Annual Report to Congress
Fiscal Year 2011 Financial Status
FHA Mutual Mortgage Insurance Fund

U.S. Department of Housing and Urban Development

November 15, 2011

Your Door to FHA Homeownership

Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance Fund Fiscal Year 2011

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Secretary's Foreword

This is my third report to Congress on the financial status of the FHA Mutual Mortgage Insurance Fund (MMI Fund). I am pleased to report that even while the Federal Housing Administration has faced the most severe economic conditions since its creation after the Great Depression in 1934, it continues to remain remarkably resilient. This is no accident. As a result of policies this Administration has put in place, we are creating a strong foundation for recovery of FHA's capital position as the economy grows more strongly.

The findings of independent actuarial reviews performed at the close of FY 2011 indicate that the MMI Fund remains actuarially sound, though there continue to be significant near-term economic risks. As of the end of fiscal year 2011, FHA's total capital resources stand at $33.7 billion, $400 million more than at the end of fiscal year 2010. Of that total, $29.0 billion is in the Financing Accounts to offset expected claims and $4.7 billion is in the Capital Reserve Account. While the Fund has remained positive, we know that we must remain vigilant to the risks before us and we will continue to take the actions necessary to protect the Fund and taxpayers.

I can again say this year that FHA is playing a critical role in stabilizing local economies through assuring that mortgage credit is readily available for home purchase and refinance. FHA continues to fill the void left by the reduction in private capital for supporting mortgage lending; that pull-back of private capital has been one of the hallmarks of the recent economic recession. It is what propelled a more than four-fold increase in FHA activity in just two years – from 2007 to 2009. It is what causes 60 percent of all minority homebuyers needing mortgage financing to rely upon FHA. And it is the reason that historically high numbers of homeowners with conventional loans are still coming to FHA to refinance into lower cost mortgages.

One of the challenges we face in the current environment is the balance between assuring mortgage credit flows for low-to-moderate income households, minorities, and first-time homebuyers, and providing space for private capital to return to supporting mortgage credit risk. I want to assure the Congress and the public that we are committed to both goals. We are already seeing signs that premium rate increases we have put in place are causing a shift of some business back to the conventional mortgage market.

As HUD Secretary, I have the privilege of working with many dedicated and talented public servants. One of those is our Acting Federal Housing Commissioner, Carol Galante. Carol originally came into this Administration to lead the FHA multifamily insurance operations. I have now asked her to assume the mantle of responsibility for all FHA programs. She brings with her a tremendous depth of expertise in lending, economic development, and organizational leadership. I am confident that her steady hand will help us to continue on the path we have followed for nearly three years now.

Shaun Donovan
Secretary
U.S. Department of Housing and Urban Development

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I. Introduction: The Mutual Mortgage Insurance Fund

This report is about the Mutual Mortgage Insurance (MMI) Fund of the Federal Housing Administration (FHA). That Fund is a system of accounts used to manage the single-family mortgage insurance programs of FHA, which itself is a wholly-owned government agency housed in the U. S. Department of Housing and Urban Development (HUD). FHA provides guarantees on mortgage loans issued by private lenders, enabling those lenders to provide credit to borrowers who might otherwise be denied access to the capital markets. The various FHA portfolios include mortgages on single-family residential properties, apartments, hospitals, assisted-living facilities, and nursing homes. As an agency, the FHA oversees an insurance portfolio of over $1.3 trillion, of which the MMI Fund programs account for approximately $1.1 trillion. MMI Fund programs represent a significant commitment by the Federal government to support economic activity. MMI Fund insurance endorsements in fiscal year (FY) 2011represented 34 percent of all projected U.S. government direct loans and guarantees.[1]

Since its inception in 1934, the MMI Fund has never required an appropriation from the Congress to support loan guarantees. Self-sufficiency faced a critical test in the 1980s as severe, rolling, regional recessions nearly depleted the MMI Fund reserve account. In 1990, Congress instituted required increases in insurance premiums in order to re-establish actuarial soundness and to rebuild capital reserves.[2] Today, in the midst of a national housing recession rivaling that of the Great Depression, FHA is again facing the challenge of a severely impacted capital reserve account. The difference this time is that HUD management has been proactive in increasing premium rates, tightening underwriting requirements, and holding FHA lender partners to a higher standard of accountability. The result of these efforts is that HUD has grown dedicated MMI loss reserves by nearly $20 billion over the past three years, paid out an unprecedented $37 billion of insurance claims—more than double those of the preceding three years—and still maintains a positive balance in its Capital Reserve Account.

The findings of independent actuarial reviews performed at the close of FY 2011 indicate that the MMI Fund remains actuarially sound, though there continue to be significant near-term economic risks. Actuarial soundness refers to the balance of insurance risk and premium rates today. Under base-case economic forecasts, insurance premiums from newly insured loans are expected to start rebuilding the MMI Fund Capital Reserve Account in FY 2012, and permit the Fund to return to the Congressionally mandated level of two-percent of unamortized insurance in force in FY 2014.

The MMI Fund Capital Reserve Account has decreased substantially over the past three years to finance dedicated loss reserves for outstanding books-of-business. Those funds have not yet been spent; they simply have been moved to the Financing Accounts, which hold all dedicated loss reserves for outstanding books-of-business. The total capital resources of the MMI Fund—the

[1] Per the FY 2012 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 FHA loan guarantees).

[2] See amendments to the National Housing Act found in P.L. 100-508 (November 5, 1990), section 2103 (mortgage premiums) and 2104 (capital ratio).Current statutory provisions for capital requirements can be found in 12 USC 1711(f)).

combined sum of the Capital Reserve and Financing Accounts—has actually grown by $5.5 billion in the past three years. At the same time, FHA has not yet seen the peak of claim expenses from this national housing recession. The so-called "robo-signing" problems at major lenders have led to a slowdown in claims from what was forecasted one year ago. It is not that those defaulted loans have cured, but rather that loans are caught in foreclosure pipelines. In many cases, foreclosure auctions have already taken place but insurance claims have not been filed because of challenges to the legal sufficiency of the foreclosure actions. Current expectations are that claims could come in very large numbers this next fiscal year and, as a result, capital resources decline significantly over the FY2012-2013 biennium as loss reserves are expended.

The contribution of individual books-of-business to the stability of the MMI Fund changed in FY 2009. Starting in January 2009, FHA was substantially free from any further insurance of the so-called seller-funded downpayment loans. At that same time, declines in interest rates that started in the preceding months brought a new wave of more stable mortgages, and a series of measures to tighten underwriting requirements at the government-sponsored enterprises Fannie Mae and Freddie Mac brought higher credit quality business to FHA. As a result of these changes, the FY 2009 book is in actuarial balance starting in January 2009, while prior books from 2000 through the first quarter of FY 2009 are expected to result in net losses for the Fund. The new FY 2010 and 2011 books are expected to both pay for their own future claims and contribute substantial amounts toward paying losses on earlier books of business.

The FHA story is a success story for federal government involvement in assuring credit flows into housing markets throughout the country at a very critical time in our nation's history. This report details FHA's role in supporting the U.S. housing market today, the financial assessment of the independent actuaries, and the many steps HUD has already taken to ensure that FHA remains a stable and stabilizing force in the U.S. housing finance system.

A. FHA ACTIVITY IN FISCAL YEAR 2011

1. Activity Levels

a) Single Family Forward Loans

New insurance endorsement activity in FY 2011 remained at a high level, though it was measurably lower than the peak levels of 2009 and 2010 (see Table 1). In terms of dollars of single-family loans insured, 2011 was the third highest year on record, after 2009 and 2010.

FHA home-purchase mortgage activity was down in 2011, both because home sales across the nation were lower, and because the FHA share of home purchases declined from 19 percent in 2009 and 2010 to 15 percent in 2011.[3] Among home buyers requiring mortgage financing, FHA activity was more prevalent, but was still a lower share of home purchase activity than in 2010

[3] HUD reports on FHA share of home purchase activity are available at hud.gov: http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts/fhamktsh/fhamkt .

(31 versus 35 percent).[4] FY 2010 was an unusual year, however, as it included two separate expiration dates for first-time homebuyer tax credits—in November 2009 and again in April 2011. For FHA, the surge in home buying activity that accompanied tax credit availability likely pulled forward many first-time buyers so that the share of first-time homebuyers in the 2011 book was down to 75 percent of purchase-loan insurance endorsements. That share had been 80 percent for 13 years, making the 2011 first-time-buyer share the lowest since 1995.

Refinance activity experienced a surge in the first quarter of the year, following a decline in mortgage interest rates to under 4.5 percent in August 2010. Though rates again fell to levels close to 4 percent in August 2011, this is not producing the same level of refinance activity as was experienced in the year-earlier period.

[4] HUD reports on FHA share of new mortgage originations are available at hud.gov: http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts/fhamktsh/fhamktqtrly .

Table 1. FHA Single-Family Mortgage Insurance Endorsements[a]

Fiscal Year	Counts by Loan Purpose					Dollar Volume (bil)
	Home Purchase	FHA Streamline Refinance	Other FHA Refinance	Convention-to-FHA Refinance	All Loans	
2000	839,869	34,443	6,780	32,007	913,099	$ 94.2
2001	806,818	188,422	17,230	46,207	1,058,677	117.7
2002	862,898	318,245	28,525	64,474	1,274,142	148.1
2003	658,640	560,891	37,504	62,694	1,319,729	159.2
2004	586,110	291,483	26,146	56,696	960,435	116.0
2005	353,844	113,062	11,840	33,581	512,327	62.4
2006	313,998	36,374	14,722	60,397	425,491	55.3
2007	278,394	22,087	16,504	107,739	424,724	59.8
2008	631,653	66,773	28,508	360,457	1,087,391	181.2
2009	995,551	329,436	38,065	468,947	1,831,999	330.5
2010	1,109,582	212,892	39,581	305,554	1,667,609	297.6
2011	777,425	180,274	44,539	195,583	1,197,821	217.8
2010Q1	304,929	88,722	7,438	86,572	487,661	86.4
2010Q2	245,881	57,153	10,840	88,385	402,259	72.1
2010Q3	289,775	21,910	9,138	65,644	386,467	67.7
2010Q4	268,997	45,107	12,165	64,953	391,222	71.4
2011Q1	196,801	93,200	16,253	65,318	371,572	72.1
2011Q2	168,775	45,766	12,937	58,575	286,053	52.8
2011Q3	201,156	22,838	8,052	41,257	273,303	47.3
2011Q4	210,693	18,470	7,297	30,433	266,893	45.6

[a]This table includes all single-family endorsements. There are a small numbers of loans today that are not obligations of the MMI Fund. For providing a complete picture of the FHA single-family activity, those are included here. Prior to FY 2009, two measurable programs were not obligations of the MMI Fund. Those are the 203K purchase-and-rehabilitation program, and the 234C condominium insurance program. Again, they are included here to provide a complete picture of FHA activity.
Source: U.S. Department of HUD/FHA.

b) Reverse Mortgages

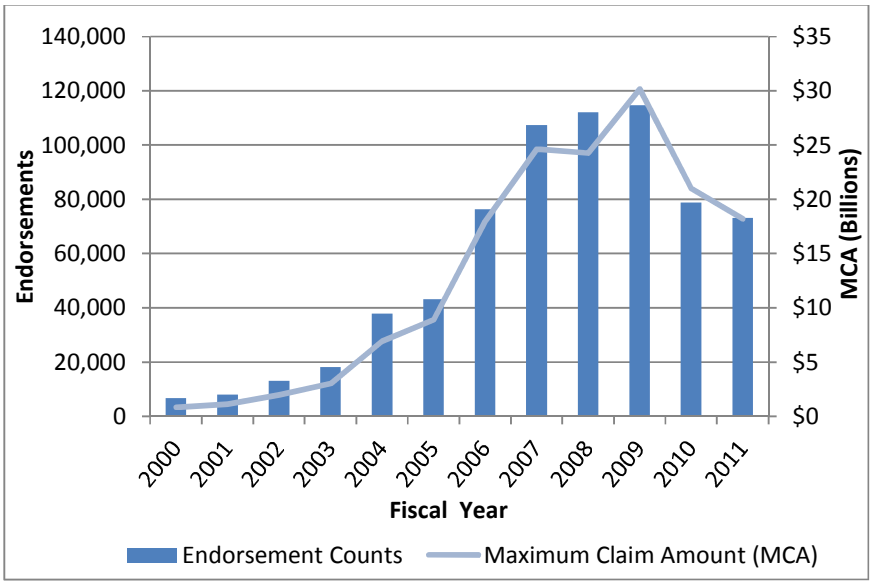
FHA's reverse mortgage product, the Home Equity Conversion Mortgage (HECM), permits senior homeowners to tap accumulated home equity without the burden of monthly payments or the necessity to sell their home.[5] HECM insurance endorsements in FY 2011 were down by seven percent from FY 2010 levels, to 73,098 loans. This was the second straight decline in HECM endorsements, but it was not as drastic as the 31 percent decline experienced in FY 2010.

[5] Information on the FHA HECM program can be found at:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfh/hecm/hecmhome

That larger fall in activity was due to reductions in equity take-out limits imposed in October 2009.[6] The decline in FY 2011 can be attributed to a number of factors. First is the more than doubling of the annual insurance premium, from 0.50 to 1.25 percent, that was enacted at the start of the fiscal year. A second cause of decline in 2011 was that three lenders ended their HECM programs mid-year, and remaining lenders have yet to replace capacity represented by those that exited. Third is the general decline in home values, which tends to make HECM less attractive to homeowners seeking cash to pay-off existing mortgages. If there are outstanding mortgages on a property, they must be fully paid off by the HECM proceeds.

HUD introduced a new HECM option in FY 2011, called HECM Saver. HECM Saver provides for a near-zero initial insurance premium in exchange for the homeowner agreeing to a lower equity take-out limit. Saver volumes have grown throughout the year such that they now represent 10 percent by count and over 14 percent of insured dollars. The higher dollar share is due to the fact that Saver is attracting seniors with higher valued homes—45 percent higher, on average. HUD expects that Saver will become an even higher-volume program in the future.

Figure 1. FHA HECM Endorsement Counts and Maximum Claim Amounts by Fiscal Year[a]

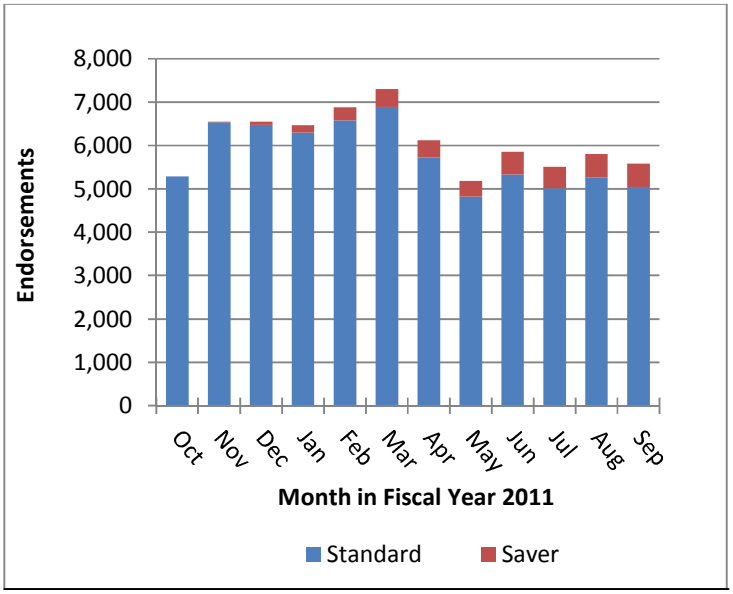


[a]Maximum Claim Amount represents the largest dollar amount of an insurance claim FHA will pay on any given loan. It is calculated as 98 percent of the appraised value of the home at the time of loan origination.

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

[6] At that time HUD instituted the first changes in equity take-out limits since the inception of the program in 1990. The limits were cut by 10 percent, across-the-board in October 2009.

Figure 2. FY 2011 HECM Standard and Saver Endorsement Counts, by Month



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

c) Geographic Concentrations of Insurance Activity

The 2010 Home Mortgage Disclosure Act (HMDA) lender-activity-report data was released in September 2011.[7] That information details lending patterns by geography, lender, borrower race, and borrower income. Compilations of annual HMDA data provide a historical record of lending patterns. Table 2 highlights FHA home-purchase-loan activity over time in the top ten states for endorsements in FY 2011. The year 2001 was the last year before a six-year slide in FHA activity. That year is also fairly representative of FHA's long-term market position between 1993 and 2010.

The first panel of Table 2 shows the outsized role FHA continues to play in supporting home purchase financing, with 2010 market shares in each State being double those of 2001 and six times those of 2006. The 2010 within-State market shares are concentrated around 30 percent. The second panel illustrates how FHA business patterns across States changed between 2001 and 2006, and then again between 2006 and 2010. Except for California, other state shares of FHA home-purchase endorsements are roughly what they were in 2001. California, however, continued to grow as the number one State for FHA activity, so that its 2010 business share was greater than 2001. For all of FY 2011, the share of FHA purchase loan endorsements coming from California has remained comparable to the 2010 HMDA data share shown here, staying just above 13 percent.

[7] Data and summary tables are available from the Federal Financial Institutions Examination Council. See, http://www.ffiec.gov/hmda/default.htm .

Table 2. HMDA Data Analysis: FHA Home Purchase Loan Market Shares and Endorsement Shares Over Time, for the US and Top-Ten States for FHA Activity[a]

State	Mortgage Market Shares Within States				Endorsement Shares Across States			
	1993-2010	2001	2006	2010	1993-2010	2001	2006	2010
US	**12.9%**	**14.5%**	**4.5%**	**29.7%**				
CA	11.7	12.2	0.4	32.4	10.6%	10.5%	0.9%	13.1%
TX	16.5	17.3	8.2	31.6	9.7	9.3	15.3	9.3
FL	9.9	11.6	2.0	33.5	6.2	6.7	4.2	6.3
PA	11.8	13.1	5.3	29.8	3.2	3.0	3.9	3.9
AZ	13.9	17.1	1.9	36.0	3.1	3.4	1.4	3.6
OH	13.4	15.7	7.2	32.1	3.8	4.0	5.2	3.5
GA	14.9	17.6	6.8	35.0	3.9	4.1	6.0	3.5
NY	10.7	11.8	4.6	24.0	3.3	3.1	3.8	3.4
IL	11.7	13.5	3.3	26.3	3.9	4.1	3.1	3.2
VA	14.0	16.1	3.0	28.6	3.3	3.7	1.9	3.1

[a]All data is based on loan counts.

Source: Home Mortgage Disclosure Act Lender Activity Reports; analysis by the U.S. Department of HUD/FHA.

d) Credit Quality of Borrowers

For all of FY 2011, the credit quality of borrowers utilizing FHA insurance set a new record high. The average score across all borrowers broke 700 for the first time ever. A three-year rise in credit quality of new FHA-insured borrowers appears to have peaked in the second quarter of the fiscal year, at an average credit score of 704. During that quarter, nearly 38 percent of borrowers had scores at or above 720. By contrast, in the second quarter of 2008, the share of such A-grade borrowers was under 10 percent.

The decline in the share of A-grade borrowers in the second half of FY 2011 can be explained by two factors. First, as refinance activity declined across the fiscal year, the largest percentage (and numerical) drop was in the highest credit-score group. Then, percentage growth in purchase loan endorsements over the last two quarters has been smallest in the top credit-score group. This second factor is likely due to the across-the-board premium increase instituted by HUD in April of this year. Conventional market guarantees are now much less expensive for borrowers with highest credit scores and who can make at least a five-percent downpayment. The result of the two factors at work this year for FHA is a greater share of new endorsements in the 580-619 and 620-679 categories. The average credit score on new endorsements in the final quarter of the year was nearly identical to what it was in the last quarter of FY 2010, 697 versus 698. [8]

[8] Average credit scores by fiscal year, from 2007 to 2011, are: 630, 647, 681, 697, and 701.

Table 3. Distribution of FHA Borrower Credit Scores by Fiscal Year and Quarter[a]

(rows add to 100%)

Fiscal Year	Quarter	Credit Score Categories						
		720-850	680-719	620-679	580-619	500-579	300-499	N/A[b]
2008	Oct-Dec	9.3%	9.1%	31.2%	23.9%	21.3%	1.7%	3.6%
	Jan-Mar	9.9	9.9	31.8	23.2	20.4	1.7	3.1
	Apr-Jun	15.2	13.2	35.6	20.9	12.2	0.7	2.2
	Jul-Sep	19.2	16.1	37.5	19.0	6.7	0.2	1.4
2009	Oct-Dec	20.5	17.2	37.6	18.7	5.1	0.1	0.8
	Jan-Mar	24.4	19.0	37.0	15.5	3.4	0.0	0.7
	Apr-Jun	29.8	21.3	38.3	8.5	1.5	0.0	0.7
	Jul-Sep	33.5	22.1	37.9	4.9	1.0	0.0	0.6
2010	Oct-Dec	33.6	22.5	38.6	4.0	0.7	0.0	0.6
	Jan-Mar	34.0	22.9	38.5	3.5	0.5	0.0	0.6
	Apr-Jun	35.1	22.7	38.6	2.7	0.4	0.0	0.5
	Jul-Sep	34.9	22.7	38.5	3.0	0.4	0.0	0.5
2011	Oct-Dec	37.2	23.3	36.2	2.5	0.3	0.0	0.4
	Jan-Mar	37.9	24.2	35.1	2.2	0.2	0.0	0.4
	Apr-Jun	35.5	23.9	37.6	2.6	0.2	0.0	0.3
	Jul-Sep	33.1	23.8	39.2	3.3	0.2	.0	0.3

[a]Credit scores are co-branded between the three major credit repositories (Equifax, Experian, Transunion) and Fair-Isaac Corporation. Values can range from 300 to 850. They are grouped here according to the "decision" score used for loan underwriting. That score represents the weakest borrower on a loan application, when there are multiple applicants. Streamline refinance loans do not require full underwriting and so they are not represented here.

[b]Borrowers without credit histories can be underwritten for FHA insurance using alternative, non-traditional forms of credit history.

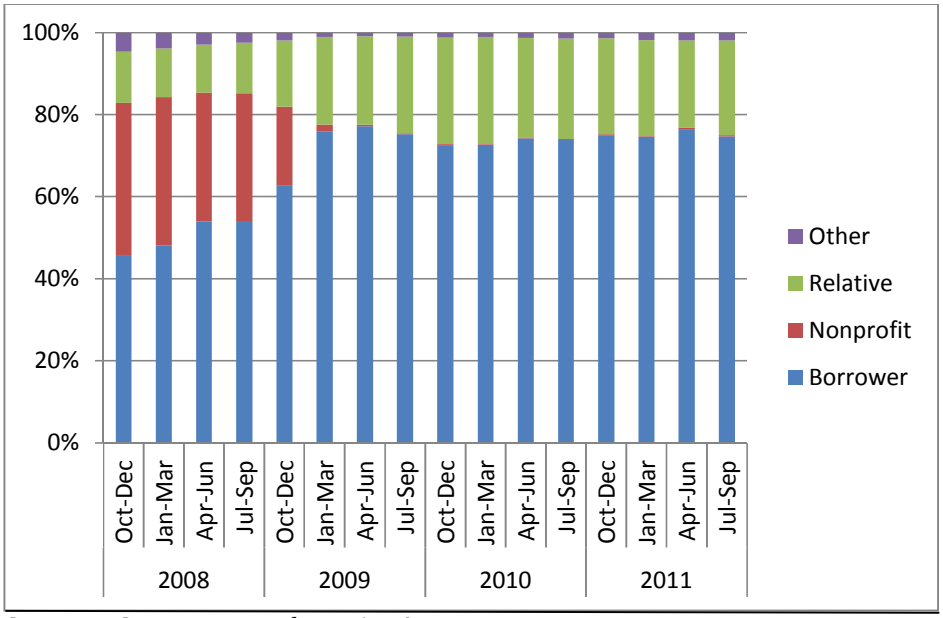
Source: US Dept of HUD, Office of Housing/FHA.

e) Source of Downpayment Funds

Prior to FY 2009, when the use of property-seller-funded downpayments was legal, the share of borrowers using their own funds for downpayments had fallen below 50 percent (see Figure 3). As a share of new FHA home-purchase loan endorsements, the very risky seller-funded-downpayment loans were as high as 37 percent in the first quarter of FY 2008. During the decade that such loans were popular, use of both borrower funds and family gifts fell dramatically. Today, the situation is much as it was in 1998, before the seller-funded era. Borrower funds were used in 75 percent of FY 2011 endorsements, family/relative gifts in another 23 percent, and Other sources (government agencies and employers) for the remaining two percent. While there

are some truly charitable, nonprofit organization downpayment gifts, they represent a very small number of loans.[9]

Figure 3. Downpayment Funds Source Distribution for FHA-Insured Home Purchase Mortgages by Fiscal Year and Quarter, 2008 -2011



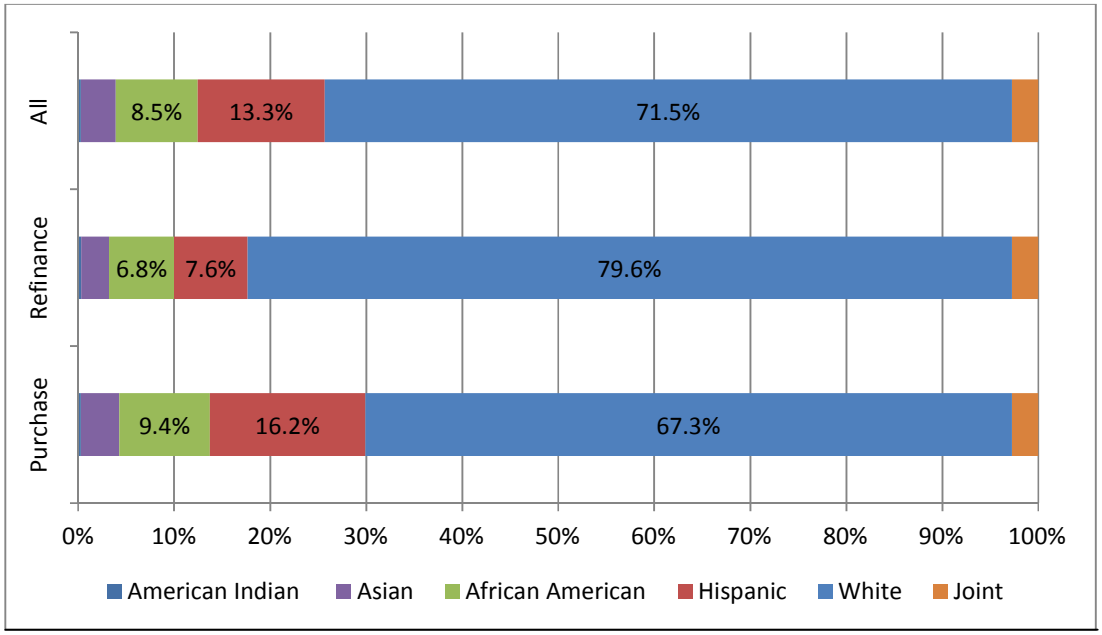
Source: U.S. Department of HUD/FHA.

f) Minority Homeowners and Homebuyers

FHA provided significant support in FY 2011 for minority homebuyers and minority homeowners seeking to refinance their properties to lower monthly housing costs. Among those borrowers who disclosed their race, 30 percent of FHA home-purchase endorsements and over 15 percent of refinance loans were for minorities. Hispanic/Latino borrowers represented 15 percent of FHA home-purchase loan endorsements and seven percent of refinance loans. African American borrowers represented 10 percent of home-purchase and seven percent of refinance loans.

[9] There were just over 2,000 such loans in FY2011, representing 0.26 percent of all home-purchase-loan endorsements.

Figure 4. Racial Composition of FHA Single-Family Endorsements in FY 2011



Source: US Department of HUD/FHA.

According to the 2010 Home Mortgage Disclosure Act (HMDA) lender activity report data, FHA continues to lead the market in support for minority homeownership. While FHA insurance was used for 37 percent of all (owner-occupant) home-purchase borrowers, its share of minority borrowers was 46 percent.[10] Among African American and Hispanic/Latinos, the FHA shares were 60 and 59 percent.

[10] The FHA share when loans with white borrowers but minority co-borrowers are included as minorities is 45 percent. FHA shares are slightly lower when investor loans are included in the totals. However, FHA does not currently insure investor/rental or vacation-home loans.

Table 4. Home Purchase Loans and Racial Shares Across Market Segments in 2010

Race or Ethnicity	Number of Loans[a]	Market Segments (Shares in rows add to 100%)			
		Conventional[b]	FHA	VA[c]	USDA Rural Development[c]
All Borrowers	2,367,818	51.9%	36.8%	7.6%	3.7%
African American	134,078	21.8	59.8	14.6	3.8
Asian	131,701	74.0	23.1	2.4	0.6
Hispanic/Latino	232,717	30.3	58.8	7.3	3.6
Native American	7,703	42.8	42.1	10.4	4.8
White	1,637,928	55.1	33.5	7.2	4.2
Not Disclosed	189,913	56.6	33.1	9.0	1.3
Mixed - White with minority co-borrower	33,778	51.5	32.1	14.7	1.8

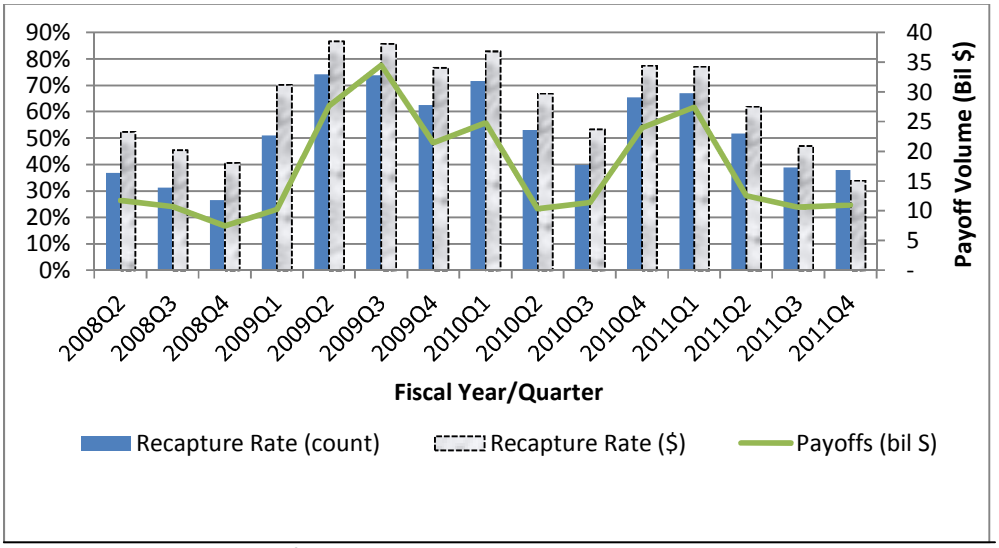
[a] Owner-occupied homes only.
[b] Conventional loans include those originated for sale to Fannie Mae or Freddie Mac, and all loans without any federal government guarantee.
[c] Like FHA, the VA and USDA provide federal government loan guarantees.
Source: U.S. Department of HUD/FHA; Analysis of 2010 Home Mortgage Disclosure Act (HMDA) Data. HMDA data provided by the Federal Financial Institution Examination Council; analysis by U.S. Department of HUD/FHA.

Even among refinance loans, FHA continues to play an important role for supporting minority access to affordable mortgage credit. According to 2010 HMDA reporting, FHA supported more than 28 percent of refinance actions among African American homeowners and 18 percent of such actions among Hispanics. Those rates compare to just 10 percent for Whites.

g) Recapture Rates on Prepayments

One of the many features of the current economic situation is that FHA has experienced very high "recapture" rates on loan payoffs. A recapture is when the borrower immediately returns to FHA via an FHA-to-FHA refinance of their home. The recapture rates over the past three years have been at historically high levels. In the past, recapture rates were much lower, even during periods of large refinance activity, because more homeowners could qualify for less expensive conventional credit. With home prices remaining depressed, and conventional credit itself more expensive than it was in the past, borrowers are now choosing to stay with FHA at much higher rates. As a result, while borrowers are benefiting from today's low interest rate environment, the MMI Fund also is benefiting from higher premium income on the new refinance loans.

Figure 5. FHA Loan-Payoff Recapture Rates, by Fiscal Year and Quarter

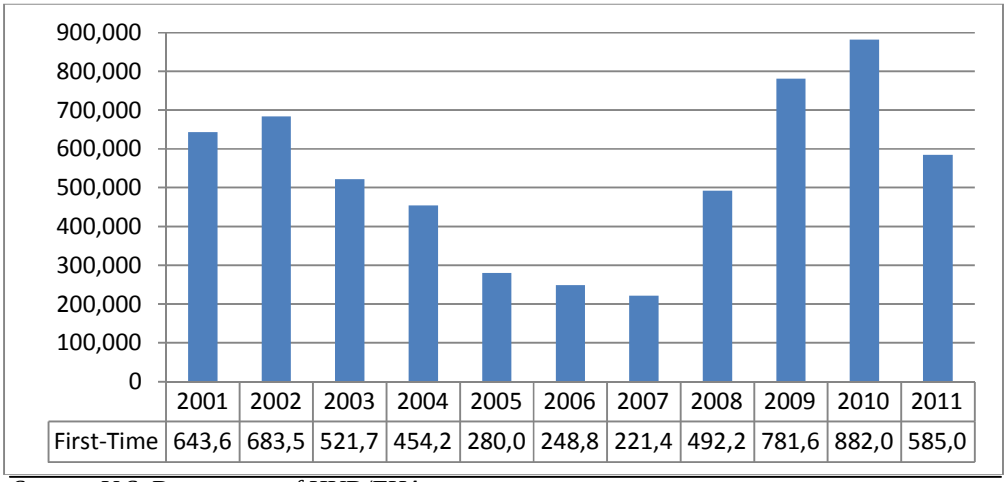


Source: U.S. Department of HUD/FHA.

2. Support for First-time Homebuyers

FHA's single-family insurance is, at the core, a catalyst for homeownership. Over the past three years, FHA has made homeownership possible for 2.27 million first-time buyers. According to annual surveys performed by the National Association of Realtors, FHA supported 56 percent of all first-time buyers in 2009 and 2010.[11]

Figure 6. Numbers of FHA-Insured First-Time Homebuyers, 2001 - 2011



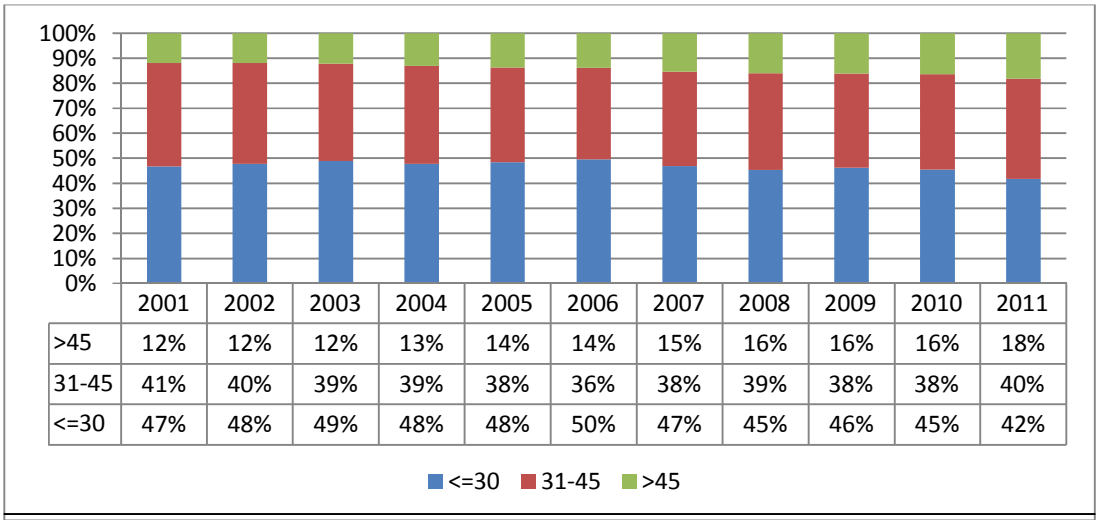
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
First-Time	643,6	683,5	521,7	454,2	280,0	248,8	221,4	492,2	781,6	882,0	585,0

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

[11] Survey results are published in the National Association of Realtors *Profile of Home Buyers and Sellers 2010*., and *Profile of Home Buyers and Sellers 2009* reports. The FHA share of first-time buyers is highlighted in press releases that accompanied publication of those reports:
http://www.realtor.org/press_room/news_releases/2009/11/survey_record ;
http://www.realtor.org/press_room/news_releases/2010/11/survey .

By age group, first-time buyers have become older in recent years. As FHA's business has grown over the past five years, the share of first-time buyers who are 18-to-30-years old has fallen by eight percentage points (from 50 to 42 percent), while shares in the 31-to-45 and over-45 age groups each increased by four percentage points. The median age is 32 years, and 70 percent of first-time buyers can be considered low-and-moderate income, having household incomes no higher than the median for their local area.[12]

Figure 7. Age Profile of FHA-Insured First-time Homebuyers, 2001 – 2011



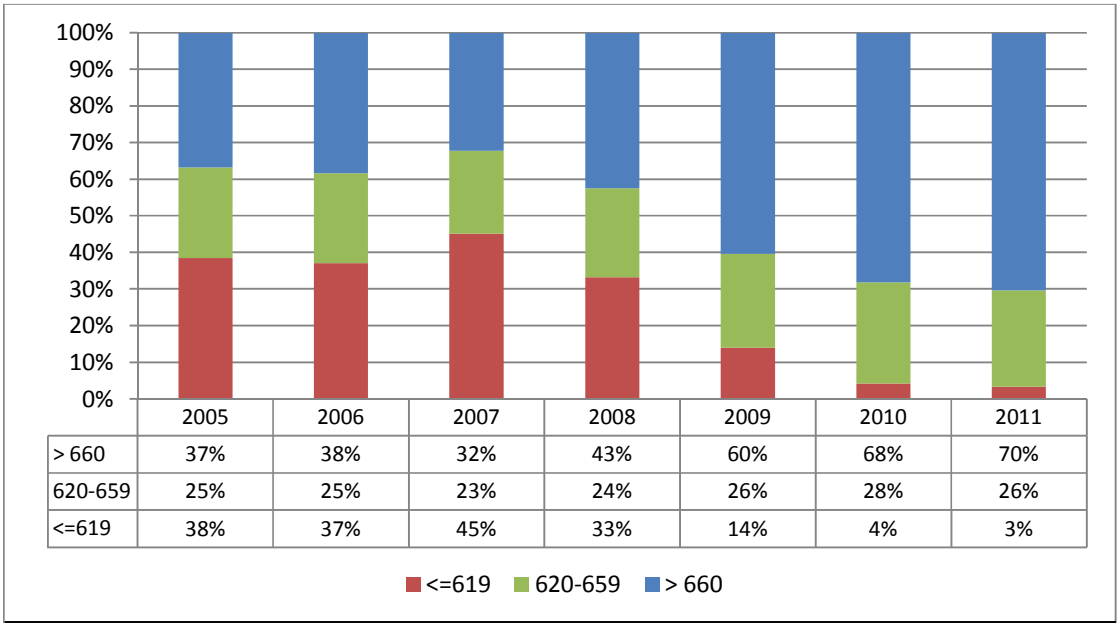
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
>45	12%	12%	12%	13%	14%	14%	15%	16%	16%	16%	18%
31-45	41%	40%	39%	39%	38%	36%	38%	39%	38%	38%	40%
<=30	47%	48%	49%	48%	48%	50%	47%	45%	46%	45%	42%

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

The migration to larger shares of high-credit-quality home buyers using FHA insurance over the past four years has dramatically affected the composition of first-time buyers in the FHA portfolio. From 2007 to 2011, the share of first-time buyers with credit scores of 660 or above rose from just 32 to 70 percent.

[12] HUD annual median income estimates are at the metropolitan area level.

Figure 8. FHA First-time Homebuyer Credit-Score Profile, 2005 - 2011

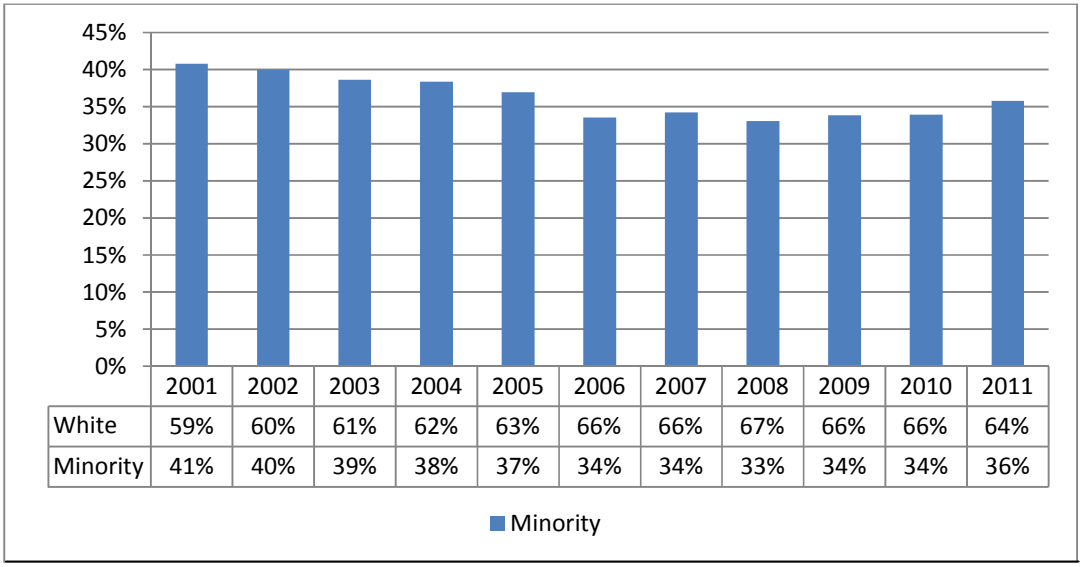


	2005	2006	2007	2008	2009	2010	2011
> 660	37%	38%	32%	43%	60%	68%	70%
620-659	25%	25%	23%	24%	26%	28%	26%
<=619	38%	37%	45%	33%	14%	4%	3%

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

Though the share of first-time homebuyers represented by minority households has started to recover from the decline experienced during the 2002-2008 period, it is not yet back to where it was in 2005, let alone 2001. It is now 36 percent, versus 41 percent in 2001. The total number of minority first-time buyers served by FHA also has not quite recovered to where it was in 2001, being 191,000 in 2011 versus 227,000 in 2001.

Figure 9. FHA First-time Homebuyer Minority Status Shares, 2001 – 2011

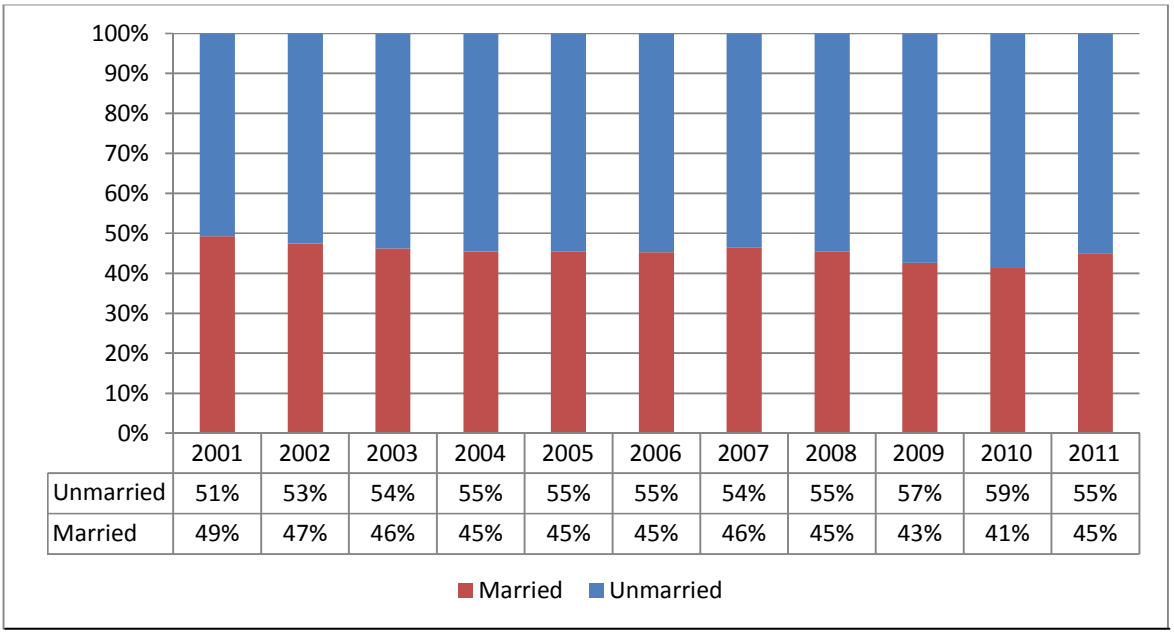


	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
White	59%	60%	61%	62%	63%	66%	66%	67%	66%	66%	64%
Minority	41%	40%	39%	38%	37%	34%	34%	33%	34%	34%	36%

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

First-time homebuyers utilizing FHA insurance are more likely to be single than married. Single borrowers accounted for 59 and 55 percent of FHA-insured first-time homebuyers in 2010 and 2011, respectively. Among single borrowers, a consistent 52 percent have been male and 48 percent female.

Figure 10. Marital Status of FHA-Insured First-time Homebuyers, 2001-2011



	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Unmarried	51%	53%	54%	55%	55%	55%	54%	55%	57%	59%	55%
Married	49%	47%	46%	45%	45%	45%	46%	45%	43%	41%	45%

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

3. Understanding Market Share

When discussing the role FHA is playing in supporting home purchase activity today, it is common to refer to FHA's market share. However, there are different bases for computing market shares, which can sometimes create confusion. HUD publishes two market-share series, one for FHA's role in supporting home purchase activity (monthly), and one for FHA's role in supporting mortgage finance (quarterly).[13] Because not all home purchases require mortgage credit, FHA's market share among home-purchase *mortgages* is always higher than its share of home-purchase activity.

Adding yet another layer of possible confusion, one can calculate market share either based on numbers of transactions or dollars. Because FHA insurance tends to be more actively used by low- and moderate-income households, FHA's dollar-based market shares have always been lower than its count-based shares. HUD then tends to focus on count-based shares to emphasize numbers of households assisted. Published mortgage market shares from other sources are

[13] Links to both report series can be found at: http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/hsgrroom .

generally only for dollar shares, though home sale data published by other sources is generally count based. HUD publishes both count-based and dollar-based shares for FHA activity.

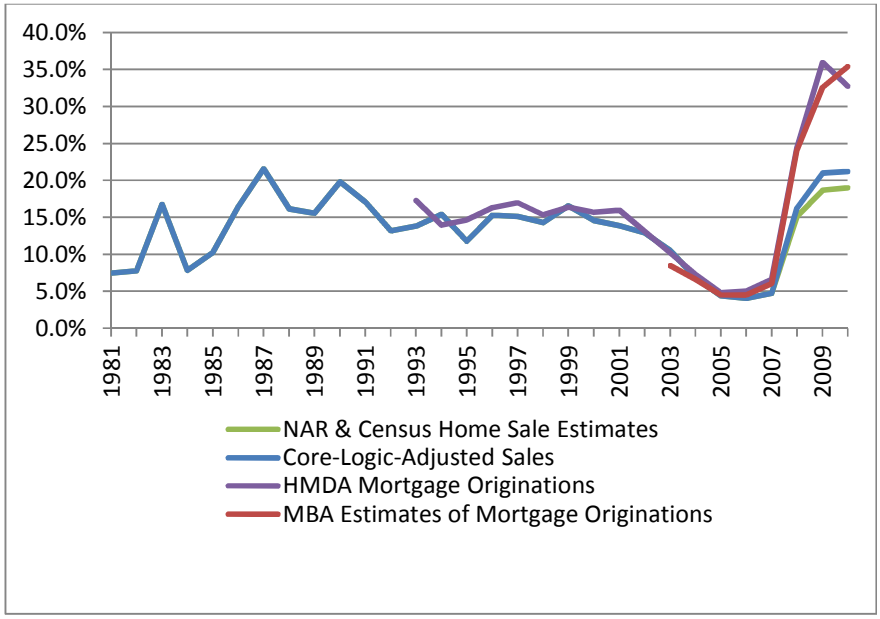
Another factor that has affected FHA market share over the past decade has been the rise and fall of home purchase activity by investors, and, to a lesser extent, purchases for vacation homes. Such sales tend to rely more on pure cash transactions without mortgages and, for those that do require access to credit, FHA does not participate in insuring such loans. According to the National Association of Realtors, 27 percent of all existing home sales in 2010 were for investment and second homes.[14] Of the 73 percent that were for owner occupancy, 91 percent used mortgage financing. That translates into FHA being a potential option for just 67 percent of buyers of existing homes in 2010. Thus, FHA's actual share of existing home sales of 18.25 percent in fiscal 2010 is also a 25.5 percent share of owner-occupant buyers requiring mortgage finance. FHA's share of newly constructed home purchases is higher than its share of existing-home purchases, and thus FHA's share of *all* home-purchase mortgages has been over 30 percent for the past three years.

Figure 11 compares FHA shares of home purchases and home mortgages since 1981, but using different underlying measures of the size of each market. For example, HUD's home-sale activity share reports have used survey data by the National Association of Realtors and the U.S. Bureau of the Census to size the market. Recently, more comprehensive data on home sale transactions has become available from aggregators such as CoreLogic. The CoreLogic adjustments to market activity indicate that FHA's share of home sale activity is higher than was previously understood.

Figure 11 also provides long-run trends for FHA purchase-mortgage market shares. Contrasted are FHA shares based on quarterly estimates of loan origination activity by the Mortgage Bankers Association—which HUD uses for current-year estimates of market share—and more comprehensive data available for historical years from Home Mortgage Disclosure Act (HMDA) reporting by lenders. One can see from the historical time series that the two measures have traditionally been very close, but that they diverged in 2009 and 2010. That divergence suggests changes in the traditional mix of loan originations across lender types and sizes over the past three years.

[14] This share was calculated by HUD using data from two annual reports published by the National Association of Realtors: *Investment and Vacation Home Buyers Survey*, and *Profile of Homebuyers and Sellers*.

Figure 11. FHA Share of Home Purchases and Home-Purchase Mortgages under Various Market and Market-Size Definitions



Source: U.S. Department of HUD/FHA analysis of data sources; all shares are count/unit based and not dollar based.

4. Outlook for FY 2012

a) Loan Limits

In 2008, the Congress passed two laws regarding FHA loan limits. The first was intended to provide a temporary increase for 2008, in order to assist in maintaining credit flows when conventional lending was curtailed. The second was intended to provide for a new, permanent loan limit regime starting in January 2009. Continued weakness in financial and housing markets caused the Congress to postpone implementation of the new, permanent rules three separate times. The last of the extensions of the temporary rules expired at the end of FY 2011. The result is that 669 counties experienced a reduction in their FHA loan limits starting October 1, 2011. Where they are located, and the size of the reduction in area loan limits, are highlighted in Figure 12. Affected Areas not shown in the graph are principally in Puerto Rico.[15]

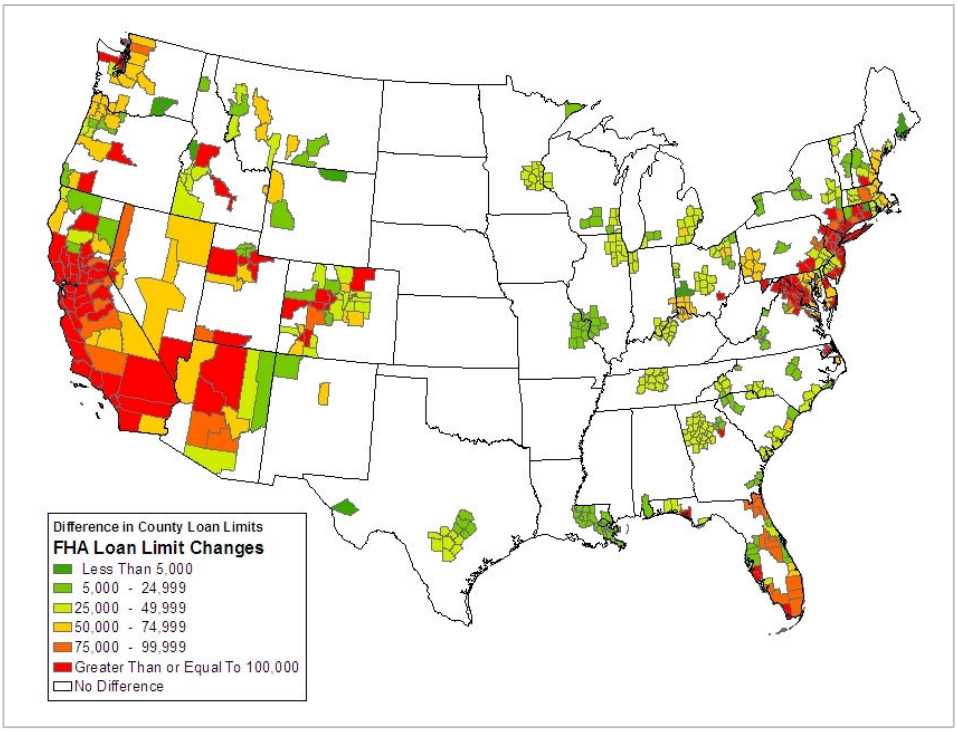
It is important to remember when looking at the absolute size of declines in loan limits that the previous limits were based on home prices prior to the housing recession. In high cost areas on the East and West coasts, it is not uncommon to see home prices that are more than $200,000 below their previous peaks. Also, the national loan-limit ceiling under the permanent rules is more than $100,000 lower than it was under the temporary rules, so the highest-priced markets took large cuts in their limits when the permanent rules took effect on October 1, 2011. For most

[15] More detailed analysis performed at HUD on the possible effects of the October 1, 2011, loan limit changes on FHA activity can be found at: http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/page_oeloanlimit.

of the country, however, loan limits did not change at that time because the national floor remains the same ($271,050). All areas with median prices below $236,000 are eligible for FHA limits at the national floor, rather than what would be a smaller amount when computed based upon the statutory formula.

Following statutory rules for setting the national floor and ceiling, high-cost area loan limits (between the floor and ceiling) are based on median price indices for each county, starting with 2008 as the base year. Over time, HUD will always choose the high point in that index. Also, by law, the high-cost county in any given metropolitan area defines the final loan limit for all counties in that area.[16] Thus, in today's environment, it is rare for any local loan limits to actually be based on recent prices in the county.

Figure 12. Metropolitan Areas Affected by Lower FHA Loan Limits in FY 2012, by Dollar Amount of Change



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

b) Small Response of Refinance Activity to Recent Declines in Interest Rates

Mortgage analysts discuss "burnout" as the phenomenon whereby prepayment and refinance activity levels tend to decline over time, even if interest rates stay attractive for refinance

[16] Metropolitan areas are defined by the Office of Management and Budget, and are labeled as either Core Based Statistical Areas (largest), Metropolitan Statistical Divisions (medium), or Micropolitan Areas (small). Micropolitan Areas typically cover only one or two counties.

opportunities. Though mortgage interest rates are at historic lows today, they are eliciting smaller responses in refinance activity than did similarly low rates one year ago. This has been documented for the mortgage industry as a whole, and it is also true for FHA.[17] Even though interest rates are at new lows, they are not substantially below where they were in the August-to-October period in 2010. In September 2010 total applications for FHA refinance loans came close to 150,000. In September 2011, they were under 50,000.

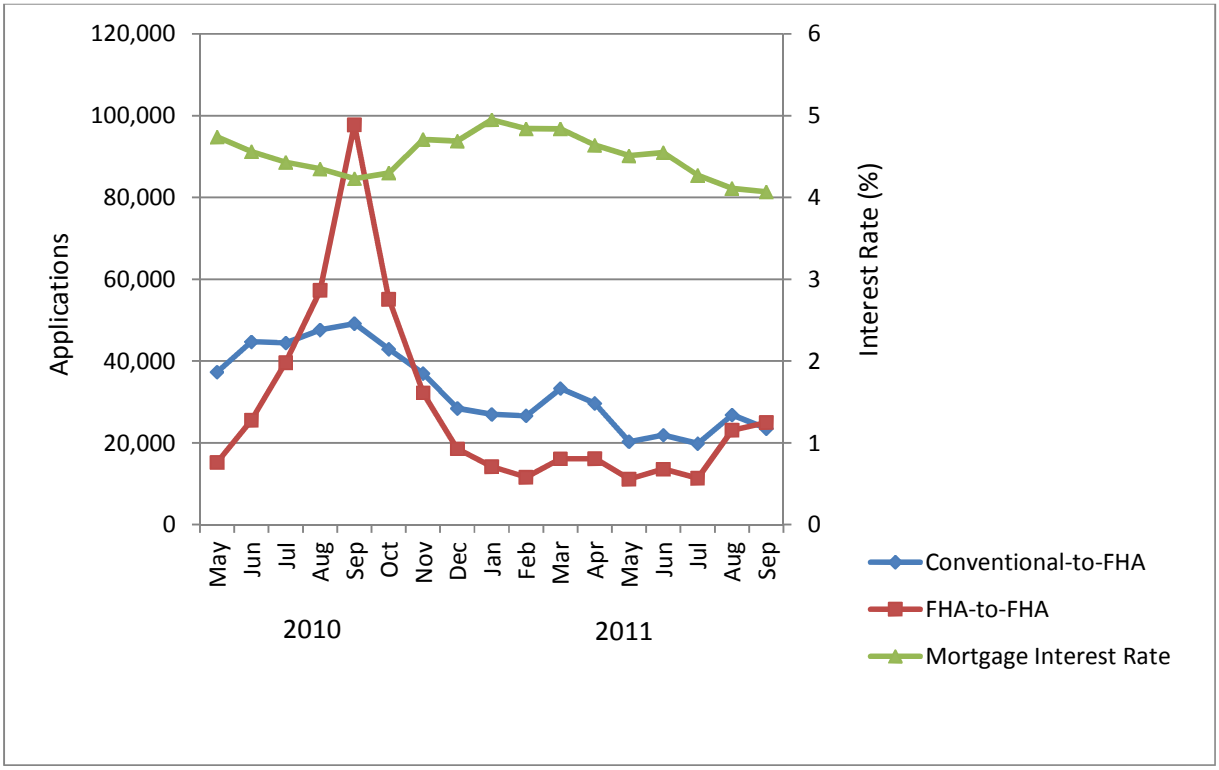
HUD estimates that there are at least 1 million active FHA-insured loans that could benefit from taking advantage of today's low interest rates.[18] They are largely spread among the 2003 through 2009 books, with the greatest numbers being in the 2008 and 2009 books. These borrowers have had previous opportunities to refinance but have not done so. Thus, there is no expectation that large numbers of them will refinance today. There could be many reasons for borrower reluctance. First is that there will be households that expect to move within the next few years. For them, the initial costs of refinancing their home are greater than the expected benefit from reductions in monthly payments. Second are borrowers that came to FHA to escape subprime loans that had very high actual or expected payment increases following an initial teaser-rate term of two or three years. Those borrowers likely are grateful to have their current, stable mortgages and do not want to take any risk of losing what they have. Then, there are likely other borrowers whose mortgage balances are far in excess of their current home values and they may not understand that there is no home-equity test for FHA streamline refinancing, or else they too find the mortgage origination and underwriting process daunting and choose to keep what they have.

HUD cannot solicit lenders to reach out to such borrowers and encourage them to refinance because FHA-insured loans are primarily pooled into Ginnie Mae guaranteed securities. Investors in those securities are expecting a certain life to the mortgage cash flows. To encourage faster repayment of loans diminishes the investment value of the securities and thus directly affects the investors. While borrowers have the right to prepay without penalty, loan servicers also have obligations to not unduly encourage behaviors that would negatively affect investors.

[17] For industry analysis, see the Economic and Mortgage Finance Commentary posted by the Mortgage Bankers Association. The October 2011 edition is available at:
http://www.mortgagebankers.org/NewsandMedia/PressCenter/78189.htm

[18] They are defined as active loans with: fixed interest rates and amortization terms over 15 years, loan balances of $50,000 or more, endorsed since 1990, not delinquent by three months or more or in foreclosure or bankruptcy, and for which a 4.25 percent interest rate would have an effective rate reduction (after paying the higher current FHA insurance premiums) of at least 1.50 percent.

Figure 13. FHA Refinance Loan Applications by Month and Source Market Sector, with 30-year Fixed-rate Mortgage Interest Rates



Source: U.S. Department of HUD/FHA and Freddie Mac Primary Mortgage Market Survey.

c) Why FHA Continues to Play a Major Role in Housing Finance

In its quarterly National Delinquency Survey (NDS), the Mortgage Bankers Association publishes year-over-year statistics on the volume of actively serviced loans in various market segments. The last available NDS summary report, for Q2 2011, indicates that FHA continues to be the only growth segment of the mortgage market. In those estimates, the active FHA portfolio increased 11.5 percent from the year-earlier period, while prime fixed-rate portfolios declined 1.74 percent and prime adjustable-rate loan portfolios declined 10.6 percent. This suggests that conventional underwriting standards continue to be much tighter than they were before the start of the financial crisis in 2008.

FHA continues to play a major role in housing finance primarily because of its support for home purchase lending. As noted earlier in this report, all sources of data indicate that FHA is providing financing for at least one-third of all homebuyers requiring mortgage finance. FHA's purchase mortgage business is a low-downpayment business, with 85 percent of loans insured in FY 2011 having downpayments of less than five percent.[19] It is difficult and costly to obtain financing for low downpayment lending in the conventional mortgage market. Even for loans for which private mortgage insurance costs might be comparable or even lower than FHA prices, the delivery fees charged by Fannie Mae and Freddie Mac can make such loans inaccessible to

[19] The minimum downpayment under FHA's standard 203(b) program is 3.5 percent.

homebuyers with limited wealth. The FHA upfront premium is one percent and may be financed into the mortgage. The delivery fees charged by Fannie Mae and Freddie Mac may be as high as 2.5 percent for loans with 5-percent downpayments, and those fees must be paid in cash and not financed into the mortgage balance. Also, Fannie Mae and Freddie Mac do not currently purchase loans with downpayments of less than 5 percent.

B. DEFAULTS AND DEFAULT RESOLUTIONS

1. New Default Episodes

HUD follows the Mortgage Bankers' Association definition of seriously delinquent loans as being those that reach 3-months (90-days) delinquency and either persist in that state, migrate to foreclosure processing, or else file for bankruptcy court protection. One hallmark of the current housing cycle is that growth in new 90-day delinquencies has been primarily driven by income and employment problems. Between 2007 and 2010, income and employment problems as a share of all new 90-day delinquencies rose from under 30 percent to nearly 50 percent. The share due to excessive obligations fell during that period from 30 to 15 percent, and the share due to other identifiable reasons fell from 30 percent to 21 percent.[20]

[20] There are often many reasons for a mortgage default, and those reasons can be inter-related. HUD requires loan servicers to report only the primary reason identified in communication with the borrower.

Table 5. New 90-day Delinquencies by Calendar Quarter with Principal Reason, 2007 - 2011

Year and Quarter	New 90-Day Delinquencies	Shares by Principal Reason[a]			
		Income or Employment	Excessive Obligations	Other Reasons[b]	No Contact
2007Q1	44,258	26.4%	28.3%	32.6%	12.7%
2007Q2	46,991	27.1	29.2	31.1	12.7
2007Q3	62,802	28.1	27.2	31.5	13.2
2007Q4	78,642	30.5	25.7	30.0	13.7
2008Q1	67,557	32.2	25.3	28.9	13.6
2008Q2	67,928	34.1	22.9	29.2	13.9
2008Q3	92,035	36.0	22.0	27.8	14.3
2008Q4	122,367	39.4	19.5	26.8	14.3
2009Q1	111,449	43.7	17.1	25.4	13.9
2009Q2	108,000	46.7	15.3	24.8	13.1
2009Q3	146,712	47.5	14.6	24.8	13.0
2009Q4	152,884	48.8	14.5	23.8	13.0
2010Q1	124,579	48.5	14.7	22.7	14.1
2010Q2	104,107	48.6	15.6	21.1	14.7
2010Q3	131,030	49.0	16.3	21.4	13.3
2010Q4	133,718	48.9	16.7	21.4	12.9
2011Q1	117,917	48.9	16.7	22.3	12.1
2011Q2	99,260	48.5	17.6	22.8	11.1
2011Q3	133,838	46.9	18.9	22.6	11.6

[a]As reported by delinquent homeowners to their loan servicers.
[b]Principal reasons in the Other category are death or illness and marital problems.
Source: U.S. Department of HUD/FHA.

While numbers of new 90-day default events have climbed since early 2007, newly insured loans have demonstrated increasing levels of resilience and strength. That is demonstrated by a dramatic decline in the rate of early payment defaults (EPD) over the past three years. EPDs are defined by three consecutive missed payments within the first six payment cycles. Among home purchase loans, the incidence of such EPDs for loans originated in early 2011 was less than one-sixth the rate seen in early 2008. For fully-underwritten (non-streamline) refinance loans, the EPD rate in early 2011 was just one-ninth of its peak in mid 2008. For streamline refinance loans, the improvement has been most dramatic, with the early 2011 rate being only one-twelfth of what it was at the peak in mid 2008.

Table 6. Early Payment Default Rates[a] by Loan Purpose and Type and by Origination Year and Selected Months

Month of Origination	Loan Purpose			
	Home Purchase	Fully Underwritten Refinance	Streamline Refinance	All Loans
2008				
Jan	2.58%	1.73%	2.78%	2.23%
Apr	1.95	1.88	4.59	2.14
Jul	1.70	2.39	7.53	2.04
Oct	1.08	1.67	4.58	1.46
2009				
Jan	1.06	1.01	2.27	1.39
Apr	0.62	0.62	2.20	1.06
Jul	0.50	0.67	2.17	0.81
Oct	0.31	0.71	1.15	0.54
2010				
Jan	0.38	0.32	0.97	0.43
Apr	0.30	0.33	0.68	0.33
Jul	0.47	0.31	0.65	0.46
Oct	0.31	0.23	0.40	0.32
2011				
Jan	0.36	0.20	0.66	0.36
Feb	0.41	0.19	0.61	0.38

[a]Percentage of new originations that have a 3^{+}-month delinquency within the first six payment cycles.
Source: U.S. Department of HUD/FHA.

2. Default Cures and Re-Default Rates

During this time of elevated financial stress on households, FHA has maintained a robust set of policies for loan servicer engagement with borrowers to provide assistance in curing mortgage delinquencies. Table 7 shows the number of cured defaults each fiscal year, 2007 – 2011, grouped by those requiring special assistance and those not requiring special assistance. The distinction is that, with unassisted cures, borrowers were able to pay off all arrears without needing either a formal repayment plan or use of one of FHA's loss-mitigation tools. Those tools include:

> *Longer-term forbearance-and-repayment plans*: forbearances (reduced or zero payments) of four or more months, followed by repayments taking more than six months. HUD instituted mandatory minimum 12 month forbearance terms for unemployed borrowers starting in June 2011.[21]

[21] See, ML-2011-23, *Unemployment Special Forbearance: Temporary Program Changes and Clarifications*, July 7, 2011.

Loan modifications: up to two months arrears can be added to the loan balance, the interest rate reduced to current market levels, and the loan re-amortized for up to 30 years.

Partial claims: HUD pays a "partial" claim to the loan servicer to bring the loan current and the borrower signs a promissory note for the amount of assistance. The note is due upon sale or refinance, but there are no interest accruals and no monthly payments are required.

FHA Home Affordable Modification Program (HAMP): this combines a loan modification with a partial claim, and the partial claim may also be used to reduce a portion of the first-lien mortgage in order to facilitate lower mortgage payments.

Table 8 indicates that FHA-insured borrowers with serious delinquencies are requiring assistance more often than not. Over the 2008 – 2011 period, 81 percent of all cures included special assistance. The assisted borrowers tend to have greater financial stability after cure than do unassisted, as evidenced by their 4-quarter re-default rates. In addition, HUD has issued new guidance to FHA servicers that requires successful completion of 3-month trial payment periods prior to finalizing loan modification or partial claim plans, starting in 2012.[22] That will substantially eliminate the problem of re-defaults in the first quarter after assisted cure, and will similarly reduce the incidence of 4-quarter re-defaults.

It is also evident from Table 7 that 2009 was the worst year for borrower re-defaults, both for assisted and unassisted cures. This is consistent with the continued growth of income and employment problems as the primary reason for default in 2009 and 2010 (Table 5), and suggests that many borrowers (and co-borrowers) may have experienced multiple income-related shocks over this time period. However, re-default rates for 2010 and 2011 cures are coming down from the 2009 high point. For assisted cures, 2010 was dramatically better than 2009, with the 4-quarter re-default rate having fallen from 39 to 30 percent.

[22] See, ML-2011-28, *Trial Payment Plan for Loan Modifications and Partial Claims under Federal Housing Administration's Loss Mitigation Program*, August 15, 2011; and ML-2011-37, *Extension of Implementation and Reporting Dates Regarding Trial Payment Plan for Loan Modifications and Partial Claims under Federal Housing Administration's Loss Mitigation Program*, October 18, 2011.

Table 7. Cured Defaults and Quarterly Re-default Rates, FY2007 – 2011[a]

Fiscal Year of Cure	Total Number of Cures[b]	Quarter after Cure				4-quarter Re-default Rate[c]
		1	2	3	4	
With Special Assistance[d]						
2007	170,315	5.34%	11.26%	6.50%	3.55%	26.66%
2008	216,792	6.95	13.74	7.68	3.99	32.35
2009	180,716	7.91	16.37	9.65	5.02	38.94
2010	281,924	4.63	12.92	8.14	4.61	30.31
2011	362,652	3.25	9.19	5.85		
Without Special Assistance						
2008	46,858	14.87%	15.35%	6.54%	2.93%	39.68%
2009	49,391	14.30	16.93	7.68	3.67	42.58
2010	76,665	10.96	16.01	7.88	3.77	38.62
2011	64,611	9.11	13.75	5.54		

[a]Data are as-of September 30, 2011; shaded cells represent quarters that are not yet complete and are subject to future revision; re-defaults are defined as 90-day delinquencies; a Quarter 1 re-default would mean that the borrower made no payments in the first three months after the initial cure.
[b]Assisted cures may have occurred at any time following a 30-day delinquency. Unassisted cures, however, are only counted here if there was an initial 90-day delinquency. This distinction is made because, had the special assistance not been applied, these 30-day delinquencies would have, in all likelihood, migrated to the 90-day status.
[c]4-quarter re-default rates are only reported when all cures in the fiscal year have had a full four quarters (12 months) of post-cure seasoning.
[d]Special Assistance is defined as the final cure coming after a forbearance and repayment plan, loan modification, or partial claim payment. Unassisted cures may have involved lender forbearance, but the borrower was able to repay the arrears without a formal repayment plan lasting more than six months.
Source: U.S. Department of HUD/FHA

3. Use of Loan Modifications to Reduce Mortgage Payments

The use of loan modifications as a tool for assisting borrowers to cure mortgage delinquencies came of-age in 2010. In that year, FHA implemented new statutory authorities to permit modifications to be accompanied by principal deferments and, also in that year, loan servicers began to more aggressively use the standard modification program to substantially lower borrower interest rates.[23] Prior to 2010, it was not uncommon for loan modifications to result in payment increases rather than decreases. This occurred because the standard modification was only to add arrears to the loan balance and reset the payment amount to respect the original loan amortization term. The modification action was then seen as a way to alleviate the burden of a repayment plan with substantially higher monthly payments. Longer delinquencies and larger

[23] See, ML-2010-04, *Loss Mitigation for Imminent Default*, January 22, 2010. This Mortgagee Letter implemented the FHA HAMP program that permitted combining partial claims with loan-term modifications.

arrears would make a borrower eligible for the FHA partial claim workout, were they unable to make the higher payments required under a standard repayment plan.[24]

The combination of principal deferment with loan-term modifications is known as the FHA Home Affordable Modification Program (HAMP). In 2011, 8,654 of these combination modifications were completed, with half of those assisted saving $218 or more per month on their mortgage payments. By contrast, the standard modification assisted over 133,000 borrowers, and the median for monthly payment reductions was just $84.[25]

Table 8. FHA HAMP Loan Modification Payment and Interest Rate Reductions, 2010-2011

Fiscal Year of Modification	Benefit Measure	Distribution Points in the Size of Benefits				Number of Modifications[a]
		25th Percentile	50th Percentile	75th Percentile	Average	
2010	Payment Reduction	$99.26	$198.90	$309.06	$219.05	1,959
	% Change in Payment	12.24%	22.27%	30.27%	20.44%	
	Rate Reduction	0.50%	1.00%	1.50%	1.03%	
2011	Payment Reduction	$121.29	$218.16	$334.42	$238.43	8,654
	% Change in Payment	15.49%	24.32%	31.85%	22.97%	
	Rate Reduction	0.50%	1.13%	1.63%	1.15%	

[a]Numbers of actions reported here are based upon loan servicer claim filings for servicing incentive payments and may not reflect the total number of actions actually undertaken by FHA loan servicers. FHA only knows the terms of modifications if an incentive-payment claim is submitted.
Source: U.S. Department of HUD/FHA.

[24] Only two months of arrears can be added to the loan balance in a standard loan modification. Partial claims are available when the total arrears reach four months or more.
[25] These data are only for cases where the loan servicer filed with FHA for incentive payments to cover the costs of enacting the loan modification. Because there are time restrictions on when such claim filings must be received, there are cases where lenders are providing modifications but HUD does not know the terms because no claim is filed. From standard delinquency reports, HUD believes that such under-reporting may be as high as 13 percent.

Table 9. FHA Standard Loan Modification Payment and Interest Rate Reductions, 2007 - 2011

Fiscal Year of Modification	Benefit Measure	Points Along Size Distribution				Number of Modifications[a]
		25th Percentile	50th Percentile	75th Percentile	Average	
2007	Payment Reduction[b]	-$78.48	-$44.56	-$24.39	-$57.75	46,045
	% Change in Payment	-13.84%	-7.46%	-4.43%	-11.82%	
	Rate Reduction	0.00%	0.00%	0.00%	0.04%	
2008	Payment Reduction[b]	-$62.21	-$28.97	-$0.34	-$40.29	56,908
	% Change in Payment	-10.76%	-4.86%	-0.26%	-7.54%	
	Rate Reduction	0.00%	0.00%	0.00%	0.08%	
2009	Payment Reduction[b]	-$32.19	$0.00	$53.74	$12.36	81,523
	% Change in Payment	-5.45%	0.00%	7.02%	-0.85%	
	Rate Reduction	0.00%	0.13%	1.13%	0.62%	
2010	Payment Reduction	$30.92	$77.38	$130.92	$89.94	144,182
	% Change in Payment	3.90%	9.92%	15.78%	10.03%	
	Rate Reduction	0.75%	1.25%	1.75%	1.28%	
2011	Payment Reduction	$22.97	$84.51	$149.27	$98.51	133,053
	% Change in Payment	4.26%	11.46%	18.07%	12.25%	
	Rate Reduction	0.75%	1.38%	1.90%	1.39%	

[a]Numbers of actions reported are based upon loan servicer claim filings for servicing incentive payments and may not reflect the total number of actions actually undertaken by FHA loan servicers. FHA only knows the terms of modifications if an incentive-payment claim is submitted.

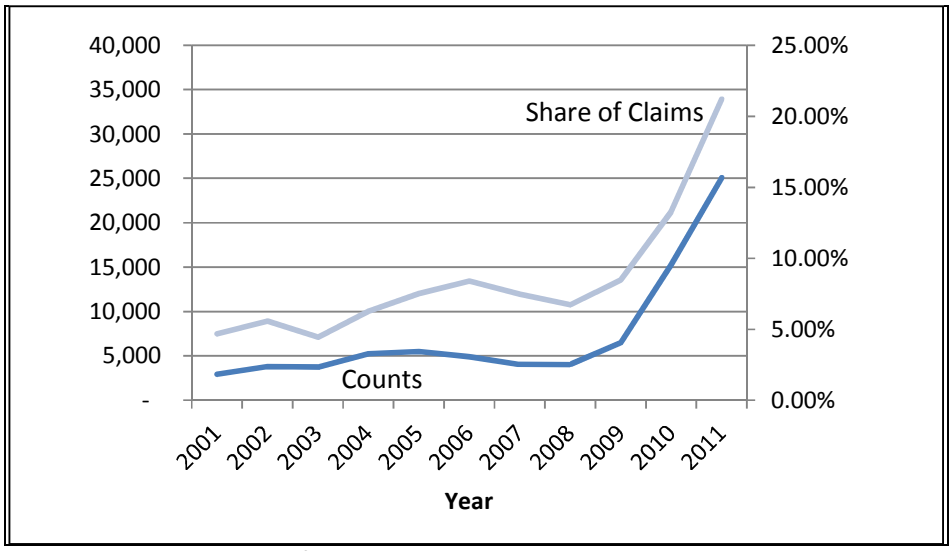
[b]Negative payment reduction amounts (increased payments) are possible and generally occur in cases for which the modification does not include an interest rate reduction but only the addition of payment arrearages to the loan balance.

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

4. Pre-foreclosure Sale Activity

The first options for FHA loss mitigation activity are designed to assist homeowners delinquent on their mortgages to re-instate loans and keep their homes. However, in many cases maintaining the home is not possible. In those cases, FHA authorizes loan servicers to accept short payoffs through what are called pre-foreclosure sales.[26] FHA then pays a claim for the short-fall. In the current economic environment, this tool has been used at a rate not previously seen since FHA started the program as a pilot in the early 1990s. The more than 25,000 approved sales in FY 2011 were a new record. Though the 21 percent share of all claims (by count) in FY 2011 was also a record, it was in part due to the slowdown of foreclosure actions and post-foreclosure conveyance actions that occurred in FY 2011.

Figure 14. Pre-foreclosure Sale Activity by Fiscal Year, Counts and as a Share of all Insurance Claims



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

5. Lengthening of the in-Foreclosure Inventory

The so-called "robo-signing" crisis that has gripped major mortgage lenders over the past year has created a lengthening of time-in-foreclosure for FHA-insured loans. That, in turn, produced a decrease in claim payments during FY 2011. The final resolution of these open cases is still unknown. The reason for loan servicers delaying final foreclosure auctions is to address legal challenges to internal procedures used to verify legal standing to foreclosure, and even to validate borrower default.

The good news for FHA is that foreclosure starts peaked in March 2010 (27,900), and are now at just a fraction of that level (less than 10,000 in September 2011). But the backlog from cases in

[26] In instances of severe hardship, HUD will also accept voluntary deed transfer by property owners. Those become (property) conveyance claims whereby HUD manages and sells the property.

the pipeline one year ago is still felt today. Table 10 indicates that, over the past year, the share of all foreclosure actions open for more than one year increased from under 8 percent to nearly 25 percent. That represents an increase in the number of loans in that category from 10,175 to 34,075.

How many of these cases will result in a final claim payment by FHA is still to be determined. Under orders from bank regulators, the largest loan servicers are reviewing the legality of foreclosure actions initiated during the entire three year period from 2008 through 2010. A separate initiative to hold loan servicers financially responsible for illegal and undocumented foreclosure actions is currently underway in a joint effort between HUD, other federal agencies, and the various State Attorneys Generals.

Table 10. FHA In-Foreclosure Inventory by Quarter and Time in-Process[a]

Reporting Month	Inventory Count	Months Since Foreclosure Initiation						
		00-03	04-06	07-09	10-12	13-15	16-18	19+
Dec 2009	111,679	55.79%	18.19%	9.00%	5.59%	3.50%	2.16%	5.77%
Mar 2010	132,125	53.70	18.53	10.76	5.39	3.48	2.34	5.79
Jun 2010	132,548	48.11	18.46	12.34	7.54	4.10	2.67	6.77
Sep 2010	130,285	42.00	19.79	12.60	8.89	5.67	3.24	7.81
Dec 2010	136,203	38.89	15.62	14.71	9.55	7.14	4.59	9.50
Mar 2011	141,910	31.48	17.12	11.55	12.22	8.25	6.27	13.10
Jun 2011	134,504	27.19	11.59	13.58	9.86	11.17	7.75	18.86
Sep 2011	136,463	27.28	9.96	8.26	11.03	8.45	10.05	24.97
Year-over-Year Change	5,457	-14.83%	-9.78%	-4.32%	2.16%	2.78%	6.83%	17.17%

[a]Loans for which foreclosure actions have started but no final auction of the property has taken place; row shares add to 100%.

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.[27] First, all business transactions related to insurance operations are maintained in a series of Financing Accounts at the U.S. Treasury.[28] Then, secondary reserves for unexpected claim expenses are maintained in a separate Capital Reserve Account, which is also held at the U.S. Treasury. The Capital Reserve Account is unique to MMI Fund operations. It was established to assist in managing to the two-percent capital ratio requirement established by Congress in 1990. FHA's MMI Fund programs, however, 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 2011, the MMI Fund had $33.7 billion in account balances with the U.S. Treasury. Of that total, $29.0 billion was in the Financing Accounts and $4.7 billion in the Capital Reserve Account. The combined balances are referred to as the capital resources of the MMI Fund. They represent liquid assets available for cash needs. Capital resources at the end of FY 2011 were $400 million higher than at the end of FY 2010, and $1.9 billion higher than at the end of FY 2009. They were also $7.7 billion higher than was predicted last year by the independent actuaries. That difference is primarily due to a slowdown in expected insurance claims resulting from foreclosure-processing problems at major banks, and also to HUD's decision to raise the periodic insurance premium rate, starting with loans insured in April 2011.

Of note, Table 11 reflects significant movement of funds from the Capital Reserve Account to the Financing Accounts over the past three years. Those fund transfers were conducted as part of the annual budget re-estimate process overseen by the Office of Management and Budget (OMB), and done in order to build dedicated loss reserves against anticipated future net claim expense outlays for outstanding loan guarantees. In the FY 2011 actuarial study, the independent actuaries estimated the amount of required loss reserves to be $29.9 billion, or $900 million more than what is currently in the MMI Fund Financing Accounts. The calculations used to arrive at that figure subtract projections of future claim expenses from the sum of future premium

[27] 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 first is the set of Program Accounts which cover all personnel and administrative expenses for FHA operations. The other 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.

[28] There are individual Financing Accounts maintained for each annual book of business, or what are called budget cohorts. There are also separate accounts for forward loans and for HECM.

revenues and property recoveries on outstanding business, without consideration for any receipts from new insurance written in the future. HUD uses this construct to book loss reserves in the FHA Annual Management Report financial statements, in accordance with federal government accounting rules. However, no funds will be transferred between the Capital Reserve and Financing Accounts at this time. Transfers only occur after consultation with OMB, and based upon updated analysis for the annual budget re-estimation process.

Table 11. FHA MMI Fund Account Balances by Quarter, FY 2009 – FY 2011[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	June	3.5	29.6	33.1
2010	September	4.4	28.9	33.3
2011	December	6.3	26.4	32.7
2011	March	7.7	23.9	31.6
2011[e]	June	2.8	28.9	31.7
2011	September	4.7	29.0	33.7

[a]Only September 2008, 2009, and 2010 represent audited figures.
[b]This is an on-budget account that records net receipts provided by FHA to the federal budget, since 1992. Balances are held in cash and (nonmarketable) Treasury securities. The securities earn interest for FHA.
[c]This is a series of off-budget cash accounts used to manage insurance operation collections and disbursements.
[d]Total Capital Resources is the sum of Capital Reserve and Financing Account balances, and it represents the sum of cash and investments at the Treasury that can be immediately liquidated into cash. It does not represent total assets of the MMI Fund.
[e]Under the requirements of Federal Credit Reform accounting, $6.8 billion was transferred in June 2011 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. Dept of HUD/FHA; October 2011.

2. Core Insurance Operation Cash Flows in FY 2011

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 this year by $400 million, actual core insurance operations had a net outflow of $2.2 billion (see Table 12). The improvement in capital resources came principally from interest earnings on the Financing Accounts. And though core insurance operations had a net cash outflow, the net result was $6.4 billion better than predicted in last year's independent actuarial study. This difference is primarily due to the unforeseen stoppage of open foreclosure actions that resulted when widespread irregularities in foreclosure documentation were discovered in the mortgage servicing industry. Those cases with open foreclosure actions have not necessarily changed their status since problems were discovered early in the fiscal year. Therefore, the anticipated cash outflow for FY 2012 is significantly larger than it would have been if foreclosures and claims had been processed with more normal timelines in FY 2011.

Quarterly cash flows in 2011 were also influenced by a significant reduction in post-foreclosure property sales during the winter months while HUD was issuing new contracts for managing property sales. Once the new contracts started operations at mid-year, sales and recoveries increased dramatically as the contractors worked down the property inventory backlog.

Premium collections this year ($7.6 billion) were down from FY 2010 levels ($9.3 billion), both because new endorsements were lower, and because of the switch toward a greater reliance on periodic premiums as opposed to the initial, upfront charge. Over time, premium collections under the new rates established in FY 2011 will be larger than they would have been otherwise. This is reflected in the projections made by the independent actuaries.

Table 12. FHA MMI Fund Financing Account Insurance Operations Cash Flows in FY2011, by Quarter[a] (millions)

	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Fiscal Year Totals
Collections					
Premiums	$ 2,232	$ 1,725	$ 1,798	$ 1,848	$ 7,603
Property Sale Receipts	913	887	2,378	1,960	6,138
Note Sale Collections	32	1	50	28	111
Other	12	16	14	18	60
Total	3,189	2,629	4,240	3,854	13,912
Disbursements					
Claims[b]	$ (3,765)	$ (3,621)	$ (3,830)	$ (3,715)	$ (14,931)
Property Maintenance	(170)	(171)	(452)	(388)	(1,181)
Other	-	-	-	-	-
Total	(3,935)	(3,792)	(4,282)	(4,103)	(16,112)
Net Operations Cash Flow	$ (746)	$ (1,163)	$ (42)	$ (249)	$ (2,200)

[a]These are unaudited figures; totals may not add due to rounding.

[b]Claim payments shown here include conveyance, pre-foreclosure sale, note sales, and loss mitigation actions.

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

B. ASSESSMENT OF THE INDEPENDENT ACTUARIES

The National Housing Act requires that HUD contract for an independent actuarial study of the MMI Fund each year.[29] The two portfolios of the MMI Fund—forward (single-family) and reverse (HECM) mortgages—are fundamentally different in characteristics and performance, so they are analyzed in two separate reports. For FY 2011, the same contractor was selected for both studies.[30] The final written reports are available online in the Office of Housing Reading Room at www.hud.gov.[31]

In summary, the independent actuarial assessments find that the MMI Fund capital ratio currently stands at 0.24 percent. That represents $2.6 billion in estimated economic net worth against an active portfolio of $1,078 billion. Last year the estimated capital ratio was 0.50 percent and the dollar capital position was $4.7 billion.

Some major reasons for the year-over-year decline in estimated capital position are:

- Home prices have fallen another 5 percent, further impairing the value of books already underwater.
- More loans, particularly from the years of the housing bubble from 2006-2008, are currently in serious delinquency, and a significant percentage have been there for more than one year. For extended delinquency loans, many of which are in foreclosure processing, eventual claim becomes the most likely outcome.
- More active loans have had a previous serious delinquency (3 months or more), and their (elevated) re-default potential is now built into the actuarial calculations. The independent actuaries made a decision to treat foreclosure actions likely affected by so called robo-signing problems as expected claims in 2012.

Before addressing the details of the actuarial assessments, it is helpful to review the major factors that contribute to this year's change in estimated economic net worth. The next sub-section of this report particularly looks at the material ways in which the approach of the actuaries has changed for 2011. That is followed by a review of how home prices have continued to fall by more than had previously been forecasted.

3. The Independent Actuarial Studies

The actuarial studies use statistical models to predict default, claim, loss-on-claim, and prepayment rates on current and future books of business. Those models are estimated using

[29] See, 12 USC 1708(a)(4).
[30] Integrated Financial Engineering Group, Inc. was the contractor utilized for these reports. In the two previous years, the actuarial study for the HECM portfolio was conducted by IBM while Integrated Financial Engineering performed the forward-loan study.
[31] See, http://www.hud.gov/offices/hsg/hsgrroom.cfm.

historical patterns of FHA-insured loan performance under a wide variety of economic conditions. They are applied to active loans, and they use commercially-available forecasts of home prices and interest rates to predict loan performance in the future. The resulting projections determine business operation cash flows needed to estimate the economic value of the Fund. For standard single-family mortgages, "default" is defined as a 90-day delinquency event. The actuarial model projects the timing and type of resolution for each current or forecasted default episode. For HECM loans, which have no monthly payment requirements, "default" on a loan typically means the borrower has stopped paying property taxes and/or property hazard insurance, and the lender has been unsuccessful in engaging them in a repayment plan. Even among those so-called tax-and-insurance (T&I) defaults, HECM insurance claims do not necessarily imply dollar losses for HUD. Losses only occur if the net proceeds from property sale are insufficient to pay-off the indebtedness. Insurance claims also are routinely paid when a loan balance reaches HUD's maximum claim payout, per standard investor rules.[32] The loans are then "assigned" to HUD, meaning HUD becomes the investor of record. Any potential for loss to FHA is not known until the borrower exits the home and the property is sold and loan paid off. Thus, the principal forecasts for HECM loans are for the event timing of claims paid to acquire active loans from lenders, and for final loan termination.

The outcome of the complete actuarial study modeling effort is the estimated "economic net worth" of the MMI Fund, which is defined by the National Housing Act as capital resources plus the present value of future cash flows of the MMI Fund.[33] The calculation of economic net worth is repeated for each of the next seven years by adding projected endorsements each year, forecasting their cash flows and adding them to those of the current portfolio, and then reassessing economic net worth on the updated portfolio at the end of each fiscal year. Economic net worth represents additional resources directly available to FHA for absorbing claim expenses above-and-beyond those already anticipated in the present-value-of-future-cash-flow calculations. Those calculations are for the remaining life of all outstanding loan guarantees and can extend for more than 30 years on HECM loans. Economic net worth is the numerator of the statutory capital ratio measure. The denominator is the outstanding dollar volume of active insurance contracts.

The remainder of this section discusses changes in data and modeling techniques that contribute to differences in this year's economic net worth calculations.

a) Forward Loans: Re-default Propensities

The ongoing housing recession has led not only to historically high delinquency rates for FHA, but also to historically-high levels of loans in the active portfolio that have had prior periods of serious delinquency, defined as delinquencies of 3 months or more in duration. The independent actuaries define these as "defaults," and they forecast both the incidence of default and rates of

[32] Ginnie Mae requires that securitized loans be bought out of pools at that point.

[33] 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.

transition to final resolutions over time. Those resolutions can be reinstatement (assisted or unassisted), payoff, or claim.

This year, for the first time, the actuarial forecasts include factors that capture the elevated re-default potential for loans with prior (but cured) default episodes. The financial weakness that led to the earlier episode suggests that these loans, once reinstated, retain an elevated risk of a new default. Once a portion of those reinstated loans re-default, they actually have lower predicted rates of claim and prepayment, and higher rates of assisted cure. On balance, however, the increased risk of re-default is higher than the offsetting reduction in the default-to-claim probability.[34] And that risk continues for loans that cure out of a second (or subsequent) default episode. Thus, in the actuarial calculations, loans that reinstate from a 90-day default event continue to have elevated exposure to the possibility of foreclosure and claim for the remaining life of the book-of-business.

On September 30, 2011, the FHA active and current portfolio included over 630,000 loans with prior default episodes (nine percent of all active loans), which are predicted to be more vulnerable to new defaults throughout the forecast period. In addition, there were over 638,000 loans in serious delinquency; nearly 36 percent of which had a prior (3+ month) default.

b) Forward Loans: Elimination of Policy Regime Effects

In the FY 2010 actuarial study model, the independent actuaries attempted to capture differences in competitive market conditions and HUD policies that could have influenced claim and prepayment rates on FHA-insured loans during various periods of time. The use of such regime effects in building the statistical model requires making assumptions about which historical conditions should be applied in the forecast period. Because that assumption is too difficult to make with any certainty, nearly all of the regime effects were dropped from this year's model.[35] That builds average historical experience into the forecasting model. The net effect is to slow future prepay speeds.

To understand how eliminating the regime effects leads to slower projected prepayment speeds, note that the regime period chosen last year as the basis for the entire forecast period was 2002-2003. That was a period of time when conventional loans were readily available for refinance opportunities, interest rates were low, and house prices were growing at strong rates. All three of those factors would lead to high prepayment speeds out of FHA, and high claim rates on the remaining loans that could not or would not refinance into the conventional market.

[34] This juxtaposition of higher rates of re-default, but lower rates of claim on those subsequent default episodes, has previously been identified for the FHA portfolio by researchers Brent Ambrose and Charles Capone. See, "Modeling the Conditional Probability of Foreclosure in the Context of Single-Family Mortgage Default Resolutions," *Real Estate Economics*, 1996, vol 26 (number 3, pp 391-429); and, "The Hazard Rates of First and Second Defaults," *Journal of Real Estate Finance and Economics*, 2000, vol 20 (3, pp 275-293).

[35] The one regime effect maintained in this year's actuarial model is for the 2004-2006 period, when subprime market activity was at its height. That is used to better calibrate the statistical model for periods without an aggressive subprime market, but is not applied in the forecast period.

For books of business prior to FY 2011, this change reduces the estimated economic value because the longer loans stay insured, the longer they are subject to default and claim opportunities. While that is likewise true for the FY 2011 book of business, the change by HUD to rely more on annual premium charges in 2011 more than offsets the increased claim risk, and it leads to increased economic value for the FY 2011 and future books.

c) Forward Loans: Adjustments for Foreclosed Loans

Foreclosure processing delays began early in FY 2011, after revelations that major loan servicers had utilized so-called "robo-signing" procedures. Such practices included routine failure to properly validate legal standing to initiate foreclosure actions, or even to document borrower default. As a result of public revelations of these problems, several major U.S. mortgage lenders suspended foreclosures across the United States in the fall of 2010. In April 2011, federal bank regulators imposed review requirements for major banks on foreclosure actions as far back as 2008.[36] HUD, along with a group of other Federal agencies and the various State Attorneys General, is currently working toward a further settlement with major mortgage lenders over correcting process mistakes that could have caused undue harm to homeowners. Then, additional process delays arise because numerous States have recently modified their laws to require servicer interaction with borrowers prior to foreclosure initiation, and the courts have been involved in declaring some foreclosure actions illegal. If a court deems the foreclosure action illegal due to insufficient documentation, the loan servicer must start the process all over again, but with correct documentation and procedures.

This situation posed two potential challenges for this year's actuarial study. The first is that there are now a large number of loans that have already gone through a foreclosure auction but have not yet gone to claim. Many of those have been in that position for more than six or even 12 months, suggesting that loan servicers are purposefully delaying filing claims until actual or potential challenges to the foreclosure actions are resolved.[37] The second is that the in-foreclosure, pre-auction inventory of loans has expanded due to the number of cases for which loan servicers are reviewing documentation to assure that it is adequate to pass court scrutiny before they schedule an auction. Exacerbating this growing foreclosure inventory are court backlogs in States that require judicial review of foreclosure actions before property auctions can be scheduled.

To address these issues, the independent actuaries first created judgmental rules to mark certain post-auction cases as most likely affected by documentation concerns. Those cases they assumed would be resolved toward claim at historical rates. They thus assumed that 90 percent will go directly to claim in FY 2012, and they assigned probabilities of claim to the other 10 percent

[36] See, for example, the consent decree with Bank of America, available from the Office of the Comptroller of the Currency at: http://www.occ.gov/static/enforcement-actions/ea2011-048.pdf

[37] Typical delays between foreclosure auction and claim filing can be two to four months, depending on the time necessary to record a valid property title in the name of the HUD Secretary, and for any eviction actions to take place. Time frames can be longer in cases involving State-required redemption periods. The number of post-auction cases that had been open for more than 12 months was 3,120 on September 30, 2010, but 10,982 on September 30, 2011.

using their default-transition forecasting model.[38] Use of the default-transition (or resolution) forecasting model to define probabilities of claim was also used for post-auction cases deemed not likely to have been affected by documentation problems.[39] The upshot is that this post-auction inventory results in close to 44,000 claims in the first two years of the actuarial forecast, with most of those in the first year (35,000).

To adjust for a portfolio where there are more unresolved cases after many quarters have passed since the initial 90-day default event, and the impact of greater concentrations of these loans being in judicial foreclosure states, the default-transition model was modified to allow for different default resolution probabilities in judicial and non-judicial states, and to provide for different resolution rates for loans for which more than four quarters have elapsed since the initial 90-day default event, as opposed to more than just three quarters (last year's model). The relative rate of claim versus other resolution types starting in quarter five is higher than in quarter four, and especially relative to (loss mitigation) assisted cures.[40]

d) HECM: Tax and Insurance Defaults

HUD's regulations require a HECM borrower-homeowner to maintain hazard insurance on the mortgaged property, and to pay all pertinent property charges (e.g., local real estate taxes) in a timely manner.[41] Failure to make those payments puts the loan in default. This year, for the first time, HUD was able to make loan-level data on such defaults available to the independent actuaries. With information on incidence of default and post-default repayment plans, the actuaries estimated a statistical model that was used to forecast loan terminations due to such defaults. The requirement to call defaulted loans due-and-payable has always been HUD policy, but in 2011 formal guidance was issued so that lenders have clear rules regarding how to address the arrears in an equitable manner. In this policy guidance, HUD instituted controls for the level to which those arrears may grow before the loan must be declared due-and-payable.[42] Under the new guidance, such actions occur when the lender/servicer determines that the borrower is unwilling to enter a repayment plan, or else they simply are unable to repay over a reasonable time period. This new guidance actually reduces projected losses on HECM loans because, without that guidance, the FY 2010 actuarial study projected accumulating arrears subject to possible HUD claim payments up to the time of borrower exit from the home. Now, they are effectively capped at two years of such arrears.

[38] The FHA foreclosure data since FY2007 suggests that about 85 percent of loans normally result in an insurance claim within one year of the foreclosure auction and 93 percent within two years.
[39] This model was built/calibrated using extended default periods that included foreclosures and post-foreclosure delays.
[40] FHA permits a borrower in default to cure their arrears up to the day of the foreclosure auction. It is not uncommon for cases to cure/reinstate or payoff even after the foreclosure auction takes place.
[41] See HUD Regulations at 24 CFR § 206.27(b)(2) and (b)(6)
[42] See Mortgagee Letter (ML) 2011-01, Home Equity Conversion Mortgage Property Charge Loss Mitigation, January 3, 2011.

4. Continuing House Price Declines

Price indices published by the Federal Housing Finance Agency are the basis of the MMI actuarial analysis. At the national level those indices peaked in mid 2007.[43] One recurring theme over the past two years has been that forecasts predicting a near-term end to declining prices have been premature. Monthly or quarterly increases in home values have often been followed by subsequent decreases. Though housing markets are recovering in many areas of the country today, a consistent upward trend over multiple quarters has not yet appeared at the national level.[44]

Figure 15 contrasts house price forecasts for the FY 2011 – 2020 period that were used in the 2009, 2010, and 2011 actuarial studies.[45] Forecasts used in the FY 2009 actuarial study predicted that home price growth would be solidly positive by 2011. Last year's forecasts predicted that there would be little negative growth in FY 2011, but this year's forecasts—dated July 2011—predict that the final house price growth for FHA's single-family portfolio in FY 2011 will be -5.6 percent.

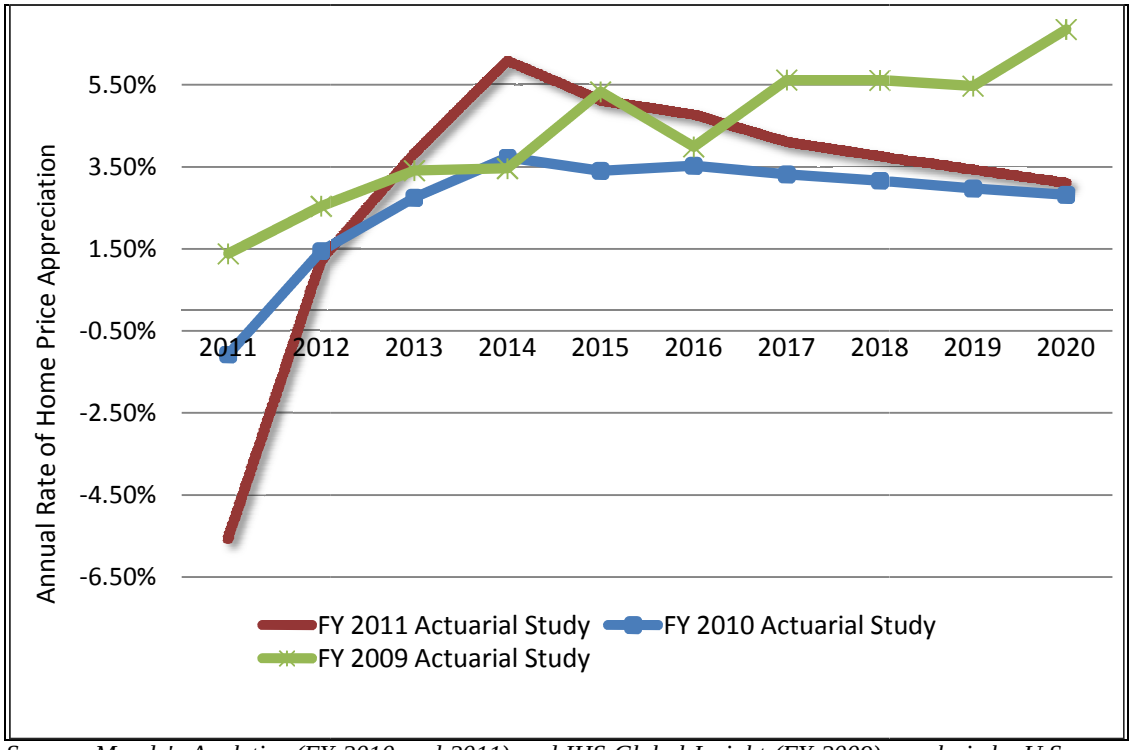
This additional year of home value declines in many areas of the country has produced additional stress on the MMI Fund portfolio, yielding both higher expected defaults and claims, and higher loss-on-claim than was anticipated one year ago.

[43] Other, broader indices such as the Standard and Poor's, Case-Shiller, 20-city index show the peak period to be in mid 2005. That index includes concentrations of properties subjected to subprime loans, and those sold in distress sales, both of which not in the FHFA index. The FHFA is also more appropriate for FHA analysis because geographic concentrations of portfolios are better matched.

[44] A discussion of the unevenness of housing recovery can be found in the narrative surrounding the most recent release of the Standard and Poor's Case- Shiller indices. The October 25, 2011, release, which describes data through August, is available at: http://www.standardandpoors.com/servlet/BlobServer?blobheadername3=MDT-Type&blobcol=urldocumentfile&blobtable=SPComSecureDocument&blobheadervalue2=inline%3B+filename%3Ddownload.pdf&blobheadername2=Content-Disposition&blobheadervalue1=application%2Fpdf&blobkey=id&blobheadername1=content-type&blobwhere=1245322696054&blobheadervalue3=abinary%3B+charset%3DUTF-8&blobnocache=true .

[45] The FY 2009 actuarial study used a national house price forecast from IHS Global Insight. For the FY 2010 study, the independent actuaries switched to metropolitan level house price forecasts by Moody's Analytics. That approach was used again for FY 2011. Using metropolitan-level price forecasts better aligns actuarial valuations with the actual geographic distribution of the insured portfolios. It also results in different overall price-appreciation rates for the single-family and HECM portfolios. In the current actuarial study, the expected FY 2011 house price decline for the HECM portfolio is 6.9 percent, versus 5.6 percent for the single-family portfolio.

Figure 15. Comparisons of 2011-2020 House Price Forecasts used in the 2009, 2010, and 2011 Actuarial Studies



Source: Moody's Analytics (FY 2010 and 2011) and IHS Global Insight (FY 2009); analysis by U.S. Department of HUD/FHA; appreciation rates are across the four quarters of each fiscal year; the FY 2010 and FY 2011 series are weighted averages based upon metropolitan level forecasts and FHA insurance volumes.

5. Economic Net Worth and Capital Ratio Estimates

The fundamental valuation of the MMI Fund is provided in Table 13. It combines the current net asset position of the portfolio (net capital resources) with actuarial estimates of the present value of future cash flows. The sum of the two is economic net worth (ENW), as defined by the National Housing Act.[46] ENW, in turn, is divided into the value of the outstanding, insured portfolio to calculate a capital ratio. ENW is down by $2.1 billion this year, from $4.7 billion to $2.6 billion. That decline is roughly evenly split between lower net capital resources and larger negative expected future cash flow. The lower ENW value, combined with a larger insurance-in-force ($1,078 versus $931 billion), yields a decline in the capital ratio this year from 0.50 to 0.24 percent.

Table 13 shows how the components of ENW are divided between the single-family and HECM portfolios. The ENW of the HECM portfolio increased by close to $1.9 billion this year while that of the single-family portfolio decreased by over $3.7 billion. The HECM portfolio is less affected by near-term economic conditions than is the single-family portfolio. In addition to

[46] See, 12 USC 1711(f).

policy and premium changes that boosted the value of HECM loan guarantees, the program also benefitted this year from a transfer of $535 million from the single-family capital accounts. That transfer was made in FY 2011 as a result of the financial position of the HECM portfolio one year ago, and principally, to offset a lower expected value of the FY 2010 book—per last year's ENW assessment. This was the second consecutive year that HECM required a transfer from the single-family accounts. Those transfers were because HECM has only been in the MMI Fund since FY 2009, and therefore, had no established capital reserves of its own. Given that HUD has now substantially re-stabilized HECM financials through various underwriting and servicing controls, lower equity take-out allowances, and higher premiums, it is highly likely that the transferred funds can be returned to the single-family accounts in the future.

Table 13. Independent Actuarial Assessments for FY 2011 (millions)

	FY 2010	FY 2011		
	Summary[a]	Single Family	HECM[b]	MMI Fund
Beginning-of-Year Positions[c]				
Cash		$ 26,309	$ 3,011	$ 29,320
Investments		4,128	20	4,148
Properties and Mortgages		3,292	2	3,294
Other Assets and Receivables		12	1	13
Total Assets		33,741	3,034	36,775
Liabilities (Accounts Payables)		(2,940)	(2)	(2,942)
Capital Resources at Beginning of Year	$ 33,594	$ 30,801	$ 3,032	$ 33,833
FY 2011 Activity				
Net Gain from Investments		$ 1,139	$ 190	$ 1,328
Net Insurance Income		(2,440)	484	(1,956)
Net Change in Value of Property Inventory		(868)	16	(852)
Net Change in Accounts Payable		85	(8)	77
Transfer to HECM Financing Account		(535)	535	-
Capital Resources at End-of-Year		$ 28,183	$ 4,248	$ 32,431
Actuarial Calculations[d]				
Present Value of Future Cash Flows on Outstanding Insurance	$ (28,937)	$ (26,990)	$ (2,890)	$ (29,880)
Economic Net Worth	$ 4,657	$ 1,193	$ 1,358	$ 2,551
Capital Ratio Calculations				
End-of-year Amortized Insurance-in-Force[e]	$ 931,272	$ 1,009,153	$ 68,373	$ 1,077,526
Capital Ratio[f]	0.50%	0.12%	1.99%	0.24%

[a]Data in this column are from the FY 2010 Actuarial Reviews of the Single-Family and HECM programs of the MMI Fund.
[b]HECM amounts appear small compared to the entire HECM portfolio. That is because HECM has been included in the MMI Fund starting only with FY 2009 insurance endorsements.
[c]Beginning of year positions are from FHA's audited FY 2010 financial statements.
[d]Actuarial calculations for Single-Family and HECM come from the respective FY 2011 Actuarial Reviews.
[e]Amortized Insurance-in-Force represents outstanding loan balances for forward loans and maximum claim amounts for HECM. Dollar amounts shown here for 2011 represent end-of-year estimates made by the independent actuaries before end-of-year data was available.
[f]The 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, FY 2010 and FY 2011 independent actuarial study final review reports.

6. How HECM Business now has Positive Value in the MMI Fund

In the FY 2010 actuarial study, the outstanding 2009-2010 HECM portfolio had negative economic net worth even after a mid-year transfer of $1.75 billion from the single-family capital account. This year, the combined 2009-2011 HECM portfolio has an implied capital ratio of nearly two percent. That, however, is with the inclusion of a total of $2.3 billion in transfers from the single-family accounts over the past two years. Without those transfers, HECM would still be in a negative capital position ($925 million).

At the same time, the FY 2011 book is actuarially sound, as are future books of business, under base-case economics. The sum of the remaining economic value of the FY 2011 book (-$159 million) and current account balances for that book ($315 million) is $256 million, which is 1.36 percent of the endorsement volume. The HECM program was substantially righted in 2011 through a more than doubling of the annual premium rate (from 0.50 to 1.25 percent), introduction of the Saver option (which has a better economic value per dollar), and slight additional reductions in equity take-out percentages under the Standard option.

Actuarial projections are that post-recession books will have economic net worth of an even higher four percent of endorsement volumes. HECM could then potentially pay back the single-family program for recent fund transfers and still have a stand-alone capital ratio of two percent by 2015.

Other factors contributing to the improved value of the HECM portfolio this year are new controls on the potential claim costs of tax-and-insurance arrears, higher annual premium rates starting in October 2010 (1.25 versus 0.50 percent), and the new loss mitigation policy that limits claim liability for tax and insurance defaults.

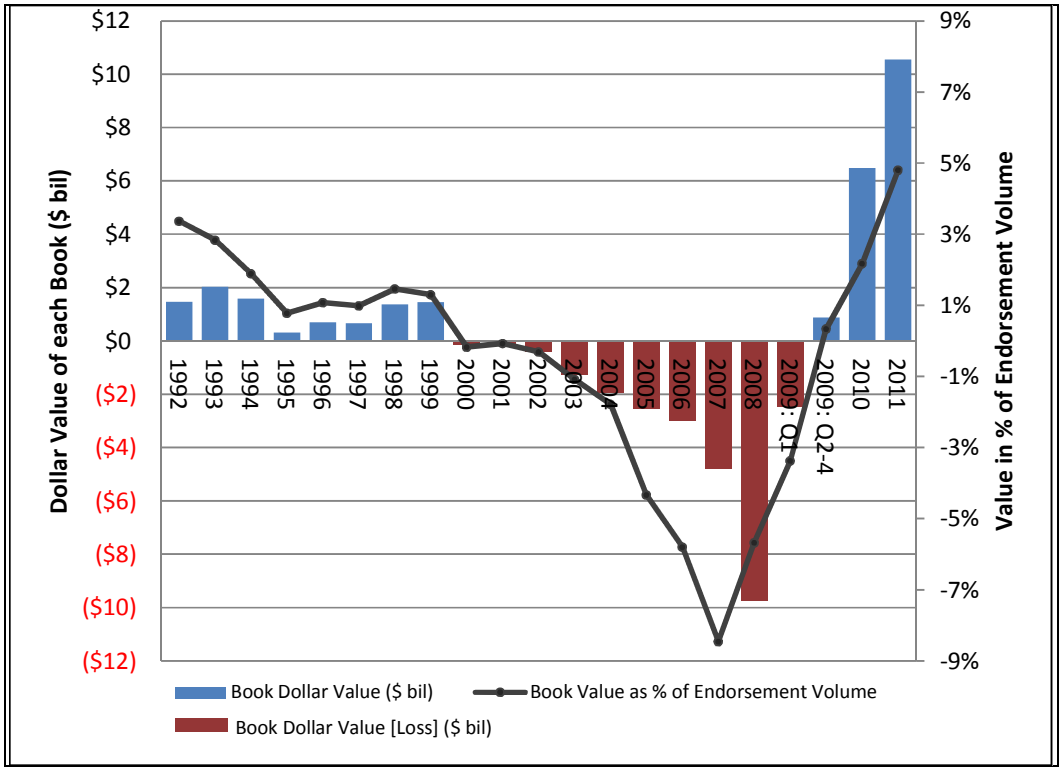
7. Economic Net Worth by Book-of-Business

The (single-family) books-of-business insured during the run-up of home prices in the past decade are all expected to result in net losses for the MMI Fund. The peak book for losses per-dollar of insured loans is 2007, the year that also is experiencing the greatest total decline in home values. When that book is finally closed, it is expected to have cost 8.5 cents for every dollar insured. Though the 2008 book has a lower loss-per-dollar—on the order of 5.7 cents—that book was three times as large as 2007, and therefore, has expected dollar losses that are double those of 2007 ($9.7 versus $ 4.8 billion). In addition to being originated near the peak of the housing bubble, the 2007 and 2008 books were also heavily affected by seller-funded downpayment loans. Those loans were eliminated by Congress as of October 2008, so they essentially disappear from new endorsements starting in January 2009. However, their ongoing effect on the financial status of the MMI Fund is still measurable.[47] The independent actuaries

[47] Their on-going effect is not only in remaining home purchase loans that could still result in an insurance claim, but also through streamline refinancing that brought many of the 2005-2008 loans into the 2009 and even 2010 books.

estimate that economic net worth would be higher by over $14 billion had such loans never been insured.[48]

Figure 16. Estimated Lifetime Value of Each Single-Family Book of Business, 1992-2001



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

8. Expected Growth in Economic Net Worth and the Capital Ratio over Time

In the base-case economic forecast, the MMI Fund capital ratio surpasses 2.0 percent in FY 2014. Such recovery is predicated upon a number of assumptions, most especially that home prices begin to recover in 2012, with robust growth beginning in 2013 (see Figure 14). A short time horizon for going from very low capital to two percent is not without precedent. When Congress instituted the 2.0 percent requirement in 1990, it provided HUD with ten years to go from zero to 2.0 percent capital. However, it took only three years to reach the 2.0 percent level once premium increases mandated by the 1990 law took effect in July 1991.[49]

[48] The net expected cost of those loans, as projected by the independent actuaries, grew by $1.8 billion over the past year to $14.1 billion.

[49] The reported capital ratio in the FY 1994 Actuarial Review was just 1.99 percent, but that was based upon original insurance volumes of outstanding loans and not current loan balances. The reported ratio using outstanding loan balances was 2.16 percent.

Today's premiums are expected to provide greater net resources than did those instituted in 1991. The expected value of today's premium revenue stream on each new dollar of insurance in FY 2012 is 7.8 cents, according to the new actuarial calculations.[50] Were the 1991-1992 premium structure applied to today's business, it would be worth a smaller 6.7 cents per dollar of insurance. The 1992-1994 premium structure established by Congress would be even less beneficial, with an expected value of only 5.9 cents per dollar of insurance. [51]

Table 14. Annual Projections of MMI Fund Economic Net Worth and Capital Ratio under Base-Case Economics, 2011 - 2018

Fiscal Year	Insurance in Force (billions)	Economic Net Worth (billions)	Capital Ratio
2011	$ 1,078	$ 2.551	0.24%
2012	1,143	11.458	1.00
2013	1,199	18.739	1.56
2014	1,278	27.712	2.17
2015	1,395	37.973	2.72
2016	1,540	47.958	3.11
2017	1,581	58.220	3.68
2018	1,662	69.481	4.18

Source: FY 2011 independent Actuarial Reviews of the MMI Fund; analysis by U.S. Department of HUD/FHA.

That recovery of MMI capital will occur is well assured by the historically-high premium rates charged today, and by controls put in place over the past two years to avoid the possibility of a repeat of the adverse selection that affected FHA prior to 2009. FHA's MMI Fund programs today are actuarially sound for new endorsements. The principal unknown for the future remains how and when housing markets will recover.

a) Volume and Loan Characteristics Forecast

Growth of economic net worth and the capital ratio over time is also dependent upon new endorsement volumes and the characteristics of loans insured in the future. The forecast of recovery of the capital ratio under base-case economics is not assuming current volumes or borrower credit quality but lower volumes and quality. The dollar volume of endorsements seen in 2011 is not expected to be matched again until 2018 (Table 18).

[50] These calculations respect the frequency and timing of loan termination events across the life of the cohort, as projected in the base-case scenario. Forecast premium revenues are discounted to calculate a present value as of today.

[51] The 1990 law raised premiums starting in 1991, but then had mandatory step-downs of the upfront premium in 1992 and 1994. HUD is under no such requirements today and will adjust premiums as necessary to balance the goals of providing affordable mortgage credit, preventing adverse selection, and restoring the capital ratio in a timely fashion.

The independent actuaries assume that FHA will migrate to a less favorable credit-quality distribution over time. The five-year projections assume credit quality returns to something similar to that of 1995-1996, a time period when there was a vibrant conventional mortgage market, but it was not overly aggressive in high loan-to-value or low- and-moderate-income lending. For home-purchase lending, the share of borrowers with credit scores of 720 or greater is projected to decline from 40 percent in 2011 to only 22 percent in 2015. For (non-streamline) refinance loans, the share of borrowers with credit scores of 720 or greater would decline from 39 to 16 percent over the same time period.

This year both single-family and HECM actuarial studies have statistical models that forecast new insurance volumes in the future. This permits insurance activity levels to be functions of economic conditions and market-level forecasts of mortgage originations, providing for more realistic assessments of the migration of the economic net worth and the capital ratio over time.

For home purchase loans, the longer-term trajectory of these models is still tied to HUD projections of FHA market shares. Without that, the models would have long-term market shares that look like an historical average of ten percent. Though the futures of Fannie Mae and Freddie Mac have yet to be determined, HUD does not envision during the foreseeable future a return of private capital to high loan-to-value ratio lending at the rates seen in the decade prior to the 2008 financial crisis. Thus, HUD asked the actuaries to permit the current purchase-loan share of 30 percent to gradually decline only to 20 percent by FY 2018.[52] That would presume some return of private capital into the market space occupied today by FHA. This would be accompanied by a movement of FHA back toward borrowers with 620-660 credit scores, and away from those with credit scores of 720 and above.

Refinance volumes, however, are fully determined by the independent actuaries' forecasting model. As the base-case economic forecast (by Moody's Analytics) is for interest rates to rise rapidly in FY 2013, forecasted refinance activity drops dramatically in that year. Refinance activity stays low for many subsequent years because the FHA portfolio will still be dominated by loans originated between 2009 and 2012, which will have below-market interest rates.

HECM volume assumptions are based on a demand-forecasting model developed by the independent actuaries. That model uses a combination of house prices, interest rates, and growth in the senior population to predict how HECM volumes will change over time. The characteristics of future borrowers are based primarily upon characteristics of loans insured in 2011. That includes cash-draw rates over time, the gender and marital mix of borrowers, geography, and distribution of home values relative to area median prices. The share of HECM Saver loans is expected to continue to grow until it reaches 20 percent of new dollar volumes in FY 2017.

[52] The most significant value of having these new forecasting equations is to permit FHA market shares and volumes to adjust with changing economic conditions. This establishes one basic requirement of future development to permit use of this forecasting tool with Monte Carlo simulations of economic conditions.

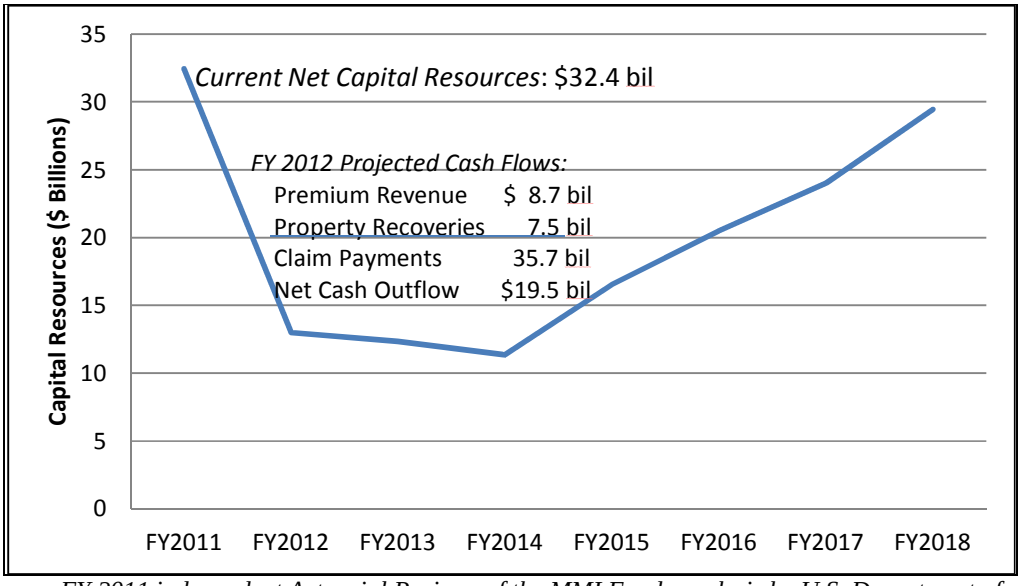
Table 15. Projected MMI Fund Program Endorsement Volumes , 2012 – 2018 (millions)			
Fiscal Year	**Single-Family**	**HECM**	**Total**
2011	$ 219,402	$ 18,792	$ 238,194
2012	153,923	17,981	171,904
2013	136,430	22,592	159,022
2014	166,753	26,425	193,178
2015	206,430	31,889	238,319
2016	199,156	36,243	235,399
2017	193,575	40,027	233,602
2018	199,247	43,451	242,698

Source: FY 2011 independent actuarial reviews of the MMI single-family and HECM portfolios.

9. Near-term Cash Flow Expectations

The independent actuaries assume that foreclosure cases affected by the robo-signing crisis will be resolved in 2012, and that those resolutions will nearly all be for FHA insurance claims and not actions that would put financial responsibility for faulty foreclosure procedures on the loan servicers themselves. This is a very conservative assumption that would establish the maximum possible cash-flow drain in 2012. Should the projected number of claim filings take place, the MMI Fund will pay out more than twice as much in claims in FY 2012 as in FY 2011, over $35 billion.[53] After accounting for expected premium revenues and property-sale proceeds, core insurance operations will have a net cash outflow of over $19 billion, and the MMI capital resources at the end of FY 2012 would be $13 billion.

Figure 17. Projected Capital Resources under Base-Case Economics, 2011-2018



Source: FY 2011 independent Actuarial Reviews of the MMI Fund; analysis by U.S. Department of HUD/FHA.

[53] This amount includes $1.2 billion in expected lender incentive payments for loss mitigation claims.

C. RISKS TO THE ACTUARIAL FORECAST

The base-case economic forecast used by the independent actuaries is the median expected path of the economy over the next five-to-ten years, as determined by Moody's Analytics.[54] That path has home prices stabilizing in the coming months, starting to rise in 2012, and then entering an extended period of sustained growth in 2013. Being a median path means there are equal chances that actual results could be better or worse than what is presented in that forecast. With economic net worth being very close to zero under the base-case forecast, the chance that future net losses on the current, outstanding portfolio could exceed current capital resources is close to 50 percent. Negative house price growth in FY 2012, rather than stable or growing prices, would cause such a situation to develop. The first place where additional support for the current portfolio would come from is net receipts on new endorsements. Under the base-case scenarios, the FY 2012 book will add an additional $9 billion in economic value to the Fund.

However, if home prices decline in FY 2012, then the value of the 2012 book will be something less than $9 billion. Thus, any worsening of economic conditions in 2012 that creates a diminished value on the current, outstanding portfolio in excess of approximately $7 billion would put the MMI Fund in a position where additional action would be required. Such action could come in the form of increased mortgage insurance premiums or special assistance from the U.S. Treasury.[55] Any assistance from the U.S. Treasury would be in the form of a one-time transfer of monies to the MMI Fund in order to re-establish the necessary loss reserves for the expected elevated level of future claim expenses (after property recoveries). Just how much assistance might be required would principally be a function of how much home prices fall in the near future, and the offsetting impact of any policy changes implemented by HUD.

Except under very severe scenarios, any special assistance needed from the Treasury would be for pre-2010 books of business only. The 2010 and 2011 books have positive economic value under base-case assumptions. It would take significant additional declines in home values to completely erode the value of the 2010 book, and even the most severe scenario run by the actuaries would not completely erode the positive value of the 2011 book.

1. Creating Alternative House-Price Scenarios

Moody's Analytics provides four alternative short-run economic scenarios. One is an optimistic case, in which home prices start to rise immediately. The other three represent successively worse housing market conditions over the 2012 -2013 period. Specifically, the scenarios presented are: a stronger near-term rebound (S1), a mild second recession (S2), a deeper second recession (S3), and a protracted slump (S4). Moody's defines the chance of each alternative in terms of percentiles in an overall distribution of potential economic outcomes. Those percentiles

[54] The FY 2011 independent actuarial studies used Moody's July 2011forecasts of house prices, interest rates, and mortgage originations, along with age-group population growth projections of the U.S. Bureau of the Census.
[55] Though the independent actuaries project under the base-case that economic net worth will reach $11.5 billion in one year, that includes the value of the new 2012 book of business of $9 billion (single-family plus HECM). Under adverse economic conditions, that value would be diminished. Under the S2 Mild Second Recession scenario, the combined 2012 book (single-family plus HECM) is worth less than $6 billion.

for each of these four scenarios are the 10th (S1), 75th (S2), 90th (S3), and 96th (S4). Each represents a position within the total range of economic environments that Moody's predicts are possible over the next several years.

Because these are short-run scenarios, the independent actuaries adjusted them to create alternative long-run scenarios for MMI Fund programs. The adjustments were designed to remove the migration back to base-case home price levels built into the Moody's short-run forecasts. In those forecasts, home prices return to the same trend line after experiencing additional downward pressures in 2012 and 2013. The return to trend occurs over a number of years, but it necessitates very high annual rates of growth in the intermediate term in order to return home prices from deeper recessionary troughs to the base-case price levels.

What the actuaries did was to follow the Moody's alternative paths until prices reach their new low points. After those time periods, annual rates of price *growth* are permitted to return to the base-case—but without any acceleration that would bring price *levels* back to the base-case trend line. This creates alternative scenarios where prices move parallel to the base case once recovery sets in, but never return to the base case values. The adjusted-scenario growth rates used by the independent actuaries are shown in Table 16. The resulting price trends are shown in Figure 18.

For FY2011, the three adverse scenarios (S2, S3, and S4) appear to present much higher price declines than could have actually occurred in FY 2011. Even though final information on home prices for the entirety of FY 2011 is not yet available, the most recent report by the Federal Housing Finance Agency (FHFA) indicates that, for the first 11 months of the fiscal year, home values were down just over 4 percent at the national level, and most of that decline occurred in the first two quarters of the year. [56] Thus, the adverse scenarios created by Moody's Analytics create extreme stress in FY 2012 and beyond by first marking down the value of the current portfolio by additional amounts at the very start of the forecast period. This affects mortgage defaults and claims immediately in FY 2012.

Even the S2 Mild Second Recession scenario represents a significant decline in home values beyond the base case. By the end of FY 2012, the Mild Second Recession has an additional 9 percent decline in home prices beyond the 5.6 percent base case decline, for a total two-year decline of 14.6 percent.[57] In contrast, the worst two-year period recorded by the FHFA was from 2007 Q2 to 2009 Q2, when prices fell just under 13 percent.[58] Thus, even the Moody's "Mild" Second Recession scenario is worse than the worst experience of the start of the recent economic crisis.

[56] See the August report, which was released on October 25, 2011, and is available at: http://www.fhfa.gov/webfiles/22726/MonthlyHPI102511F.pdf . Nearly all of the year-to-date declines in home values came in the first two quarters of the fiscal year. There was then growth in most regions during the third quarter, and then a mixture of growth and decline across Census Divisions in the first two months of the fourth quarter.

[57] The comparative decline under each alternative scenario is computed based on cumulative declines from the start of FY 2011.

[58] See the full 2011 Q2 HPI Report, which is available at: http://www.fhfa.gov/webfiles/22638/2q2011HPI.pdf .

Table 16. House-Price Growth Rates on the Current FS2 HA Single-Family Portfolio under Various Economic Forecast Scenarios

Economic Forecast Scenario[a]	Time Period				
	FY2011[b]	FY2012	FY2013	FY2014	Additional Price Decline Beyond Base Case[c]
Base-case	-5.6%	1.2%	3.8%	6.1%	
S1: Stronger near-term rebound	-3.8	1.3	3.8	6.1	
S2: Mild Second Recession	-13.7	-1.3	3.8	6.1	9%
S3: Deeper Second Recession	-16.2	-6.2	2.5	6.1	16
S4: Protracted Slump	-18.4	-8.3	-0.3	6.1	20

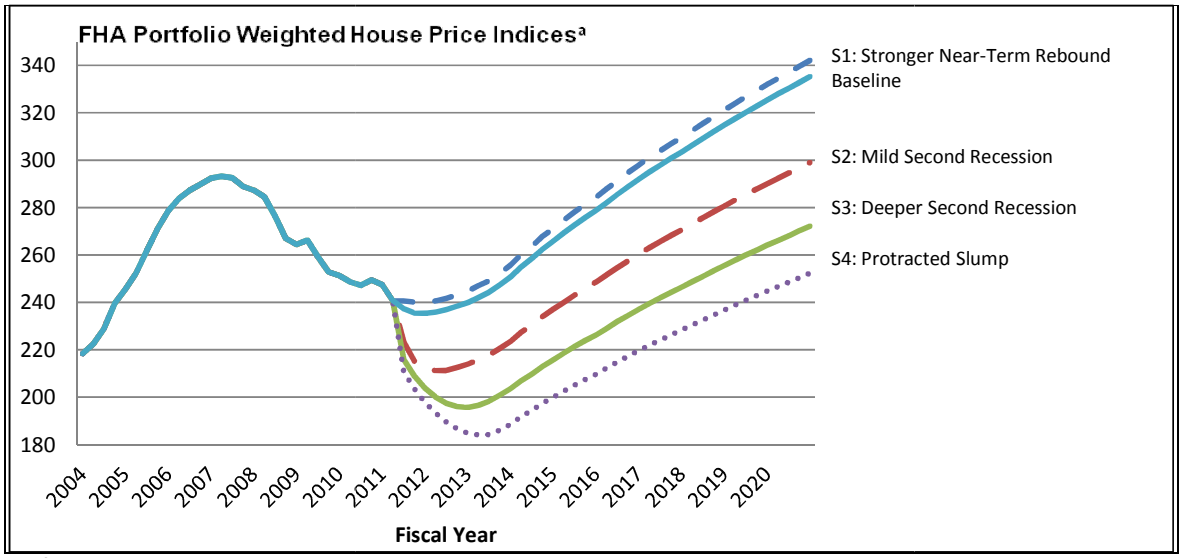
[a]These scenarios are named for the general economic climate and not the housing market itself. Thus, the additional house-price decline in the "Mild" Second Recession is of significant consequence.

[b]The severe FY 2011 price declines under the S2, S3, and S4 scenarios assume there are latent forces at work that reveal themselves through increased mark-downs of the value of the current portfolio at the start of the forecast period.

[c]Using the start of FY 2011 as the base period for comparison of total effects.

Source: Moody's Analytics (July 2011 forecasts) and IFE Group; analysis to create FHA portfolio-weighted growth rates from MSA rates by U.S. Department of HUD/FHA; fiscal year growth rates are computed as calendar year 3rd quarter over previous year 3rd quarter; in the FHA portfolio-weighted price index the peak time period was 2007 Q1.

Figure 18. House Price Paths used by Independent Actuaries for Sensitivity Analysis



[a] Portfolio weighting involved creating weighted average national price growth rates using metropolitan level forecasts and FHA active insurance volumes in each MSA (and non-metro areas) as of July 2011. Index values equal 100 in 1995 Q1.

Source: Analysis by the U.S. Department of HUD/FHA using historical and Moody's Analytics' forecasts of the FHFA all-transactions house price index at the metropolitan level, as adjusted by IFE Group.

2. Economic Net Worth under Alternative House-Price Scenarios

Under the base case and S1 scenarios, the MMI Fund begins immediately to grow capital. In those scenarios the two percent threshold is reached in 2014 and 2013, respectively.

The principal risk confronting the MMI Fund is a continued decline in home prices into 2012 and even into 2013. That brings attention to the S2, S3, and S4 scenarios. In surveying the results of each house-price scenario, there are two outcomes to focus on. First is the estimated economic net worth at the end of FY 2012. If one of the more stressful house-price paths reveals itself over the next year, the resulting negative economic net worth at that time, without considering the impact of any potential policy changes, is the amount of special assistance from the U.S. Treasury needed to immediately cover the new and larger expected losses on the older books of business. The second outcome of focus is the additional time necessary to build two percent capital after starting again from zero.

Table 17 shows the special assistance required from the U.S. Treasury at the end of FY 2012, should any of the three more stressful scenarios tested by the independent actuaries emerge over this next year, and presuming no further policy changes. Those amounts are simply the amounts of negative economic net worth projected at the end of FY 2012. The table further shows how quickly the MMI Fund would rebuild capital after the one-time assistance effectively resets it to zero. Under each scenario, having excess losses on the older books eliminated through this special assistance permits the new books of business to rebuild capital over a reasonable period of time. By 2018, the Fund has re-built two percent capital even under the S4 Protracted Slump scenario.

Were such special assistance required, it would be a one-time injection of monies into the MMI Fund Financing Accounts to re-establish required loss reserves. FHA's ability to rebuild capital after that suggests that, were HUD required to repay the special assistance, it could do so in a reasonable amount of time. In the S2 Mild Second Recession scenario the payback period would be just over two years; in the S3 Deeper Second Recession it would be just over five years; and in the S4 Protracted Slump it would take eight years to produce enough net receipts from new business to repay the assistance provided at the end of FY 2012.

Table 17. Future Capital Positions under Stressful Alternative House-Price Scenarios (millions)

Fiscal Year	S2: Mild Second Recession	S3: Deeper Second Recession	S4: Protracted Slump
Required Assistance from the Treasury to Meet Loss Reserve Targets			
2012	$ 13,170	$ 29,782	$ 43,229
New Capital Accumulation Over Time			
2012	$ 0	$ 0	$ 0
2013	4,842	3,110	2,011
2014	11,423	7,821	5,268
2015	19,584	14,316	10,491
2016	27,709	21,063	16,111
2017	35,993	27,950	21,846
2018	45,081	35,535	28,195
2018 Capital Ratio	2.98%	2.52%	2.12%
Year Capital Ratio Reaches 2%	2016	2017	2018

Source: FY 2011 independent Actuarial Reviews of the MMI Fund; analysis by U.S. Department of HUD/FHA.

3. Low Interest Rate Scenario

The base-case Moody's forecast assumes that vigorous economic growth in 2013 is accompanied by a significant rise in interest rates. What that does for outstanding books of business is slow down future prepayment speeds. Such a situation presents both positive and negative realities for the MMI Fund. The slow-down of prepayments exposes loans to default and claim potential for longer periods of time. With books prior to 2011, that leads to increased losses because net new claim expenses are greater than increases in premium revenues. For the 2011 and future books, which have substantially higher annual premium rates, the longer expected life of loans actually enhances the value of each book.

After the publication of the Moody's forecast in July 2011, the Federal Reserve Board of Governors announced an intention to maintain very low rates well into FY 2013.[59] To measure Fund performance under such a deviation from the Moody's base-case forecast, the independent actuaries created an alternative economic scenario in which current interest rates are held steady for two more years, and then permitted to gradually increase until they reach the Moody's base-case forecast values. While that effectively would result in a negative capital ratio today (-0.31 percent), it is only because of the additional run-off of the current portfolio in FY 2012 and FY

[59] See the announcement at: http://www.federalreserve.gov/newsevents/press/monetary/20111102a.htm .

2013, without respecting the recapture of much of that business in new endorsements. Once new endorsements are added, the capital ratio is 0.63 percent at the end of 2012 and 1.59 percent at the end of 2013. The two percent threshold is met in 2014, just as in the base-case scenario. Most of the projected increase in loan prepayment activity in 2012 and 2013 in the low-interest-rate scenario would come from loans currently in the pre-2010 books.[60] Those loans that refinance again with FHA will pay higher premiums than they are paying today.[61]

[60] Forecasted loan prepayment speeds do slow down from current rates, however, because of the "burnout"phenomenon mentioned earlier in this report. The independent actuaries build burnout into their forecasts, via statistically-derived factors that reduce prepayment speeds over time even as refinancing stays in-the-money for various groups of borrowers.

[61] In the base-case, the projected FY 2012 single-family endorsement volume is $154 billion. In the low-interest-rate scenario that rises to $195 billion. The increase would primarily be from new refinance loan endorsements, but would also include some increase in home-purchase loan activity spurred by the lower interest rates.

III. Actions Taken to Strengthen the Fund for the Future

Having taken office in the midst of the greatest recession since the Great Depression and faced with a housing market in crisis, this Administration acted immediately to strengthen FHA and protect its insurance Funds. By instituting the most sweeping reforms to credit policy, risk management, lender enforcement, and consumer protection in FHA history, HUD is ensuring that FHA will continue to be a stabilizing force in the nation's mortgage markets for many years to come. The impact of these reforms is clear, as the independent actuaries estimate that even under significantly worst economic scenarios FHA's books of business from 2010 forward will maintain positive economic value.

A. PREMIUM CHANGES

Beginning in 2010, FHA raised its mortgage insurance premiums three times. In April of 2010, the upfront mortgage insurance premium (MIP) was raised to 2.25 percent. Then, in October of 2010, using new flexibility granted by Congress, FHA decreased the upfront MIP to 1% and increased the annual MIP by 35 basis points. Finally, in April of 2011, the annual MIP was increased once again by 25 basis points. In addition, HECM annual premium rates were more than doubled in October 2010, from 0.50 percent to 1.25 percent per year. FHA's current premium levels are the highest they have ever been in the agency's history. The new annual mortgage insurance premium structure alone led to an increase in the FY 2011 economic value of the MMI Fund of $1.37 billion. It should also be noted that due to today's historically low interest rates, FHA has been able to strengthen the MMI Fund through its premium increases without jeopardizing housing affordability.

B. PROGRAM AND CREDIT POLICY

1. Minimum Borrower Credit Quality

In addition to changing its insurance premiums, FHA has undertaken a number of program and credit policy changes over the past year. These changes, some of which are described below, will continue to contribute to the long-term sustainability of the Fund. The first and most important of these is the implementation last year of a two-step credit score policy for FHA borrowers. Those with credit scores below 580 are now required to contribute a minimum down payment of 10 percent, or have equity of 10 percent at the time of refinance. Only those with stronger credit scores are eligible for FHA-insured mortgages with the minimum 3.5 percent down payment.

2. HECM

Another significant area of change has been in the HECM program. In September of 2010, FHA introduced the HECM Saver product as a second option for reverse mortgage borrowers. The HECM Saver offers significantly reduced upfront loan closing costs for mortgagors who wish to borrow less than the maximum amount available under a standard HECM loan. In addition, FHA adjusted the principal limit factors used to determine the maximum claim amount for HECM loans to assure that HECM Standard could be self-supporting. Finally, FHA provided guidance for lenders regarding the treatment of tax-and-insurance defaults by HECM borrowers. These policy measures have significantly strengthened the HECM program so that it can continue to provide important financial options for seniors without posing unnecessary risks to the MMI Fund.

3. Condominium Policy

FHA also made substantial modifications to its condominium policies this past year. These include the introduction of a project re-approval and recertification process for FHA-approved condominium projects, as well as a comprehensive revision of FHA's Condominium Project Approval and Processing Guide. These changes ensure the compliance of condominium projects with FHA requirements while updating those policies to better accord with industry trends and norms.

4. Lender Loss Mitigation Requirements

Finally, enhancements were made to FHA's loss mitigation requirements to increase the use of trial payment periods prior to the mortgagee executing a Loan Modification or Partial Claim action to cure a default. Trial payment plans are expected to reduce re-default rates on loan modifications and partial claims, and thereby reduce costs to the FHA Insurance Fund.

C. STRONGER LENDER ENFORCEMENT AND OVERSIGHT

In addition to enhancements to credit and program policies, HUD has also worked diligently to strengthen its FHA lender oversight and enforcement capabilities. Beginning with the Department's approval requirements for lenders that wish to participate in FHA programs, HUD has instituted new policies and procedures to address the full lifecycle of its counterparty risk.

1. Lender Approval

As of May 20, 2011, the required net worth for FHA lender approval or renewal was increased to $1 million, with 20 percent of that amount being in liquid assets. Effective May 20, 2013, the

required net worth for FHA lenders will increase further and be a function of lender annual dollar volumes of FHA endorsements. An exception is provided for lenders that meet the small business size standard set by the Small Business Administration. Such lenders must currently possess a net worth of $500,000, but they must still achieve HUD's higher required net worth standards by 2013. These changes to FHA's lender net worth requirements will make certain that only those entities with the financial capacity appropriate to the conduct FHA business receive and maintain FHA approval.

Additionally, HUD eliminated the approval of loan correspondents for originating FHA-insured loans. This change drastically reduced FHA's pool of approved lenders, focusing FHA's lender monitoring resources on the principal underwriting lenders, and permitting better targeting of resources to those that pose a higher risk to the MMI Fund.

HUD also began requiring audited financial statements for supervised lenders (i.e. banks, thrifts, and credit unions) when they submit applications to renew their FHA lender approval status. Non-supervised lenders have always been required to submit such financial statements, so this measure both increases consistency for FHA's lender approval requirements for bank and non-bank lenders, and provides FHA with greater assurance of the health of its supervised lender partners.

2. Lender Oversight and Monitoring

HUD is now instituting substantial changes to Post Endorsement Technical Reviews (PETR) of underwriting files for newly endorsed loans. This includes the development of improved methods of identifying loans for review and focus on lender portfolio performance. Specifically, FHA has worked to create a risk-based algorithm for loan selection that provides differential weights to each element based on their importance in underwriting, and has established consistency between PETER review methodology and other types of lender reviews performed by HUD.

Enhancements have also been made to the loan selection criteria for FHA lender compliance reviews. That includes an increase in the number of risk indicators considered in the loan-targeting methodology to ensure that those lenders that pose the highest risk to FHA are identified for review. This new targeting methodology has allowed staff to review a smaller number of loans while focusing on a wider array of potential risk factors. A single loan reviewed may be flagged for numerous risk factors, resulting in more in-depth scrutiny.

HUD has also worked to strengthen accountability for lenders participating in the Lender Insurance (LI) Program, the program by which the majority of FHA loans are insured. In accordance with a final rule to be published in the very near future, FHA will evaluate lender eligibility for participation in the LI Program on a continual basis to ensure ongoing compliance with program requirements and provide specificity regarding those requirements. Additionally, the rule outlines requirements related to lender indemnification of HUD for loans that were improperly originated, or for which fraud or misrepresentation were involved. This final rule will

permit FHA to improve its oversight of LI lenders and better protect its insurance Funds from the adverse effects of non-compliant loans.

Finally, FHA is also in the process of fully implementing a Servicer Performance Scorecard (SPS) following a successful pilot with major servicers. The SPS will provide a better method of ranking servicer engagement in loss mitigation and selecting high performers for payments of quality-based incentives. Those incentives are in the form of better reimbursements rates for expenses related to foreclosure and property transfers to HUD, and the use of SPS to better select incentive recipients will provide estimated savings of over $12 million per year.

As HUD continues to seek ways to strengthen its management of risk, additional authority from Congress would further enhance its ability to protect the various FHA insurance Funds. Specifically, FHA would benefit fromṇan expansion of the Department's authority to require indemnification for loans that do not comply with FHA requirements and increased flexibility in FHA's ability to terminate lenders.

D. CONTINUED DEVELOPMENT OF THE OFFICE OF RISK MANAGEMENT

Integral to the long-term sustainability of the MMI Fund is a culture of risk-minded decision making at HUD. An effort that began with this Administration is the development of the Office of Risk Management and Regulatory Affairs (ORMRA) within the Office of Housing. This new Office provides for a central focus on risk tolerance, risk exposure, and risk management for each of the various FHA program areas. The complete establishment and integration of the Office within FHA are top priorities for the Department. While there is still work to be done to fully establish a comprehensive risk-management framework, significant progress has already been made.

1. Staffing ORMRA

Over the past fiscal year, ORMRA has hired over 15 new employees. These hires bring with them a diverse background in risk management, covering all of FHA's core lines of insurance business; Single-Family, Multi-Family, and Health Care Programs. In addition to hiring risk managers to advise and oversee core business areas, ORMRA has also hired risk managers to oversee the broader operational risks that are present within any financial institution. Following the transition of the first Deputy Assistant Secretary for ORMRA to a new role as special advisor to the HUD Secretary, a Senior Advisor for Risk has recently joined FHA to provide continued leadership and expertise in risk management.

2. ORMRA and Risk Management at FHA

ORMRA has become a significant part of the business operations within FHA. As partners to each business line and program area, the risk managers are involved in a wide array of policy and

operational decision making processes. On a monthly basis, formal meetings are held between ORMRA and each of the business lines to discuss emerging risks, recent trends, and policy updates. In addition, ORMRA provides substantial capacity for risk monitoring and reporting, and for general portfolio analysis. Over the next fiscal year, ORMRA has plans to further enhance its analytical capabilities with a variety of new tools.

E. LEVERAGING NEW TECHNOLOGY RESOURCES

In addition to the steps HUD has taken to strengthen the Fund via policy, process, and organizational changes, the Department is also engaged in a large-scale effort to acquire and employ a modern financial services information technology environment to better manage and mitigate counterparty risk across all of FHA's insurance programs. The FHA Transformation Initiative will enable risk detection and fraud prevention by capturing critical data points at the front-end of the loan lifecycle, and leveraging risk and fraud tools, rules based technology, and transactional controls to minimize exposure to FHA's insurance Funds.

These tools will enable FHA to leverage 21st century information technology systems to manage risk at all points of the loan lifecycle. For example, the FHA Transformation Initiative will automate the application process for FHA lender approval, and will provide enhanced data validation capabilities for the evaluation of lender applications. In addition, the initiative will also provide risk analytics mechanisms to identify & manage risk-based exceptions for inbound endorsements & appraisals, permitting FHA to address these concerns at the loan level. Finally, the initiative will provide FHA with comprehensive portfolio analysis tools by which it can identify and evaluate current and emerging risk trends in order to more effectively take appropriate action to avoid or mitigate risks to the MMI Fund.

IV. Conclusion

The new findings of the independent actuaries are cause for caution, as they suggest that stress on outstanding books-of-business has increased over the past year. Yet their reports also confirm that the steps HUD has taken since the start of this Administration have been both necessary and prudent. This can be seen in the significantly improved performance estimates for the FY 2010 and FY 2011 books of business, when compared to earlier books. However, although the changes FHA has made have had substantial positive impacts on the MMI Fund moving forward, the Fund must still compensate for the poorer quality loans insured prior to 2009, and for how the ongoing housing recession has created expectations of significant dollar losses on loans insured near the peak of home prices. Thus, the task at hand for HUD is to continue originating high-quality, profitable business while executing a robust comprehensive risk management strategy to minimize the impact of losses associated with lower-quality earlier books. HUD is committed to both of these endeavors and will work diligently toward accomplishing them in the coming year.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