increased from 1.75 to 2.25 percent.³² There was no change in the annual premium rate at that time because HUD was already charging the maximum allowable by law, which was 0.50 percent on loans with LTV ratios up to 95 percent, and 0.55 percent on those with LTV ratios above 95 percent. By way of contrast, private mortgage insurers—before the present economic crisis began—were charging close to one percent per year for loans with LTV ratios above 95 percent, and approximately 0.75 percent for loans with LTV ratios greater than 90 and up to 95 percent.³³

²⁹ See, Mortgagee Letter 2010-29, *Minimum Credit Scores and Loan-to-Value Ratios*, September 3, 2010.

³⁰ Mortgagee Letter 2009-29, *Appraisal Portability*, September 18, 2009.

³¹ Mortgagee Letter 2009-30, *Appraisal Validity Period*, September 18, 2009.

³² See, Mortgagee Letter 2010-02, *Increase in Upfront Premiums for FHA Mortgage Insurance*, January 21, 2010. The new rate of 2.25 percent was last charged between 1994 and 2000. From 2001 through 2008, HUD charged an upfront fee of 1.50 percent.

³³ Private mortgage insurers have rate charts that differentiate among loans on many dimensions. The reference here is to a typical premium rate for fixed-rate, fully-amortizing loans, with standard insurance coverage levels required

In August 2010, the Congress gave HUD authority to increase the FHA single-family annual premium rates, with a maximum of 1.50 percent for loans with LTV ratios up to 95 percent, and 1.55 percent for loans with higher LTV ratios. This change, which was requested by HUD, has permitted FHA to restructure the upfront and annual premium rates to provide greater reliance on the annual premium for overall revenues. The new premium structure, effective October 2010, has a 1.0 percent upfront charge and 0.85 and 0.90 percent annual charges, based on the initial LTV ratio.³⁴

At a time when FHA needs to increase insurance premiums to help rebuild MMI Fund capital account balances, greater reliance on the annual premium is more equitable to the borrower and reduces risk to the MMI fund. Today the upfront premium is typically financed into the loan balance and thus paid for in the monthly mortgage payments. Reducing the upfront premium reduces risk exposure to FHA by reducing the overall loan balance while continuing the policy of permitting borrowers to pay all of their insurance premiums through their monthly mortgage payments. For those borrowers who do not finance the upfront premium, this also reduces the amount of cash necessary at the time of closing without reducing the required downpayment. In addition, a structure that relies more on the annual/periodic premium is more closely aligned with a pay-as-you-go concept where borrowers pay premiums (and FHA receives the greatest share of its revenues) based on the length of time the loan is a risk insured by FHA.

The new authorities give HUD greater flexibility to increase premium revenue in the future, if necessary to ensure the safety and soundness of the MMI Fund.³⁵ If HUD had authority to implement the current premium structure at the start of FY 2010, it could have generated an additional \$4.51 billion of economic net value for the MMI Fund and the capital ratio today would be 1.05 percent, rather than 0.50 percent.

5. HECM Changes

HUD instituted two principal changes to the HECM program over this past fiscal year. The first was to reduce maximum principal-limit factors (PLFs) across-the-board, effective October 2009. This was done by reducing the original HECM PLFs by 10 percent.³⁶ Those factors had been in place since the inception of the program in 1989 and were based upon higher long-term house price growth assumptions than are prudent in today's economy.³⁷ Credit risk on HECM loans is long-term actuarial risk which will not reveal itself for many years. Thus, reducing the PLFs is a prudent risk-management tool during uncertain times.

by Fannie Mae and Freddie Mac. The most significant changes made by private mortgage insurers in 2008 and 2009 were to restrict eligibility based on geography and credit scores, rather than increases in insurance rates themselves.

³⁴ See, Mortgage Letter 2010-28, *Changes to FHA Mortgage Insurance Premiums*, September 1, 2010.

³⁵ To see this, note that the typical mortgage will be active for around six years. An approximation of the equivalency of an upfront premium rate to an annual rate is then found by dividing the upfront rate by six. So, the reduction of the upfront rate from 2.25 to 1.00 percent is roughly balanced by 0.20 percent increase in the annual premium. By raising the annual premium by 0.35 percent in October 2010, HUD instituted a premium rate structure that provides more expected revenues than did the temporary structure that was put in place in April 2010.

³⁶ See, ML 2009-34, *Home Equity Conversion Mortgage (HECM) – Principal Limit Factors*, September 23, 2009.

³⁷ The principal limit factors are specific to each unique combination of borrower age and the initial mortgage interest rate. They define what percentage of the house value the borrower is eligible to extract in HECM proceeds, based on actuarial calculations that balance longevity risk with the insurance premium rates.

One year later, in October 2010, HUD made slight adjustments to the PLFs, raised the annual insurance premium rate to 1.25 percent, and introduced HECM Saver, a new option for borrowers. The increase in the annual premium rate was to address newly-measured risk factors in the program without having to impose sizable reductions to the PLFs instituted one year ago. With HECM Saver, the maximum equity take-out limit is considerably lower than it is with the HECM Standard option, reducing risk to the MMI Fund. In return, FHA charges only a minimal upfront insurance premium. The annual insurance premium for HECM Saver is 1.25 percent of the outstanding loan balance, as it is with HECM Standard, but the upfront insurance premium for HECM Saver is just 0.01 percent.³⁸ Both the increase in the annual premium rate and the introduction of HECM Saver are designed to assure that HECM remains a self-sustaining program in the future. The assessment of the independent actuaries is that these changes should in-fact provide for the desired result. Otherwise, the expected value of new endorsements has been negative for two years now and would still be too close to zero were it not for the changes now instituted.

C. MANAGING COUNTERPARTY RISK

Over the past year, FHA has implemented a series of new polices to better manage the many counterparties who originate, underwrite, and service its insured portfolio. Actions by and business practices of these partners can have a profound effect on the credit quality of loans insured, the probability of loan default, and ultimate credit losses.

1. Origination and Underwriting

At the very start of FY 2010, HUD implemented new statutory authorities permitting it to debar certain individuals who had been sanctioned by HUD, or who had criminal records involving FHA or mortgage lending. Such individuals can no longer act as principals, officers or underwriters in FHA-approved mortgagee firms.³⁹

At the same time that HUD issued this new policy, it also set in place a new requirement that all supervised mortgagees (correspondent lenders who sell to larger, aggregators) submit annual audited financial statements. The inability to submit such statements, by itself, is a sign of possible financial difficulties that could lead to problems with overly-aggressive originations (to generate revenues), or signal a lack of management attention to the core business.

HUD has also set in motion a three-year phase-in of higher net worth requirements for FHA-approved lenders. Effective May 2010, the minimum net worth requirement for newly approved lenders is \$1 million.⁴⁰ That minimum will take effect for all FHA-approved lenders in 2013. Also in 2013, lenders handling more than \$25 million in FHA loans each year (origination or servicing) will have higher net worth requirements, up to \$2.5 million. HUD has also stopped approving and monitoring “loan correspondents” (e.g., mortgage brokers) as independent originators of loans. This relieves HUD of the responsibility for monitoring them, a task for which HUD does not have sufficient resources. In the future, FHA-approved lenders must

³⁸ Current regulations require that some positive upfront premium be charged for HECM loans.

³⁹ See, Mortgagee Letter 2009-31, *HUD Counterparty Risk Management*, September 18, 2009.

⁴⁰ The former requirements were for \$250,000 plus one percent of the previous fiscal year’s volume of originations or servicing. Designated small businesses had a maximum capital requirement of \$500,000.

sponsor such third parties and take full responsibility for underwriting quality. This change moves FHA to a more industry-standard model of placing full responsibility for loan quality with the underwriting firms.⁴¹

HUD is also implementing new procedures for targeted loan-level file reviews. While these reviews can be performed at any point in the loan lifecycle, they are currently most commonly conducted as a post endorsement technical review (PETR) of the underwriting documentation. New file-selection and review procedures (both automated and manual) will be consistent with industry-best practices and current market conditions. Specifically, the updated methods will provide quality control staff with the detail necessary to swiftly and efficiently identify individual loans having the potential for problems that could signal a high propensity for early default and insurance claim.

2. Indemnification Against Potential Loss

Through a proposed rule issued on October 8, 2010, HUD intends to strengthen FHA's lender indemnification and insurance process.⁴² For those lenders with special authority to insure mortgage loans on FHA's behalf, HUD seeks to force indemnification against possible claim losses for 'serious and material' violations of FHA origination requirements. These violations would be such that the mortgage should not have been originated in the first place. Specifically, these lenders may be required to indemnify HUD if they failed to: (1) verify and analyze the creditworthiness, income, and/or employment of the borrower; (2) verify the source of assets brought by the borrower for payment of the required downpayment and/or closing costs; (3) address property deficiencies identified in the appraisal affecting the health and safety of the occupants or the structural integrity of the property; or (4) ensure that the property appraisal satisfies FHA appraisal requirements. HUD may seek indemnification irrespective of whether the violation caused the mortgage default. The proposed rule will also require those mortgagees with delegated lender insurance authority to continually maintain an acceptable claim and default rate, both to gain this special lender status as well as to preserve it. HUD proposes that all new unconditional direct endorsement lenders who have the authority to self-insure mortgages must demonstrate a default and claim rate at or below 150 percent of the FHA portfolio average for the previous two years. These measures will ensure that lenders granted special authority to insure loans on FHA's behalf perform appropriately, and if they do not, will grant FHA the requisite authority to recover losses.

3. Loan Servicing

To further ensure accountability and reliability, HUD has expanded its counterparty oversight processes. Enhanced reviews on the loss mitigation activities of large servicers are now a standard part of regular performance evaluations. Servicers that violate FHA guidelines are subject to numerous actions including: repayment of loss mitigation incentives, indemnification against loss, and referral to HUD's Mortgagee Review Board for appropriate sanctions. To help reinforce the new servicing guidelines, HUD has also expanded training programs for servicers.

⁴¹ The policy changes mentioned in this paragraph are discussed in Mortgagee Letter 2010-20, *Implementation of Final Rule FR 5356-F-02, "Federal Housing Administration: Continuation of FHA Reform—Strengthening Risk Management through Responsible FHA-Approved Lenders,"* June 11, 2010.

⁴² See, 75 FR 195 (October 8, 2010, 62335), *Federal Housing Administration (FHA) Single Family Lender Insurance Process: Eligibility, Indemnification, and Termination.*

4. IT Infrastructure

In addition to tightening lender enforcement policies, HUD has begun to implement system changes to facilitate lender and loan-risk management. Under the FHA Infrastructure Transformation Initiative, HUD has embarked on a multi-year effort to modernize the technology infrastructure and applications for origination and underwriting of FHA loans, the approval and recertification of FHA's lender partners, and the monitoring of those business partners over time. Under the FHA Risk and Fraud Initiative, HUD has initiated contracts to enable more effective mitigation of credit risk and mortgage fraud utilizing cutting-edge analytical methodologies and IT solutions.⁴³ These tools will help HUD identify lender and associated loan-level weaknesses, and to respond faster to conditions affecting FHA's programs and insurance portfolio.

HUD is implementing functionality to access and aggregate counterparty information from disparate data sources into an enterprise-wide platform for listing, monitoring and reporting on risk. Based on industry "best of breed" tools, this platform will streamline the process by which FHA Quality Assurance managers target risky and potentially fraudulent business counterparties. The platform will provide FHA with the ability to perform specified analytics, both routine and on-demand, to identify patterns and individual cases of risk and fraud at the entity level. It will also automate some processes that are currently manual, making them more efficient and facilitating the data requirements for this analytic capability.

These improvements to FHA policies and processes are components of a comprehensive effort to identify and eliminate potential areas of risk in its operations. This work to improve counterparty risk management capabilities, and to enhance program requirements, has the potential to significantly improve the finances of the MMI Fund portfolio.

IV. The Continuing Role of the FHA

Though HUD expects the role of the FHA insurance to diminish as the credit industry recovers, the reasons enumerated above suggest that, in the short term, FHA must continue to function as a major source of support for the mortgage market. Over the longer term, the events of the past four years indicate the need to assure that FHA remains a viable institution, with sufficient resources and market presence to assure a quick response to the next potential crisis. From an operations standpoint HUD has, and will continue to align underwriting, premium structures, and lender monitoring/controls so that FHA emerges from the current environment both stronger and more efficient than before.

⁴³ The request for proposals can be viewed at:
https://www.fbo.gov/index?s=opportunity&mode=form&tab=core&id=84476707d86b82bbcc74512af6e153b7&_cv_iew=0