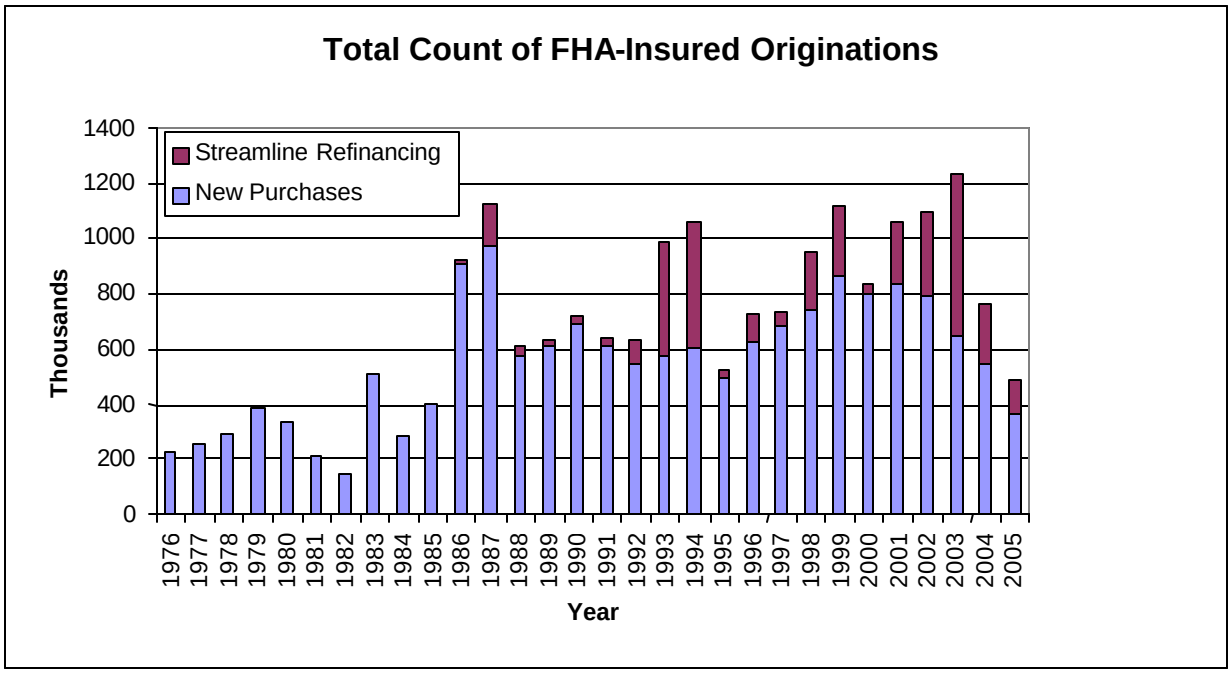
Section IV: Characteristics of the Fiscal Year 2005 Book of Business

This section takes a closer look at the characteristics of the FY 2005 book of business. The characteristic descriptions include: the analysis of loan origination volume and composition, the breakdown of new purchase versus refinancing, and the distribution of loans by relative loan size and loan-to-value ratios. This section also examines and compares the FY 2005 book with previous books in order to gain insights into how the FY 2005 book is likely to influence future performance.

A. Volume and Share of Mortgage Originations

In FY 2005, FHA insured about $ 58.3 billion in single-family mortgages through the MMI Fund, bringing the fund's total unamortized insurance-in-force to about $ 359 billion. Exhibit IV-1 shows the annual FHA originations count as well as the streamline refinancing count from FY 1976 to FY 2005.

Exhibit IV-1



Source: FHA data warehouse, March 31, 2005 extract.

From Exhibit IV-1, note that FHA's book of business started to decrease after reaching its peak at FY 2003. Exhibit IV-2 shows FHA's recent market share.

Exhibit IV-2

FHA's Market Shares of New Insurance Counts and Volumes National Home Purchase Market						
Fiscal Year	**Number of Mortgages Originated (000)**			**Volume of Mortgage Originated (billions, current dollars)**		
	FHA[a]	**Market[b]**	**FHA Share (%)**	**FHA**	**Market**	**FHA Share (%)**
1989	678	4,243	15.99	43	510	8.39
1990	742	4,084	18.16	49	502	9.83
1991	656	3,784	17.34	45	480	9.44
1992	597	4,055	14.71	43	527	8.07
1993	639	4,497	14.21	48	593	8.17
1994	652	4,935	13.21	52	676	7.65
1995	556	4,758	11.69	45	666	6.69
1996	686	5,197	13.20	58	758	7.68
1997	751	5,379	13.96	66	827	7.97
1998	789	6,020	13.10	71	976	7.31
1999	909	6,449	14.09	89	1,099	8.14
2000	856	6,335	13.52	89	1,135	7.87
2001	869	6,405	13.57	96	1,196	8.03
2002	806	6,615	12.18	94	1,321	7.11
2003	655	7,148	9.16	80	1,527	5.25
2004	505	7,902	6.39	63	1,842	3.40
2005[c]	193	5,119	3.77	24	1,274	1.85

Source: Existing Home Sales are from the National Association of Realtors; FHA numbers are from HUD.

[a] Home purchase loans endorsed by FHA under either the General Insurance Fund or the MMI Fund.

[b] Total number of home sales in the nation.

[c] FY2005 data is for the October 2004 - May 2005 period.

The steady decrease in mortgage interest rates during the last 5 years has substantially improved housing affordability in the United States. Although the rapid rising house price during the same period partially offset the housing affordability, we observed highest number of homes sold in the nation's history over the past four years. In specific, the number of homes sold increased steadily from FY 2000 to FY 2004 by about 25 percent. On the other hand, the home-purchase loans endorsed by FHA dropped by 41 percent. Combining this trend with the rapid house price appreciation rates observed during the same period, the market volume of home sales rose by 62 percent, while the FHA endorsement dollar volume dropped by 29 percent.

The opposite trend between the number of houses sold and number of loans FHA endorsed led to the substantial decrease in FHA's market share in the recent years. FHA's share by loan count decreased from 12.18 percent in 2002 to 6.39 percent in 2004 and could be as low as 3.77 percent for the 2005 fiscal year. The same decreasing trend is observed when measured by dollar volume. The estimated FHA market share in dollar amount insured is about 1.85 percent, down from 8.03 percent in 2001.

The longer history shown in Exhibit IV-2 shown that during the decade of 1992 to 2002, FHA's market share remained stable around 13 percent of the market in terms of number of loans insured. Because of the smaller size of FHA insured loans, FHA's market share by dollar volume were around 8 percent during the same time period. This relationship had been stable regardless the total market volume and the macroeconomic conditions.

The high rate of house price appreciation has contributed to this decrease in FHA market share. On June 1, 2005, the Office of Federal Housing Enterprise Oversight (OFHEO) announced that its national house price index showed another strong one-year growth rate of 12.5 percent. This growth rate is substantially higher than the 4.07 percent assumed in last year's Review. The continued strong housing value expansion during 2005 has strengthened the quality of the FY 2004 and previous books of business by lowering their current loan-to-value ratios. However, the rapid growth rate also implies that many houses have become too expensive to be financed through FHA programs due to the loan size limit.

Another hypothesis raised by the mortgage industry is that the continuous expansion into the less than prime mortgage business by private mortgage lenders and private mortgage insurers could marginalize FHA's business volume and adversely affect the overall quality of loans endorsed by FHA. Again, such a hypothesis has not been carefully researched. In the rest of this section, we examine FHA's business concentration pattern to determine if there exist adverse quality indicators that were not incorporated into the actuarial models we developed for the MMI Fund.

B. Originations by Location

Even though FHA insures loans in all parts of the U.S., about half of FHA's total dollar volume is concentrated in only ten states. Exhibit IV-3 illustrates the percent of FHA's total dollar volume originated in these ten states over FYs 2001 through 2005. The table includes the top 9 States during FY 2005 plus California.

Exhibit IV-3

Percentage of FHA Dollar volume Originated Between FY 2001 and FY 2005					
State	**2001**	**2002**	**2003**	**2004**	**2005**
Texas	7.00	8.35	9.55	11.52	13.46
Georgia	4.59	4.60	4.37	5.37	5.88
Colorado	4.71	4.98	5.70	5.04	4.87
Illinois	4.89	4.80	5.15	4.82	4.47
Florida	5.21	5.09	4.93	5.32	4.45
New Jersey	3.53	3.53	3.76	4.09	4.28
Ohio	3.34	3.53	3.50	3.85	4.01
Maryland	5.03	4.98	5.64	3.80	3.11
New York	3.68	3.73	3.09	3.59	3.07
California*	14.25	12.21	9.17	5.24	2.83
% of Total	56.23	55.80	54.85	52.63	50.44

Source: FHA data warehouse, March 31, 2005 extract.
* California had been one of the top 10 States in FHA's business till FY 2004. During the first two quarters of FY 2005, it is ranked 12th in FHA's origination volume.

Using this year's ranking, Maryland, Ohio and New Jersey appear for the first time in the top ten list. We also see that California has experienced a gradual decrease in the percentage while Texas has been increasing its percentage share. The rapid growth in California house prices during the past few years has pushed more home mortgages over the FHA loan size limit. According to OFHEO, California ranks second while Texas ranks last in house price appreciation among all states. FHA's large concentration in Texas for FY 2004 and 2005 is likely a reflection of the relatively low rate of house price appreciation there.

The historical house price growth rates at the MSA level is captured by our econometric model through the probability of negative equity variable. As a result, the geographical concentration of the MMI Fund and the historical house price growth rates of the various locations have been accurately reflected in the actuarial simulation model.

C. Originations by Mortgage Type

Exhibit IV-4 shows historically that the 30-year FRM made up almost all of FHA's business. This trend began to change in the early 1990s when FHA introduced the adjustable rate mortgage (ARM) and the streamline-refinancing mortgage (SR). Gradually, adjustable rate and streamline refinancing mortgages took on a bigger share of the annual originations. For the past few years, it is clear from Exhibit IV-4 that the 30-year FRM share has decreased relative to SRs, with 2003 being the extreme condition. As indicated by Exhibit IV-4, as market interest rates have raised recently, this trend was reversed.

The 15-year FRMs and 15-year SRs continue to be minor product types of the MMI Fund. With relatively low interest rates, some borrowers were able to convert a previously borrowed 30-year mortgage into 15 years without much increase in the payment burden. However, for the vast majority of cash-out refinancers, the 30-year FRM remains the popular choice.

FHA's ARM share has decreased from its mid-1990s high to an insignificant level during the beginning of the 2000s, then it started to increase over the past two years. With the expectation that interest rates will continue to rise in the future, borrowers see an opportunity to lock in their mortgage rates for the long term by choosing 30-year FRMs. This tends to keep the portion of borrowers choose to take adjustable rate loans small. The increase in ARM share could be attributed to borrowers with shorter expected tenure in the houses and those believing the rates will remain low in the near future to take the advantage of the interest rate spread between FRMs and ARMs. However, there could still be some income-constrained borrowers who need the lower initial payments of ARMs in order to qualify for or afford the mortgage.

The dynamics of MMI Fund's concentration among product types is captured by our econometric models with six different models separately fitted to the historical performance of the individual product types.

Exhibit IV-4

FHA-Insured Originations By Mortgage Type (Percentage of FHA-Insured Mortgages by Dollar Volume)						
	Purchase Mortgages			Streamline Refinancings		
Year	30-Year FRMs	15-Year FRMs	ARMs	30-Year SRs	15-Year SRs	ARM SRs
1976	99.78	0.22	n/a	n/a	n/a	n/a
1977	99.84	0.16	n/a	n/a	n/a	n/a
1978	99.89	0.10	n/a	n/a	n/a	n/a
1979	99.90	0.10	n/a	n/a	n/a	n/a
1980	99.84	0.16	n/a	n/a	n/a	n/a
1981	99.77	0.22	n/a	n/a	n/a	n/a
1982	99.50	0.49	n/a	n/a	n/a	n/a
1983	92.58	7.41	n/a	n/a	n/a	n/a
1984	93.45	6.54	n/a	n/a	n/a	n/a
1985	92.02	7.81	0.15	0.02	n/a	n/a
1986	88.96	8.12	0.75	1.84	0.33	0.00
1987	80.53	4.88	1.49	11.20	1.84	0.06
1988	86.54	3.31	5.04	4.63	0.45	0.04
1989	93.26	2.37	1.54	2.64	0.19	0.00
1990	93.35	2.46	0.81	3.13	0.25	0.00
1991	88.42	2.77	4.47	3.71	0.59	0.04
1992	66.55	2.38	16.35	11.07	2.23	1.41
1993	45.20	1.95	12.05	30.53	8.05	2.22
1994	41.93	1.59	16.88	28.49	8.30	2.81
1995	64.81	1.22	29.24	3.01	1.01	0.72
1996	60.15	1.05	25.19	9.59	1.97	2.06
1997	56.51	0.94	34.73	4.28	0.86	2.68
1998	63.75	0.89	11.70	19.60	1.66	2.40
1999	72.01	0.90	4.17	19.91	1.96	1.05
2000	84.83	0.65	10.92	2.58	0.32	0.69
2001	74.18	0.76	2.00	21.43	0.81	0.81
2002	65.10	0.93	5.79	22.97	1.86	3.36
2003	49.10	0.93	3.51	39.38	3.58	3.50
2004	61.43	1.04	8.17	21.76	2.76	4.84
2005	62.37	0.95	10.02	19.88	1.85	4.93

Source: FHA data warehouse, March 31, 2005 extract.

D. Initial Loan-to-Value Distributions

Based on the econometric studies of mortgage behavior, a borrower's equity position in the mortgaged house is one of the most important drivers of default behavior. The larger the equity position a borrower has, the greater the incentive to avoid default on the loan. The LTV is an inverse measure of the borrower's equity at the origination date. Exhibit IV-5 shows the distribution of mortgage originations by initial LTV categories.

Exhibit IV-5

Distribution of Originations by Initial LTV Category (Percentage FHA-Insured Mortgages by Dollar Volume)									
Book of Business	**Unknown LTV**	**0-75%**	**75-80%**	**80-90%**	**90-95%**	**95-97%**	**97-98%**	**98-100%**	**100-105%**
1976	18.26	2.04	2.04	12.50	32.24	27.01	1.85	4.07	0.74
1977	11.54	2.59	2.58	14.38	37.35	26.21	1.89	3.46	0.00
1978	17.42	2.75	2.13	12.03	27.99	32.05	2.61	3.01	0.00
1979	22.15	4.03	2.48	12.38	23.60	31.92	1.95	1.50	0.00
1980	12.03	8.02	4.77	19.65	25.73	27.59	1.36	0.85	0.00
1981	28.27	6.76	4.66	18.44	21.07	19.68	0.68	0.44	0.00
1982	16.61	12.42	7.20	22.72	23.72	16.56	0.45	0.31	0.00
1983	20.55	13.06	6.94	22.38	21.74	14.38	0.59	0.35	0.00
1984	2.74	10.55	6.28	24.25	26.03	23.36	2.03	4.64	0.13
1985	1.09	10.47	6.06	30.52	27.00	22.95	1.03	0.87	0.02
1986	0.54	11.47	7.01	30.24	27.15	21.95	0.87	0.74	0.02
1987	0.17	9.82	5.95	27.19	29.64	25.30	0.76	1.10	0.07
1988	0.05	4.95	3.02	19.56	35.54	33.55	1.21	2.09	0.00
1989	0.08	4.89	2.55	18.26	36.33	34.39	1.25	2.24	0.01
1990	0.01	4.71	2.44	18.24	36.38	34.51	1.46	2.23	0.01
1991	1.36	3.72	2.07	15.59	29.58	31.38	11.44	4.60	0.26
1992	1.07	2.93	1.71	13.90	28.13	38.87	8.40	4.59	0.41
1993	0.08	2.06	1.51	12.40	25.76	33.51	20.56	3.82	0.29
1994	0.06	1.95	1.38	11.26	24.48	33.48	24.02	3.20	0.18
1995	0.02	1.54	1.16	10.18	24.49	34.69	24.21	3.49	0.23
1996	0.00	1.42	1.20	10.42	25.62	35.41	23.11	2.61	0.19
1997	0.00	1.64	1.46	10.86	26.30	35.29	22.03	2.15	0.26
1998	0.00	1.73	1.55	11.18	26.46	35.85	21.08	1.81	0.33
1999	0.00	1.52	1.39	8.10	13.06	31.65	42.23	1.79	0.26
2000	0.00	1.12	1.13	5.86	6.75	34.41	49.24	1.35	0.15
2001	0.00	1.50	1.44	6.45	6.57	37.92	45.01	0.92	0.19
2002	0.00	1.81	1.52	6.61	6.49	40.56	42.16	0.69	0.16
2003	0.00	2.51	1.86	7.17	6.63	41.74	39.48	0.48	0.14
2004	0.00	2.57	1.89	7.31	7.11	43.22	37.37	0.40	0.12
2005	0.32	2.73	2.00	7.69	6.90	42.94	36.91	0.42	0.42

Source: FHA data warehouse, March 31, 2005 extract, and the December 2003 extract prepared for FHA's external auditor

As Exhibit IV-5 indicates, the LTV distribution of FY 2005 originations is very similar to that of FY 2004 originations. Nearly 80 percent of the mortgages originated in FY 2005 have LTV ratios of 95 percent or more, and over 85 percent have LTV ratios above 90 percent. LTV ratios

between 95 percent and 98 percent comprise the most popular category, with 80 percent of loans falling in this range.

The LTV concentration of individual books of business affects our econometric models in two respects. First, it serves as the starting position for updating the probability of the negative equity variable. Second, the initial LTV itself is also included in the model to capture the behavioral difference among borrowers self-selected into different initial LTV categories.

E. Initial Loan Size Distributions

One of our model's explanatory variables is the loan size category. This variable is identified by comparing the size of a particular loan with the average loan size of all other FHA insured loans originated in the same period and within the same location. Existing literature indicated that using *relative* loan size categories eliminates the upward bias that occurs when classifying loans in higher-cost areas using *absolute* loan size categories. The upper limits for categories one through six are based on breakpoints determined by a percentage of the average loan amount in each of the metropolitan statistical areas (MSAs) or the Census regions depending on the specific location of the mortgaged house.

Exhibit IV-6 shows the percentage of new originations within each relative loan size category. Overall, the FY 2005 book of business is similar to the FY 2004 book of business. One noticeable difference is that FY 2005 book has a higher percentage share in the largest loan size category. Over the years, the largest loan size category (>140% of the average loan size) has been gradually increasing. Most of the increase results in a decrease in the percentage of 80-100%, 100-120% and 120-140% loan size categories.

FHA experience indicates that larger loans tend to perform better in two respects compared with smaller loans in the same geographical area, all else being equal. Larger loans incur claims at a lower rate, and in those cases where a claim occurs, the loss severity tends to be lower. The loss severity is defined as the percentage of a claim amount not recovered through the sale of the conveyed property or mortgage note. Those houses associated with larger FHA loans tend to be in the average house price range for their surrounding areas. Since this market is relatively liquid and there are a relatively large number of these similar-quality homes in the area, the house price volatility of these houses tends to be relatively small in comparison to the house price volatility of the extremely low- and high-priced houses. With similar initial LTVs, the higher priced houses tend to be associated with larger loan amounts. In addition, because a large portion of claim costs are fixed and do not vary with regard to loan or property value, larger loans are generally accompanied by lower loss severity rates.

Exhibit IV-6

Distribution of Originations by Relative Loan Size Category (Percentage FHA-Insured Mortgages by Dollar Volume)

Book of Business	0-60% of Average Loan Size	60-80% of Average Loan Size	80-100% of Average Loan Size	100-120% of Average Loan Size	120-140% of Average Loan Size	>140% of Average Loan Size
1976	3.59	12.55	23.68	28.27	20.17	11.73
1977	3.14	11.83	24.42	31.06	21.04	8.51
1978	3.52	12.23	25.49	27.27	18.18	13.31
1979	3.81	11.78	23.90	28.19	21.03	11.29
1980	4.14	11.69	22.47	30.04	19.47	12.18
1981	4.58	11.84	22.27	26.77	19.57	14.96
1982	5.46	11.72	20.42	25.56	19.68	17.16
1983	4.45	11.80	21.73	27.22	21.87	12.93
1984	4.59	12.05	21.81	26.94	21.11	13.50
1985	4.40	11.75	21.66	27.66	23.92	10.61
1986	3.62	11.52	23.00	29.94	24.05	7.86
1987	3.53	11.82	23.13	29.38	23.91	8.24
1988	4.25	12.23	21.71	28.28	21.49	12.04
1989	4.53	12.43	21.38	25.99	21.33	14.34
1990	4.82	12.69	21.26	25.55	18.91	16.77
1991	4.83	12.59	21.38	24.08	21.41	15.70
1992	4.44	12.35	21.98	25.55	21.60	14.08
1993	3.92	12.31	23.15	26.86	20.92	12.83
1994	4.34	12.82	22.32	24.95	20.29	15.28
1995	4.74	12.98	20.92	24.61	20.85	15.89
1996	4.56	12.87	21.02	25.27	21.54	14.74
1997	4.63	12.92	20.49	25.78	21.68	14.49
1998	4.29	12.53	21.14	27.72	21.53	12.80
1999	4.63	12.94	21.45	25.83	19.07	16.07
2000	5.27	12.82	20.80	23.99	18.92	18.19
2001	4.93	12.31	22.02	24.85	19.11	16.78
2002	5.14	12.29	21.71	24.52	18.88	17.46
2003	5.08	12.22	21.78	25.08	18.88	16.95
2004	5.89	12.47	20.10	22.97	18.79	19.79
2005	6.07	12.51	19.36	22.75	18.84	20.46

Source: FHA data warehouse, March 31, 2005 extract

Exhibit IV-7 provides a detailed breakdown of average loan sizes by relative loan size category.

Exhibit IV-7

Average Loan Size by Relative Loan Size Category ($)						
Book of Business	**0-60% of Average Loan Size**	**60-80% of Average Loan Size**	**80-100% of Average Loan Size**	**100-120% of Average Loan Size**	**120-140% of Average Loan Size**	**>140% of Average Loan Size**
1976	12,698	17,905	23,647	28,979	33,637	37,158
1977	13,660	19,543	25,778	31,221	36,454	39,139
1978	15,900	23,215	30,021	36,236	42,453	49,687
1979	17,781	26,165	33,960	41,814	49,193	53,185
1980	19,548	29,037	37,984	47,805	53,828	59,862
1981	20,920	31,405	41,602	51,221	58,781	67,016
1982	21,965	32,853	43,402	53,542	62,880	70,693
1983	24,876	36,515	47,482	58,344	67,974	75,885
1984	25,576	37,835	49,992	61,892	71,577	78,618
1985	27,927	41,399	54,746	67,516	79,181	83,456
1986	29,813	43,454	56,443	69,697	80,755	85,936
1987	30,469	43,571	56,435	69,807	81,093	86,530
1988	29,366	42,188	54,928	69,110	79,510	85,943
1989	30,049	43,579	56,482	70,626	82,158	90,752
1990	31,801	45,854	59,525	74,086	84,561	98,393
1991	32,900	47,664	61,837	76,061	90,533	100,455
1992	34,462	49,476	64,047	78,492	92,902	104,399
1993	36,886	52,556	67,519	81,894	96,219	112,181
1994	37,256	53,205	67,775	82,164	97,598	115,729
1995	39,378	56,169	71,444	87,812	104,537	121,516
1996	41,862	59,828	75,916	93,406	111,350	128,081
1997	43,636	62,585	78,878	97,707	116,312	134,242
1998	45,847	65,640	82,834	102,635	121,185	140,384
1999	48,827	69,386	87,721	108,061	127,121	154,356
2000	51,655	72,815	93,315	114,999	134,903	165,772
2001	55,883	79,060	101,783	125,044	144,346	179,771
2002	57,897	81,963	105,284	128,930	148,709	188,709
2003	59,622	84,900	108,937	132,900	153,266	195,408
2004	59,091	83,908	108,024	132,322	153,631	196,975
2005	57,675	83,708	108,257	132,809	154,468	196,074

Source: FHA data warehouse, March 31, 2005 extract

Despite the record high national house price growth rate revealed by the OFHEO house price index during the past three years, the average loan size of FHA business remained virtually unchanged.

F. Initial Contract Interest Rate

Exhibit IV-8 shows the average contract rate by mortgage type since FY 1989. Over the years, the average contract rate has been gradually decreasing. On average, the FY 2005 book of business has the lowest average contract rate since FY 1989. Even though the FY 2005 book of business has a lower overall average contract rate than the FY 2004 book of business, the rates of most mortgage types are actually increasing. However, the 30-year fixed rate and the 30-year streamline refinance experienced a slight decrease in interest rates.

Research has found that, in general, an FRM with a lower contract rate tends to experience fewer claims, but they also have prepaid more slowly. Slower prepayment rates imply that mortgages are exposed to default risk for longer periods of time. Recent research has confirmed the competing risk theory of prepayments and claims. That is, a borrower can only exercise either the prepayment or the default option. Under an environment in favor of prepayment, the conditional claims rate would be lower than otherwise similar situations. Likewise, during a housing recession where default is more likely, the conditional prepayment rate also tends to be low. This competing risk nature of prepayments and claims drives the performance of FRMs in particular. As the interest rate is expected to rise, the prepayment rate of the FY 2005 book would be low, which would leave more loans subject to claim risk for a longer period. Meanwhile, the low house price growth rate forecasted by Global Insight, Inc. also suggests the claim probability could rise from the past few books of business. As a result, the FY 2005 book of business is expected to experience higher cumulative claim rates than other books originated in the early 2000s.

Exhibit IV-8

Average Contract Interest Rate by Loan Type and in the Aggregate (Percent)							
Year	**F30s**	**F15s**	**ARMs**	**S30s**	**S15s**	**SRARMs**	**Average**
1989	10.06	9.98	9.08	11.16	10.22	9.18	10.07
1990	9.69	9.56	8.54	10.70	9.95	8.86	9.71
1991	9.46	9.20	7.56	10.09	9.31	7.74	9.40
1992	8.54	8.36	6.47	8.91	8.37	6.51	8.26
1993	7.76	7.42	5.87	8.16	7.58	6.27	7.64
1994	7.57	7.14	6.06	7.75	7.42	6.08	7.36
1995	8.39	8.24	7.18	8.67	8.69	7.32	8.10
1996	7.84	7.57	6.49	7.98	7.65	6.75	7.53
1997	7.97	7.77	6.53	8.23	7.97	6.77	7.51
1998	7.37	7.22	6.12	7.55	7.16	6.45	7.25
1999	7.24	7.00	6.00	7.16	6.88	6.05	7.16
2000	8.29	8.08	6.95	8.32	8.04	6.30	8.16
2001	7.56	7.16	6.19	7.41	6.85	6.12	7.49
2002	7.00	6.57	5.28	6.95	6.41	5.31	6.84
2003	6.08	5.54	4.39	6.01	5.48	4.45	5.92
2004	6.12	5.59	4.46	5.99	5.52	4.39	5.87
2005	5.96	5.59	4.71	5.88	5.61	4.67	5.78

Source: FHA data warehouse, March 31, 2005 extract.

G. Downpayment Assistance through Gifts

One newly observed trend in this year's data extract is the rapidly rising concentration of loans with gift letters in the newer books of business. FHA's database started tracking the sources of loans with downpayment gift supports back in 1998. Exhibit IV-9 shows the distribution of MMI loans by gift source.

Exhibit IV-9 shows that virtually all downpayment gifts prior to FY 2000 were funded by the borrower's relatives. However, starting FY 2000, there was a rapid increase of share of loans with gift letter from nonprofit, religious, or community entities. This concentration reached about 10 percent by FY 2003 and almost doubled to 18 percent of the entire FY 2004 book of business.[4]

[4] The downpayment assist loans only exist in purchase mortgages. The concentration rate would be even higher if refinance loans were excluded from the denominator.

Exhibit IV-9

Concentration of Loans with Gift Letter by Sources (Percent)*					
Origination Year	**No Gift**	**Relative**	**Nonprofit, Religious, or Community**	**Government Assistance**	**Employer**
1998	77.60	21.87	0.19	0.31	0.03
1999	82.20	16.32	0.55	0.86	0.06
2000	77.17	18.81	1.83	2.10	0.09
2001	83.23	11.08	4.25	1.36	0.07
2002	82.26	9.15	7.05	1.48	0.06
2003	81.44	7.39	9.67	1.44	0.06
2004	70.26	9.57	18.04	2.06	0.08

Source: FHA data warehouse, March 31, 2005 extract.

* In percentage of all MMI Fund endorsed loans, including purchase and refinance loans. The concentration rate of gift loans would be much higher if refinance loans were excluded from this calculation.

With the significant number of loans receiving gifts for downpayments and the aging of these loans, this year is the first time we have enough historical data to conduct a closer investigation of the performance of these gift loans. Exhibit IV-10 shows the conditional claim rates realized on loans by gift source and origination year.

Exhibit IV-10

Conditional Claim Rates of Loans with Different Gift Sources (Percent)					
Exposure Year	**No Gift**	**Relative**	**Nonprofit, Religious, or Community**	**Government Assistance**	**Employer**
2000 Book					
2000	0.01	0.02	0.04	0.01	0.00
2001	0.42	0.81	1.18	0.82	0.67
2002	1.70	2.88	5.68	3.73	2.39
2003	3.62	4.95	9.97	5.76	7.12
2004	4.39	5.18	10.45	6.26	5.48
2005*	1.99	2.31	4.68	2.81	4.14
2001 Book					
2001	0.01	0.02	0.02	0.03	0.00
2002	0.38	0.75	1.34	1.08	1.26
2003	1.68	2.33	5.73	4.10	1.75
2004	3.23	3.91	9.38	5.51	5.39
2005*	1.73	2.10	4.61	2.71	5.50
2002 Book					
2002	0.01	0.01	0.03	0.01	0.15
2003	0.42	0.51	1.34	0.97	1.23
2004	1.75	2.02	5.57	3.71	1.96
2005*	1.13	1.27	3.73	2.36	1.32
2003 Book					
2003	0.01	0.01	0.02	0.03	0.00
2004	0.42	0.49	1.57	1.10	0.55
2005*	0.50	0.64	1.91	1.54	1.15
2004 Book					
2004	0.04	0.06	0.12	0.03	0.00
2005*	0.21	0.25	0.61	0.31	0.18

Source: FHA data warehouse, March 31, 2005 extract.
* Partial year data.

Holding everything else the same, we find those non-relative gift loans performed worse than the loans without gifts across all origination years and all exposure years. Although not reported in this Review, we also found the loans with gift letters generally have slower prepayment rates. In order to capture this significant difference in the conditional claim rate, we further refined the econometric models to capture this performance difference by gift source. Without further research and investigation, it is unclear why these loans performed significantly worse than the non-gift loans.

In order to reflect this growing business concentration and the different performance of loans with different sources, we refined our econometrics model by incorporating a series of categorical variables. As shown in Appendix A, the estimated coefficients of these gift-source variables are both economically and statistically significant.