

HOUSING
FHA--MUTUAL MORTGAGE INSURANCE FUND
2014 Summary Statement and Initiatives
(Dollars in Thousands)

| FHA--MUTUAL MORTGAGE & COOPERATIVE MGMT. HOUSING INSURANCE FUND | <u>Enacted/ Request</u> | <u>Carryover</u> | <u>Supplemental/ Rescission</u> | <u>Total Resources</u> | <u>Obligations</u> | <u>Outlays</u> |
|--|-----------------------------|------------------|-------------------------------------|----------------------------|--------------------|----------------|
| 2012 Appropriation | \$207,000 ^a | ... | ... | \$207,000 | \$119,532 | \$102,000 |
| 2013 Annualized CR | 136,767 ^b | \$15,968 | ... | 152,735 | 139,500 | 121,000 |
| 2014 Request | <u>127,000^c</u> | <u>13,235</u> | ... | <u>140,235</u> | <u>138,000</u> | <u>188,000</u> |
| Program Improvements/Offsets | -9,767 | -2,733 | ... | -12,500 | -1,500 | +67,000 |

a/ Includes a non-expenditure transfer of \$71.5 million to the HUD Working Capital Fund. The transfer amount is excluded from obligations and outlays.

b/ Excludes \$71.5 million transferred to the Working Capital Fund.

c/ This number includes an estimated Transformation Initiative (TI) transfer that may be up to 0.5 percent of Budget Authority.

1. What is this request?

The Mutual Mortgage Insurance (MMI) Fund is the largest fund covering activities of the Federal Housing Administration (FHA). Since 1934, mortgage insurance provided by FHA has made financing available to individuals and families not adequately served by the conventional private mortgage market. Through MMI, the Department offers several types of single family forward mortgage insurance products and Home Equity Conversion Mortgages (HECMs) for seniors. Activity for the Cooperative Management Housing Insurance (CMHI) Fund – which insures mortgages for multifamily cooperatives – is reported together with MMI.

The fiscal year 2014 Budget request will enable FHA to continue in its mission of providing access to mortgage credit for families with low and moderate wealth, and to play an important countercyclical role in the stabilization and recovery of the nation's housing market. By facilitating the availability of vital liquidity through a variety of HUD-approved lenders, including community banks and national credit unions:

- FHA has helped over 3.5 million families buy a home since President Obama took office – more than 75 percent of which were first-time buyers.
- According to the most recent data available, FHA accounted for 50 percent of home purchase mortgages for African American borrowers and 49 percent for Hispanic/Latino borrowers. Over that same time period, FHA has also helped over two million existing homeowners refinance into stable, affordable mortgage products.

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- FHA's share of the mortgage market has gone from a low of 3.1 percent of loan originations in 2005, up to a peak of 21.1 percent in 2010, and more recently down to 13.9 percent in the 3rd quarter of 2012 (*U.S. Housing Market Conditions Report, 3rd Quarter 2012*). In fact, total FHA volume has declined to levels comparable to that seen in fiscal years 2002 and 2003, when FHA's market share was lower than it is today, indicating that FHA's current slightly elevated market share is primarily due to a substantial decrease in the size of the total mortgage market rather than exceptionally high FHA loan volumes.

FHA is making it a priority focus to assist homeowners through early delinquency intervention, loss mitigation programs, and specific joint efforts with the Department of Treasury, including: the Home Affordable Modification Program and the FHA Short Refinance program for underwater borrowers with conventional loans. Over fiscal years 2013 and 2014, FHA has a 2-year goal of having 500,000 homeowners assisted through early delinquency interventions and 200,000 assisted through loss mitigation programs. At least 80 percent of loans receiving this assistance are anticipated to be current on their mortgages for at least 6 months. The prevention of foreclosures through loss mitigation activities benefits the borrower, stabilizes communities by preserving property values, and may save money in the MMI fund by reducing full default claims.

The fiscal year 2014 request for MMI includes four components:

- **Commitment authority for up to \$400 billion in new loan guarantees.** The fiscal year 2014 Budget requests \$400 billion in loan guarantee limitation, which is to remain available until September 30, 2015. The requested limitation has been unchanged since 2010. This limitation includes sufficient authority for insurance of single family mortgages, mortgages under the HECM program, and the FHA Short Refinance program. Total loan volume projected for all MMI programs for fiscal year 2014 is \$199.3 billion. Of that total, \$178 billion is estimated for standard forward mortgages, \$6.4 billion for HECM, and \$14.9 billion for FHA Short Refinances. The 2-year availability for this commitment authority will reduce the likelihood of program disruption under a continuing resolution.
- **Negative Subsidy Receipts.** The \$199.3 billion in loan volume projected for the entire MMI portfolio in fiscal year 2014 is expected to generate \$12.96 billion in negative subsidy receipts, which are transferred to the MMI Capital Reserve where they are available to cover any projected cost increases for the MMI portfolio.
- **Appropriations for Administrative Contracts.** The Department requests an appropriation of \$127 million for administrative contract expenses for fiscal year 2014, a reduction of \$80 million from the fiscal year 2012 enacted. This request supports administrative functions for all of FHA programs, including multifamily and healthcare programs operating under the General and Special Risk Insurance Fund (GI/SRI). No amounts are included in the MMI request for transfers to the working capital fund in fiscal year 2014, accounting for \$71.5 million of the decrease. Resources to support IT are instead being requested under the Working Capital Fund.
- **Commitment authority for up to \$20 million in direct loans to facilitate single family property disposition.** The loan authority requested is for short-term purchase money mortgages for non-profit and governmental agencies to make

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HUD-acquired single family properties available for resale to purchasers with household incomes at or below 115 percent of an area's median. This commitment limitation request is reduced from \$50 million to \$20 million in light of low program participation. Though the program has been infrequently utilized in recent years, it remains a valuable tool for HUD in managing its property portfolio. The loan program is designed to operate at break-even for the government, so no credit subsidy is involved.

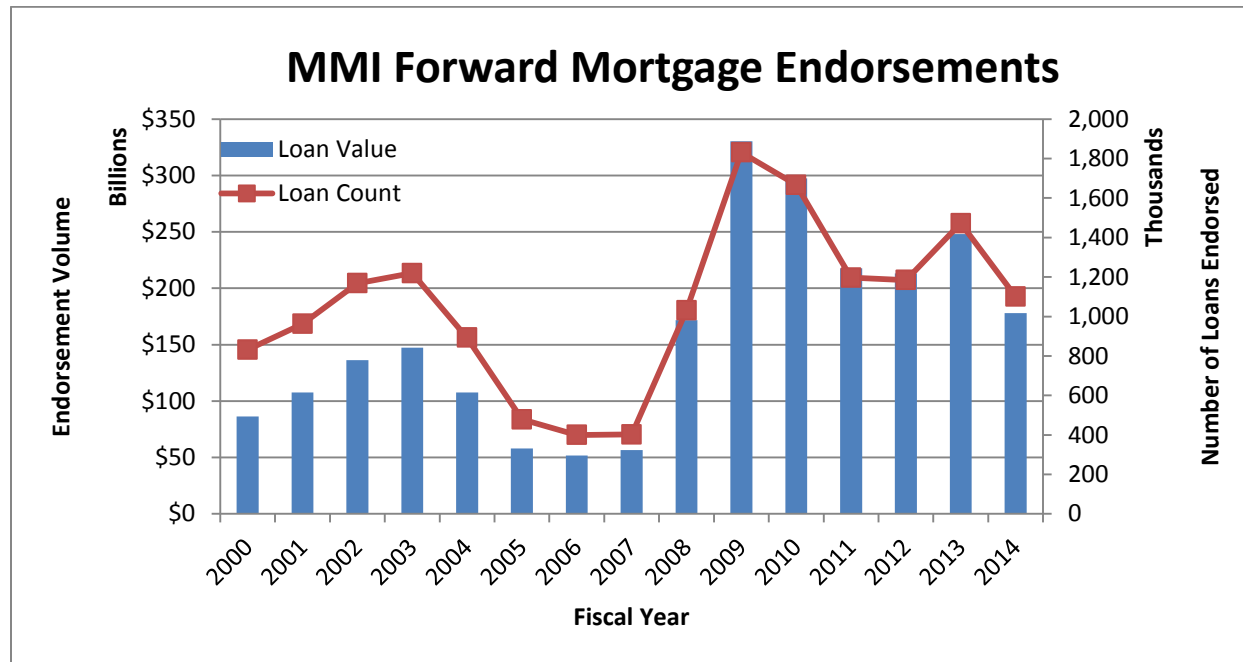
2. What is this program?

FHA has insured over 41 million home mortgages since 1934. In exchange for adherence to strict underwriting and application requirements established by HUD and the payment of insurance premiums, HUD-approved lenders are able to file claims with FHA when a borrower defaults. Mortgage insurance premiums and specific terms for claim payments vary by program. FHA insurance has played a key role in mitigating the effect of economic downturns on the real estate sector, as FHA plays a countercyclical role, providing access to mortgage credit during periods of constriction in credit markets. The FHA includes a strong, mandatory loss mitigation program. Through the recession, FHA has become a key support for the national mortgage market and is mitigating the foreclosure crisis and the overall economic downturn.

At the end of fiscal year 2012, the MMI insurance portfolio included 7.8 million loans with an unpaid principal balance exceeding \$1.1 trillion. FHA mortgage insurance enhances a borrower's credit and provides banks with better access to capital markets, most notably through Ginnie Mae securities. FHA has long been a valuable resource for enabling the purchase of a first home, especially among minority and low-income families. FHA loans are highly attractive to borrowers who are credit-worthy but have difficulty assembling a large down payment or securing conventional financing.

For budgetary purposes, the programs of the MMI Fund are broken into three risk categories, each of which is discussed below: Forward Mortgages, FHA Short Refinances (Refi), and HECM.

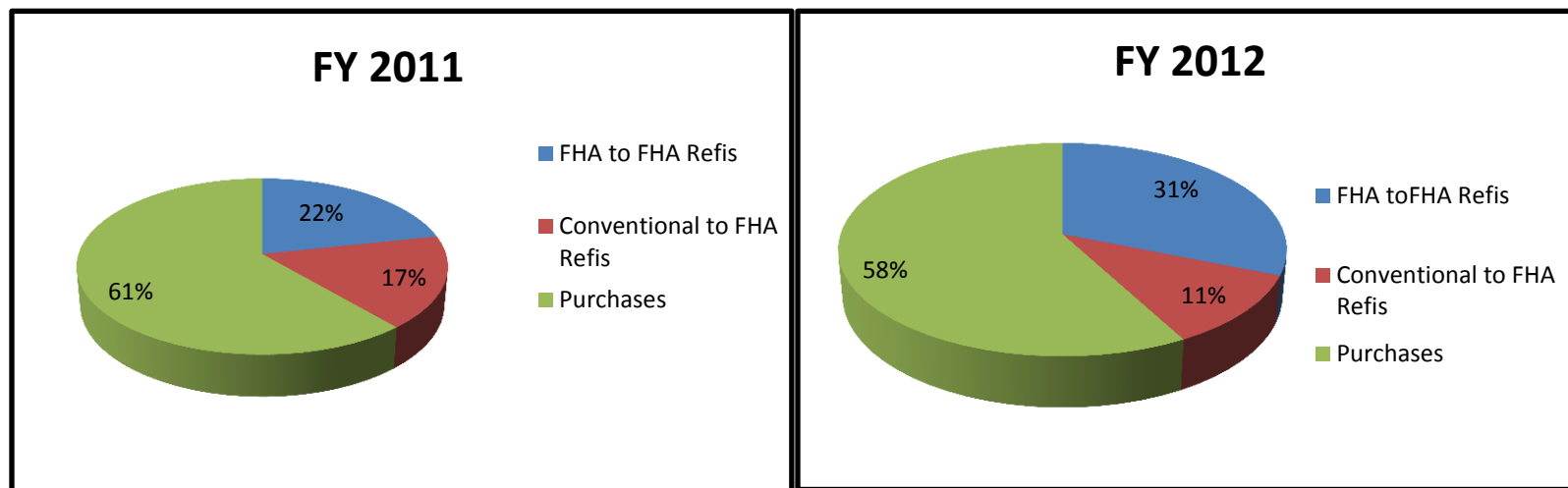
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Mortgage Insurance and Guaranteed Loans. The largest FHA insurance program is the single family program authorized under Section 203(b) of the National Housing Act. Through the end of fiscal year 2012, 92.4 percent of the \$226 billion in insurance endorsements for the MMI Fund were under the Section 203(b) program. Beginning in fiscal year 2009, FHA consolidated a majority of its single family mortgage insurance programs under this risk category, including those for condominiums, purchase of homes on Indian and Hawaiian lands, and rehabilitation loans (Section 203(k)). Single family programs provide mortgage insurance for the purchase and refinance of homes with one to four units. Maximum mortgage amounts insured by FHA are calculated annually by HUD and are tied to the median house price in each county. Maximum mortgages in high cost areas were legislatively increased in 2008 in order to expand the number of families who would be able to access affordable mortgage financing during the economic downturn. Currently, the limits start at \$271,050 for a one-unit dwelling and go as high as \$729,750 for a one-unit dwelling in “high cost” areas. The authorization for the higher loan limits is slated to expire on December 31, 2013 and replaced by the permanent law limit of the lessor of 115 percent of median house price or \$625,500.

FHA endorsement activity peaked in fiscal year 2009, when monthly volume surpassed \$25.8 billion, compared to just \$4.7 billion in 2007. From this peak, FHA’s annual endorsement volume dropped markedly through 2010 and 2011, then held steady in 2012. Current estimates show modest increase in 2013, then a decrease in fiscal year 2014. FHA’s current loan volumes are comparable to levels experienced in 2002 and 2003, when FHA’s market share was considered more “normal.”

203(b) Endorsement Volume by Loan Type



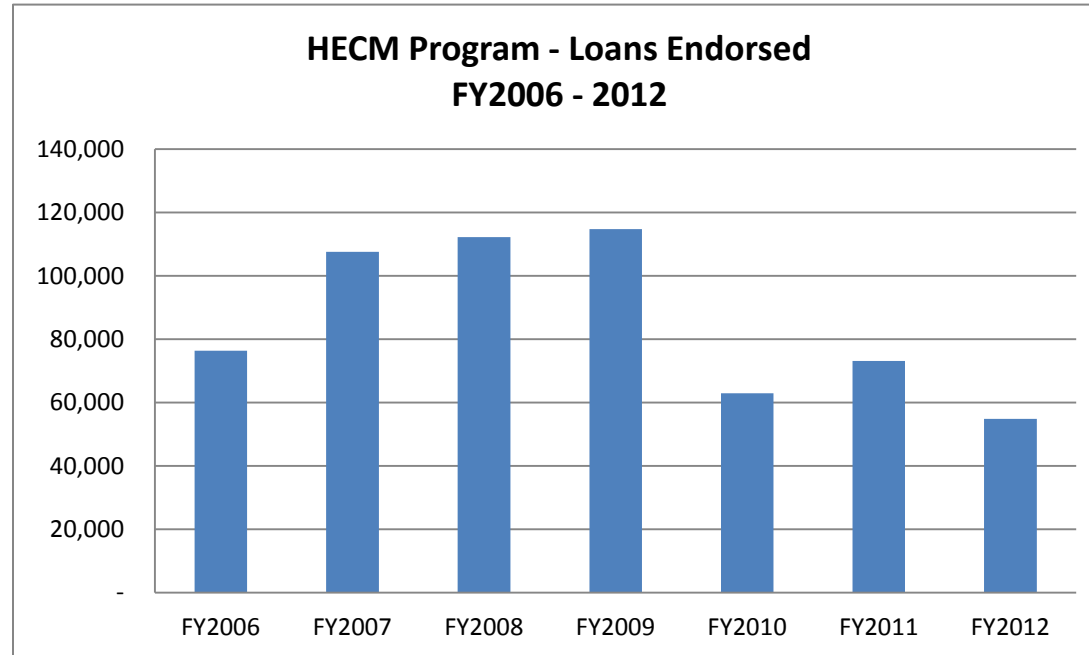
FHA Short Refinance. In fiscal year 2010, HUD and the Department of Treasury announced enhancements to FHA’s refinance program that give a greater number of responsible borrowers the opportunity to remain in their homes. The enhancements were designed to maintain homeownership by borrowers who owe more on their mortgages than the value of their homes with opportunities to refinance into an affordable FHA loan. This program allows a borrower who is current on his mortgage to qualify for an FHA refinance loan, provided that the lender or investor writes off the unpaid principal balance of the original first lien mortgage by at least 10 percent. FHA will accept applications for this program through the end of calendar year 2014.

HECM. FHA’s HECM program allows senior homeowners age 62 and older access to FHA-insured reverse mortgages to convert the equity in their homes into monthly streams of income and/or a line of credit to be repaid when they no longer occupy the homes. In fiscal year 2010, HUD introduced a new product – HECM Saver – that offers lower upfront loan closing costs for mortgagors who want to borrow a smaller amount than that available with the Standard HECM product. Homeowners who select either option are required to receive consumer education and counseling by a HUD-approved housing counselor so they can be sure this program meets their needs. The amount a borrower is eligible for is based on the borrower’s age, current interest rates, and the lesser of the appraised property value or the FHA mortgage limit for HECM. Unlike forward mortgage borrowers, the HECM borrower has no income or credit qualifications to meet and makes no payments as long as the property securing the HECM loan continues to be the borrower’s main residence. In fiscal year 2012, FHA endorsed more than 54,000 HECM loans with a total maximum claim amount of \$13.2 billion. HECM volume estimates and credit subsidy rates for fiscal year 2014 reflect only the HECM Saver product. The

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Department is currently exploring options to modify the program in ways that will improve the expected loan performance and allow for other products to be offered in fiscal year 2014. Key reform elements are discussed under Section 4.

From the beginning of the HECM program in fiscal year 1990 through fiscal year 2011, over 723,129 loans have been endorsed under the program. Over 65 percent of these loans were endorsed during fiscal years 2007 through 2011. (HECM endorsements made prior to 2009 were under the General and Special Risk Insurance Fund.)



Salaries and Expenses (S&E) and Full-Time Equivalents (FTE) Request

The primary workload for FHA programs in the MMI fund is carried out by HUD's Office of Housing, mainly the Office of Single Family Housing. Critical functions are also supported by financial, procurement, IT, and other administrative organizations. A total of 897 FTE are requested for the Single Family Housing programs. Total S&E funding is \$113.7 million, or an increase of \$4.7 million from the fiscal year 2012 enacted level. Personnel services increase by \$4.3 million or 4.0 percent, reflecting the cost of salary and fringe benefits. Non-personnel services are increased by \$468 thousand due to increase in training. All other Non-personnel services remain at the fiscal year 2012 level.

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Workload by Function

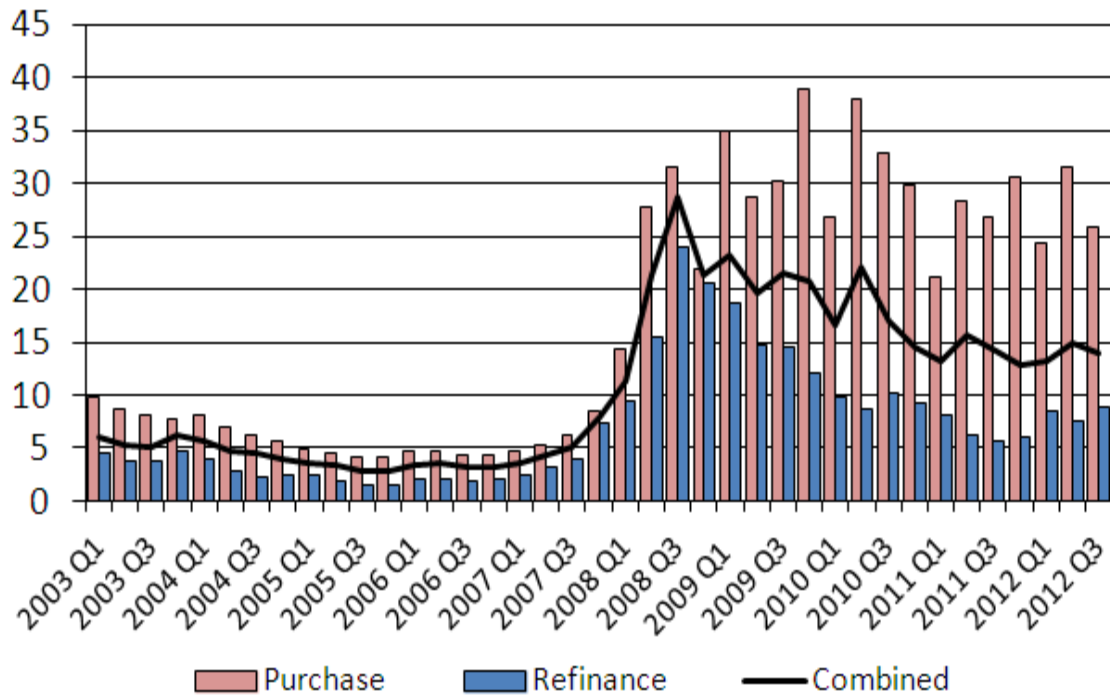
The overall S&E requests reflect the following workload by functions for the Single Family Programs:

- The Single Family Production/Processing staff administering FHA Mortgage Insurance Programs has 376 FTE (41.9 percent) to ensure oversight of contractors that process case-level endorsement for mortgage insurance; reviews underwriting and mortgage credit analyses of pre-endorsement files for FHA-approved lenders; provide oversight of contract field appraisers that conduct site reviews; monitor appraisers for compliance with FHA requirements and provide oversight of condominium approval process.
- The Single Family Asset Management Staff has 233 FTE (26.0 percent) who develop and update policies related to all aspects of implementing and monitoring the program. The Asset Management Staff provides contract requirement development and oversight of Field Service Manager and Asset Manager Contractors that perform property maintenance services and property disposition/sale services for all HUD Real Estate Owned (REO) properties in inventory.
- The Single Family Lender Oversight staff has 187 FTE (20.8 percent) who develop and update policies related to oversight of FHA-approved lenders; oversee and coordinate audit response for lender-related activities; conduct lender performance evaluations; and provide referrals to the Mortgagee Review Board (MRB) for lenders with serious violations.
- The Single Family Policy Development staff has 76 FTE (8.5 percent) who administer FHA Mortgage Insurance Programs, initiate and execute program and policy changes in response to market changes; support SF Credit and Appraisal handbooks, FAQs and policy publications, market outreach, communication, and training.
- The Single Family Customer Service has 25 FTE (2.8 percent) associated with performing activities in connection with internal and external customer relations, responding to congressional and White House requests and to non-policy related customer requests, providing outreach to customer groups, providing Technical Assistance, conducting Programmatic Training, and responding to OIG, GAO, OMB Audits and Inquiries.

3. Why is this program is necessary and what will we get for the funds?

FHA provides mortgage insurance on single family mortgage loans made by FHA-approved lenders throughout the United States and its territories. FHA's single family mortgage insurance program supports our nation's housing recovery by meeting the needs of borrowers facing difficult economic conditions, such as declining property values and contracting credit markets. FHA remains active and viable in all markets during times of economic disruption, playing an important counter-cyclical role until private capital returns to its natural levels. FHA will continue to meet the needs of many first time and minority homebuyers who—without the FHA guarantee—may otherwise find mortgage credit to be prohibitively costly.

**FHA Supports Mortgage Lending During Crisis
FHA As Share of Quarterly Mortgage Originations By Type (Percent)**



Sources: MBA and HUD.

The HECM program fills a special niche in the national mortgage market and offers critical opportunities for the nation’s seniors to preserve their quality of life by tapping into their home equity. According to a 2009 study by MetLife’s Mature Market Institute, today’s issues of increased longevity, rising health care and other costs, fewer defined benefit pension programs, and diminished investment values have put extraordinary pressure on seniors in finding new sources of income and creative ways to stretch out accumulated savings during retirement. Options once available to tap home equity, such as selling the home and moving to less costly housing, are also more limited in today’s market as homes can languish on the market for extended periods of time, and when they do sell, the price may be significantly below the homes’ pre-crisis value. To supplement their budgets, older homeowners are increasingly considering the option of tapping their housing wealth. Consequently, reverse mortgages offer a viable option. Due to the tightening of conventional credit since the housing crisis, HECM has become nearly 100 percent of the reverse mortgage market. As the economy recovers, home prices rebound and credit becomes less constricted, conventional reverse mortgages will likely become available again. However, until then, FHA will continue to play a countercyclical role in this market like it has with

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forward loans, providing access to credit. In addition to requesting commitment authority for HECM, the Budget proposes to permanently lift the statutory aggregate cap of 275,000 HECM loan guarantees. Prior appropriations have lifted the cap on an annual basis. This change will help the program operate without disruption.

Commitment Authority and Subsidy Projections

The fiscal year 2014 Budget request will provide the commitment authority and administrative funding for FHA to continue its important work.

Below is a table indicating loan commitment volumes, credit subsidy rates, and subsidy obligations for each MMI risk category in fiscal years 2013 and 2014. Credit subsidy rates represent the projected net cost (positive credit subsidy) or savings (negative credit subsidy) to the government of operating a loan guarantee program, and take into account projected claims, pre-payments, premium revenue, and recoveries on defaults for a cohort of loans over their lifetime. For more information on credit subsidy calculation please see the Notes section.

Estimates of single family commitment volume are calculated using both empirical inputs such as recent loan application volume and endorsement trends, as well as a variety of assumptions regarding expected condition in the housing and credit markets, interest rates, historic seasonal adjustment, and anticipated effect of program changes. These estimates are also very sensitive to other factors that cannot readily be anticipated or predicted, such as economic or fiscal policy changes. Even model variations in market trends or economic assumptions can result in significant changes in actual program demand and commitment volume.

| <u>MMI COMMITMENT VOLUME BY RISK CATEGORY</u> <u>(in millions)</u> | <u>FY 2012 Commitments</u> | <u>FY 2013 Commitments Estimate</u> | <u>FY 2013 Subsidy Rate</u> | <u>FY 2013 Negative Subsidy</u> | <u>FY 2014 Commitments Estimate</u> | <u>FY 2014 Subsidy Rate Estimate</u> | <u>FY 2014 Negative Subsidy Estimate</u> |
|---|---------------------------------------|--|--|--|--|---|---|
| MMI Purchase and Refinance | \$213,126 | \$248,000 | -7.22% | (\$17,908) | \$178,000 | -7.25% | (\$12,902) |
| MMI HECM | 13,164 | 11,723 | -2.29% | (269) | \$6,397 | -0.90% | (\$57) |
| FHA Short Refi | <u>233</u> | <u>10,457</u> | <u>0.00%</u> | <u>0</u> | <u>\$14,939</u> | <u>0.00%</u> | <u>0</u> |
| Totals | 226,523 | 270,180 | | (18,177) | \$199,336 | | (\$12,959) |

Administrative Contract Appropriations

The request for fiscal year 2014 will provide funding for contracts necessary in the administration of all FHA programs, including those operating under MMI and GI/SRI. (Beginning in fiscal year 2010, appropriations for FHA administrative contracts were consolidated under MMI to allow for more efficient management of funds.) This request will fund activities including, but not limited to: construction inspections on multifamily projects, the required annual FHA actuarial review and financial audit, management and oversight of asset disposition, risk analysis and accounting support, and assistance with claims and premium refund processing.

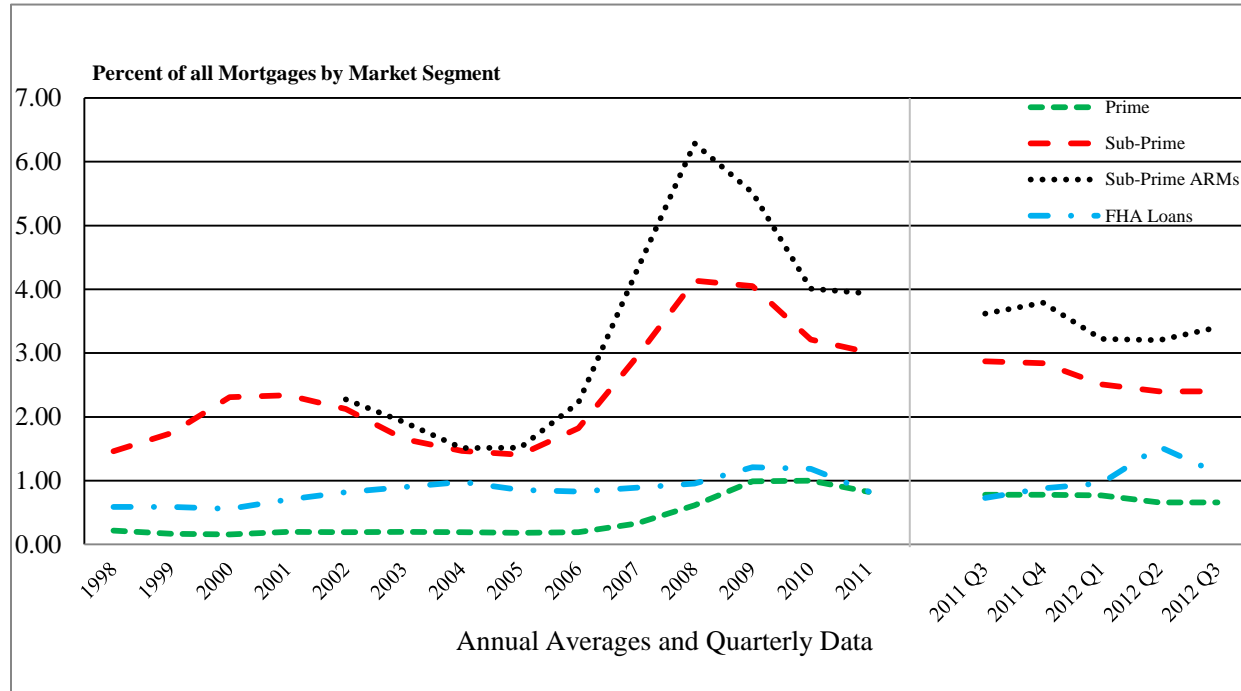
4. How do we know this program works?

FHA single family insurance is known to work not only because it provides a countercyclical backstop, but also because it:

1) increases liquidity for mortgage lending, including mortgage lending for low wealth families; 2) serves as a primary source of mortgage credit for minority and first time homebuyers; and 3) has key features that provide consumer protections that were lacking in much of the private lending leading up to the mortgage market collapse.

As the following chart shows, even prior to the market collapse, FHA-insured mortgages had foreclosure rates that were much lower than the subprime sector. Furthermore, as the market imploded and subprime foreclosures skyrocketed, FHA remained much more stable, which was likely due, at least in part, to underwriting terms that were more conservative and to consumer protection features in the basic loan terms.

Foreclosure Start Rate by Mortgage Market Segment



Source: U.S. Housing Market Conditions Report, Fourth Quarter 2012.

http://www.huduser.org/portal/periodicals/ushmc/winter12/USHMC_4q12_historical.pdf

FHA continuously monitors and evaluates the results of its programs, and updates its policies as necessary to take into consideration product performance as well as market forces. To address current and difficult conditions in the housing market, aid homeowners, and mitigate risk to FHA’s insurance fund, FHA develops new programs, modifies existing programs and improves controls. For example, FHA has recently modified its premium structure and tightened underwriting requirements for forward mortgages, steps necessary to raise negative subsidy receipts and restore FHA’s capital reserve.

The continued weakness in the housing market and reduction in private lending have increased the demand for loss mitigation actions, and FHA has expanded its tools to meet that need. The Department has provided increased targeted loss mitigation training for lenders, and has increased monitoring of mortgagees and servicers to assure they are making sincere efforts to curb

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foreclosures. As part of its annual performance plan, the Department established an agency priority goal to assist homeowners who are at risk of losing their homes due to foreclosure. For FHA, that translates to specific targets and tracking of its early delinquency intervention efforts and loss mitigation program. For fiscal year 2012, HUD assisted 290,216 homeowners with early intervention actions such as formal forbearance agreements, surpassing the 1-year target of 250,000 by 16 percent. During the same period, FHA also assisted 154,933 homeowners through its loss mitigation program, exceeding the 1-year goal of 100,000 by nearly 55 percent. HUD's loss mitigation efforts can be considered successful only if the program has effective solutions for homeowners in both the short and long term. In 2012, HUD set and met a target of having no more than 13 percent of loans that received loss mitigation assistance experience a re-default within 6 months. Effective loss mitigation not only assists homeowners but also reduces losses to the MMIF, helping to restore the Capital Reserve.

Strengthening FHA's Capital Reserves

HUD continued to strengthen the MMI Fund and improve the quality of endorsements by implementing a number of policy changes in early 2013. These include:

- Premium increases – Building upon 2012 increases to mortgage insurance premium (MIP) rates, HUD again increased by 5 to 10 basis points the annual insurance premium for all forward mortgages except single family forward streamline refinance transactions that refinance existing FHA loans that were endorsed on or before May 31, 2009, and loans in Indian reservations and Hawaiian homeland.
- HUD also removed the exemption from the annual MIP for loans with terms of 15 years or less and loan to value ratios of less than or equal to 78 percent at origination. All loans are now subject to an annual mortgage premium. In addition, HUD revised the period for assessing the annual MIP for the maximum period permitted under statute, which, for most FHA-insured loans, will result in required MIP payments for the life of the loan.
- Lender enforcement – A Mortgagee Letter is scheduled to be published in the second quarter of fiscal year 2013, implementing a final rule published in January 2012, which outlines new indemnification requirements for lenders participating in the Lender Insurance (LI) Program. Lenders will be required to indemnify HUD for losses associated with loans that were improperly originated, or for which fraud or misrepresentation were involved. This rule and Mortgagee Letter will permit FHA to improve its oversight of LI lenders and better protect its insurance Funds from the adverse effects of non-compliant loans. FHA also continues to evaluate other opportunities to further strengthen its counterparty risk management.
- Loss mitigation – A Mortgagee Letter published on November 16, 2012, outlines FHA's update to its loss mitigation home retention options. One of the key elements of this update was moving FHA's Home Affordable Modification Program (HAMP) product up in FHA's loss mitigation waterfall so servicers could more quickly offer deeper payment relief to struggling FHA borrowers, resulting in an increase in the number of borrowers being able to retain their homes. FHA is also exploring additional mechanisms to facilitate refinance activity whereby distressed borrowers can benefit from today's low interest

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rates, and the execution of a robust and impactful housing counseling strategy that equips homeowners to make smart housing choices and obtain assistance when necessary.

- Borrower qualifications – HUD now requires manual underwriting for borrowers with credit scores below 620 and a debt to income ratio greater than 43 percent. In addition, refinements to FHA's TOTAL Scorecard were released in January, which will further enhance FHA's ability to identify and mitigate risks via this tool. Finally, FHA increased the required down payment for borrowers seeking loans in excess of \$625,500.
- REO and Pre-REO recovery - Through the Distressed Asset Stabilization Program (an expanded and targeted version of the Mortgage Acquisition and Disposition Initiative (601 Notes Sales)), FHA has implemented a successful strategy to increase REO recovery rates and limit losses to the MMI Fund. In September 2012, HUD sold approximately 9,400 non-performing loans with a combined unpaid principal balance of \$1.72 billion. In March 2013, FHA conducted a second similar note sale secured by properties in neighborhood stabilization areas located in Southern California, Southeast Florida, Greater Orlando, Atlanta and Northern Ohio. FHA is also utilizing other innovative strategies, including ramping-up what was a pilot program into a broad-based effort whereby foreclosed properties are sold and a claim paid by FHA without the conveyance of these properties to FHA. These strategies build upon FHA's success in improving its REO disposition process, and, together with FHA's work to comprehensively address asset management and disposition, will have a measurable impact on improving loss severities arising from non-performing FHA-insured loans.
- HECM – Mortgagee Letter 2013-01 was published on January 30, 2013 and announced the consolidation of the Fixed Rate HECM Standard program's initial mortgage insurance premiums and maximum principal limit factors with those of the Fixed Rate HECM Saver, which will result in a reduction of the maximum amount of funds available to a HECM borrower.

Over a longer term, either through the granting of the legislative authority described below or via the much longer rule making process, FHA will also pursue other material changes to ensure the long-term viability of the HECM program. These measures include:

- Limiting the draw at origination to mandatory obligations (i.e. closing costs, mortgage liens and federal debt), providing greater flexibility in addressing the individual needs of borrowers than the across-the-board reductions to principal limit factors described above, while still protecting the Fund from losses on loans where the maximum loan amount is drawn up-front;
- Performing a financial assessment of borrowers as a basis for loan approval and determining the suitability of various HECM products to protect consumers from acquiring loans not fit for their situation; and
- Establishing a tax and insurance set-aside to ensure sufficient equity or an annuity is available to pay taxes and insurance on the mortgaged property so that defaults resulting from nonpayment of taxes and insurance can be avoided.

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- In total, FHA expects that the steps outlined above will protect and strengthen FHA's MMI Fund and assist in returning the Fund's capital ratio to a level of 2 percent. The 2012 actuarial review indicated the MMI portfolio is expected to reach a capital ratio of 2 percent during fiscal year 2017.

Strengthening FHA Business Practices – FHA Transformation IT Investments

FHA Transformation is developing and implementing a modern financial services IT environment to better manage and reduce risk across all of FHA's Mortgage Insurance Programs. To date, FHA Transformation has delivered a new lender certification system, and has made sound progress on the Single Family Housing's systems and its new risk management tool. HUD has also made critical enterprise software and infrastructure investments for FHA that will reduce maintenance costs once the FHA Transformation initiative is completed.

FHA Transformation will allow HUD to start the careful process of migrating relevant portions of Housing's legacy applications into a modern financial service automated environment, and will help administer many aspects of the multifamily and health care insurance programs. FHA Transformation monitoring and enforcement projects will allow the Office of Lender Activities to automate many currently manual processes.

FHA Transformation will also bring a new level of intelligent rules-based activities such as automated risk analysis and lender targeting according to a risk scoring framework. This will help HUD manage its credit risk prudently at the portfolio and loan level, and will enable HUD to respond rapidly to changing market conditions. The new Federal Financial Services Platform will be leveraged across several Housing programs by migrating away from the 30-year old Computerized Home Underwriting Management System (CHUMS). These FHA Transformation initiatives will enable FHA to better recognize risk and fraud trends in borrower attributes, collateral attributes, and appraisal valuation accuracy during the transaction process, and to help identify cases that may be detrimental to the MMI fund.

The next steps for FHA Transformation will enable risk detection and fraud prevention by capturing critical data points at the front-end of the loan life cycle; and will leverage the right set of risk and fraud tools, rules-based technology, and transactional controls to minimize exposure to FHA's Insurance Funds. These IT investments will facilitate enhanced business analytics and informed decision-making by providing decision-makers with data that is higher quality and more up-to-date.. This will enable FHA's leadership to analyze portfolio trends and patterns across the lending community, and will help with the identification of fraudulent lenders and reduce risk in the FHA portfolio.

Risk Management

The major objective of the Office of Risk Management and Regulatory Affairs (ORMRA) is to: conduct analysis and recommend actions to reduce exposure to FHA insurance funds while meeting its housing mission; ensure that FHA operates in compliance with statutory capital requirements; and promote a well-controlled operational infrastructure. The risk management staff's scope of credit and operational risk management work encompasses Program Area (Single Family, Multifamily and Healthcare) activities conducted at headquarters and the Field Offices.

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ORMRA performs the following functions to manage risk:

- performs analyses and recommends actions to support FHA's ability to reduce risk exposure to its insurance funds;
- identifies the policies and processes that are key drivers of risk via a structured risk identification framework;
- recommends risk mitigation strategies for FHA and specific program areas and provide independent oversight and assessment of risk remediation activities;
- designs and maintains a comprehensive risk governance infrastructure, including implementing policies, processes, and committees to reduce risk exposure to the insurance funds;
- maintains risk management processes to perform independent internal risk and control assessments aligned with federal standards, including front end risk assessments of new and high impact programs and activities;
- ensures that risks are measured, monitored and managed according to an integrated framework across programs.

In fiscal year 2014, the Department renews its request for the Transformation Initiative Fund, which provides the Secretary the flexibility to undertake an integrated and balanced effort to improve program performance and test innovative ideas. This program may transfer up to 0.5 percent or \$15 million, whichever is less, to the Transformation Initiative Fund for the operation of a second-generation Transformation Initiative (TI2). More details on TI2 and its projects are provided in the justification for the Transformation Initiative Fund account.

5. Notes to Justification

Credit Subsidy Calculations and the Annual Re-estimate

Credit subsidy rates represent the projected net cost or savings to the government of operating a loan guarantee program, and take into account projected claims, pre-payments, premium revenue, and recoveries on defaults for a cohort of loans over their lifetime. In accordance with the Credit Reform Act of 1990, administrative costs (excluding property disposition) are not included in credit subsidy calculations. FHA credit subsidy rates reflect historic performance data for similar loans made over the past 40 years, with adjustments made for significant policy shifts as well as changing economic and market conditions. The Department devotes significant efforts to updating and continuously refining the credit subsidy estimates. Each year the extensive statistical base, from which projections of future loan performance are calculated, is updated with an additional year of actual data. The Department and OMB continue to examine the data, assumptions, and calculations that are used to estimate loan program cash flows and subsidy rates in order to eliminate errors and improve the accuracy and reliability of projections.

Each year, FHA completes a required re-estimate of liabilities and subsidy costs associated with the existing insurance portfolio. Revised liability estimates take into account another year of actual loan portfolio performance and the latest economic assumptions. Vacancy rates, Treasury interest rates, and house price appreciation are among the key variables that shape MMI projected cash flows. Multivariate statistical models generate the claim and prepayment rates that drive the fund's financial worth. To determine the amount of the re-estimate, the revised liabilities (net of projected loan default recoveries) are compared to the current assets on hand. When assets exceed projected liabilities, a downward re-estimate occurs with the difference being transferred from the

Mortgage and Loan Insurance Programs – MMI/CMHI Account

Financing Account to the MMI Capital Reserve account. When projected liabilities exceed assets, an upward re-estimate occurs and the fund must transfer cash from its Capital Reserve account to bring the assets and liabilities in balance. For example, if the portfolio of loans made in a given year has a net liability of \$250 million and cash on hand of \$300 million, then the cohort would require a downward re-estimate in which \$50 million would be moved from the fund's Financing account (which handles all loan guarantee cash flows) to the MMI Capital Reserve account. If the financial position was reversed – if a cohort had assets of \$250 million and a net liability of \$300 million – then a \$50 million upward re-estimate would be transferred from the Capital Reserve to the MMI Program Account (an "on-budget" account) and then forwarded to the Financing Account to ensure it contained sufficient cost to cover the anticipated lifetime liabilities of the portfolio.

Re-estimates are calculated each year for each cohort of loans (from 1992 onward). As of 2012, 19 MMI cohorts had a lifetime upward re-estimate, meaning the original subsidy calculation is now believed to have underestimated the costs. Two cohorts had net lifetime downward re-estimates, meaning costs to the government for that group of loans are now projected to be less than the original subsidy calculation.

Mortgage and Loan Insurance Programs – MMI/CMHI Account

HOUSING
FHA – MUTUAL MORTGAGE INSURANCE FUND
Summary of Resources by Program
(Dollars in Thousands)

| <u>Budget Activity</u> | <u>2012 Budget Authority</u> | <u>2011 Carryover Into 2012</u> | <u>2012 Total Resources</u> | <u>2012 Obligations</u> | <u>2013 Annualized CR</u> | <u>2012 Carryover Into 2013</u> | <u>2013 Total Resources</u> | <u>2014 Request</u> |
|---------------------------------------|------------------------------|---------------------------------|-----------------------------|-------------------------|---------------------------|---------------------------------|-----------------------------|---------------------|
| Administrative Contract Expense | \$135,500 | ... | \$135,500 | \$119,532 | \$136,767 | \$15,968 | \$152,735 | \$127,000 |
| Working Capital Fund transfer | 71,500 | ... | 71,500 | ... | ... | ... | ... | ... |
| Transformation Initiatives transfer . | ... | ... | ... | ... | ... | ... | ... | ... |
| Total | 207,000 | ... | 207,000 | 119,532 | 136,767 | 15,968 | 152,735 | 127,000 |

HOUSING
FHA – MUTUAL MORTGAGE INSURANCE FUND
Appropriations Language

Below is the italicized appropriations language for the Mutual Mortgage Insurance Fund.

New commitments to guarantee single family loans insured under the Mutual Mortgage Insurance Fund shall not exceed \$400,000,000,000, to remain available until September 30, 2015: Provided, That during fiscal year 2014, obligations to make direct loans to carry out the purposes of section 204(g) of the National Housing Act, as amended, shall not exceed \$20,000,000: Provided further, That the foregoing amount in the previous proviso shall be for loans to nonprofit and governmental entities in connection with sales of single family real properties owned by the Secretary and formerly insured under the Mutual Mortgage Insurance Fund. For administrative contract expenses of the Federal Housing Administration, \$127,000,000, to remain available until September 30, 2015: Provided further, That to the extent guaranteed loan commitments exceed \$200,000,000,000 on or before April 1, 2013, an additional \$1,400 for administrative contract expenses shall be available for each \$1,000,000 in additional guaranteed loan commitments (including a pro rata amount for any amount below \$1,000,000), but in no case shall funds made available by this proviso exceed \$30,000,000.

Note.--A full-year 2013 appropriation for this account was not enacted at the time the budget was prepared; therefore, the budget assumes this account is operating under the Continuing Appropriations Resolution, 2013 (P.L. 112-175). The amounts included for 2013 reflect the annualized level provided by the continuing resolution.