Section VIII: Conclusions -- Compliance with the National Affordable Housing Act

According to our estimates for the base-case economic scenario, as of the end of FY 2007 the MMI Fund has an economic value of $21.277 billion and unamortized IIF of $332.293 billion, resulting in a capital ratio of 6.40 percent. Furthermore, we projected that by FY 2014 the capital ratio would gradually increase to 7.25 percent. Therefore, we conclude that the Fund will continue to exceed the 2.0 percent minimum level required by NAHA.

Observed house price growth rates slowed significantly in FY 2006 -- they declined to annualized rates of 2.2 and 0.3 percent during the first two quarters of FY 2007, respectively. This was much lower than the rates forecasted by Global Insight in June 2006 (and thus were applied in the forecasts for last year's Review). Global Insight's revised economic forecasts for August 2007 projects the house price growth rate to turn negative in the second half of FY 2007 and to remain negative through most of FY 2008. This weakening of the trend in the nation's housing market had a significant impact on the projected financial strength of the MMI Fund by reducing economic value by over $3 billion, leading to the year end FY 2007 capital ratio of 6.40 percent – 42 basis points lower than the 6.82 percent estimated for yearend FY 2007 in the FY 2006 Review.

One might question whether problems in the subprime mortgage industry could extend to the performance of the FHA portfolio, but there are two major arguments against projecting the subprime meltdown onto FHA. First, FHA has never insured the types of mortgages that have been popular in the subprime market. FHA's concentrations in high loan-to-value ratio loans, in adjustable rate loans, in streamline refinance loans, and in states with high subprime activity all declined rapidly during the past few years, which suggest an *improved* initial credit quality for the FY 2006 and FY 2007 books of business relative to previous books. Second, and perhaps more importantly, we did not observe modifications in FHA's underwriting standards or product designs during the past five years that would contribute to a degradation of credit quality of FHA loans, while the private mortgage market – and the subprime and Alt-A markets in particular – has experienced dramatic changes, including relaxed underwriting standards and new product designs that are particularly vulnerable to economic fluctuations, such as payment option adjustable-rate mortgages that allow negative amortization. Although FHA has lost substantial market share during these years, maintaining its underwriting and loan product policies has helped sustain the credit quality of the FHA portfolio and actuarial soundness of the MMI Fund. Nevertheless, to the extent that the subprime situation exacerbates the general weakness in regional housing markets, this can cause an indirect negative impact on the MMI fund.

One of the most important changes to our modeling approach this year was the improvement of the way borrower credit history was captured in the econometric model. The enhanced model is now capable of analyzing the quality of individual loans by the credit score of their specific borrower(s), by contrast with the models applied in the FY 2006 Review that incorporated credit score information at an aggregate level. This enhancement was made possible by the availability of historical credit scores at the loan level and newer FHA books of business with more comprehensive credit score coverage. The enhanced econometric models confirmed the strong relationship between credit scores and claim probabilities of individual mortgages found in last year's model. It further showed the strong relationship between credit scores and prepayment rates. That is, borrowers with higher credit scores are more likely to prepay while borrowers with lower credit scores may encounter difficulty in obtaining a new loan and, therefore, have to keep the existing mortgage (with less favorable terms). This is an important consideration for initial underwriting, portfolio evaluation, and risk-based pricing.

Loans with downpayment gift assistance from non-profit organizations continued to represent over one-fifth of FHA's new endorsements in FY 2006 and FY 2007. These loans experience claim rates that are considerably higher than otherwise comparable non-gift loans. In May 2006, the IRS published a ruling that will terminate the tax-exempt status of non-profit organizations that provide downpayment assistance to homebuyers using funds contributed by the involved home sellers. In October 2007, HUD issued a separate ruling that explicitly prohibits FHA from insuring loans that receive downpayment assistance gifts from any entity that is funded or financially supported by the home sellers. These two rulings have confirmed the government's intent to eliminate this type of high-claim-rate loan from the FHA insurance program. The effective enforcement of these rulings will help improve the credit quality of the FHA portfolio, particularly the new books of business to be endorsed in the coming years.

Finally, the newly announced *FHASecure* plan for helping some qualified subprime mortgage borrowers and the FHA modernization initiative can change the volume, composition, and performance of FHA's future books of business. Their impacts to the actuarial soundness of the MMI Fund will need to be carefully monitored in future Reviews.