## 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 2006 the MMI Fund will have an economic value of $22.021 billion and unamortized IIF of $323.028 billion, resulting in a capital ratio of 6.82 percent. Furthermore, we projected that by FY 2013 the capital ratio would decrease slightly to 6.73 percent, mainly due to the increase in insurance-in-force. Therefore, we conclude that the Fund would continue to exceed the 2.0 percent minimum level required by NAHA.

The house price growth in the year spanning the second quarter of 2005 through the first quarter of 2006 was much higher than what had been predicted by Global Insight as of May 2005. The longer-than-expected strong house price appreciation strengthened the quality of loans originated prior to FY 2006. The economic value of the Fund increased with the reduced claim rate estimates for these outstanding books of business. On the other hand, as the slowdown in the house price growth rate is now expected to start in the second half of 2006, the economic values of the FY 2006 and the next few books of business are estimated to be lower than that were projected in the FY 2005 Review.

An important change to our modeling approach this year was the incorporation of borrower credit history in the econometric model. The enhanced model showed a significant impact of borrower credit history on the mortgage claim rate. Using a sample of loans with credit history provided by a credit bureau, the FCIO score appears to be one of the more significant drivers of the mortgage claim probability for FHA insured loans. Although FHA currently employs FICO scores for loans underwritten by automated underwriting, such information is not required as a general underwriting criterion. The econometric model reveals a strong relationship between FICO scores and claim probabilities of individual mortgages. This finding suggests that borrower credit history should be included as a key component of the underwriting process and/or in determining the fair insurance premium, should FHA choose to risk-base price the insurance policies. However, currently, the inclusion of the credit history information had no significant impact to the economic value at the portfolio level of the MMI Fund.

Similar to last year’s findings, loans with downpayment gift assistance from non-profit organizations represent about one quarter of FHA’s new endorsements for FY 2005 and FY 2006, and these loans continue to experience considerably higher claim rates than otherwise comparable non-gift loans. In May 2006, the IRS published a ruling against non-profit organizations that provide downpayment assistance to homebuyers using funds contributed by the involved home sellers. The IRS expects that organizations involved in these activities will be completely eliminated from their 503(c) tax-exempt statuses within two years. The effectiveness of the IRS in enforcing its ruling is a key factor in determining the credit quality of the next few books of business.

The yearend FY 2006 capital ratio of 6.82 percent is substantially higher than the 6.16 percent estimated in the FY 2005 Review. The economic value is about the same as estimated, while the insurance-in-force is much lower than projected. For recent year's Reviews, the capital resources accounted for almost all of the economic value, while the variation of future performance has had little impact on the size of the economic value. On the other hand, the fluctuations in the insurance-in-force, influenced by the volume of new books of business and the prepayment of existing books, is the main driving force of the capital ratio of the MMI Fund, which is based on, by statute, the unamortized loan balances. As a result, the current definition of the MMI Fund capital ratio may not fully capture the credit quality of the Fund, especially the financial strength of newly endorsed mortgage portfolios. Additional risk measures might be needed to enhance the assessment of the adequacy of FHA's current underwriting process and the level and structure of the insurance premiums.