U.S. Department of Housing and Urban Development

ANNUAL REPORT TO CONGRESS
FISCAL YEAR 2013 FINANCIAL STATUS
FHA MUTUAL MORTGAGE INSURANCE FUND

DECEMBER 13, 2013

Your Door to FHA HOMEOWNERSHIP

Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance Fund Fiscal Year 2013

U.S. Department of Housing and Urban Development
December 13, 2013

Secretary's Foreword

I present my fifth annual report on the financial status of the Federal Housing Administration (FHA) Mutual Mortgage Insurance Fund (MMIF) at a time when the housing market recovery continues to gain momentum. Five years after the bubble burst, home sales and values are rising once again, foreclosures are down, and millions of families have seen their homes return to positive equity. Although much work remains, it is encouraging that the market continues to trend in a positive direction, generating new economic activity and optimism in communities across the nation.

The Federal Housing Administration has played a critical role in this recovery. At the depths of the economic crisis, when financial institutions stopped lending, the FHA was forced to quickly step up to keep credit flowing. Over the past five years, it has helped 7 million families buy or refinance their home. As independent economists have noted, if not for the agency, the housing market would have experienced a much steeper decline.

In the midst of the recession, FHA's Single Family program more than quadrupled its activity in order to stabilize the nation's housing market. Recognizing that such expanded activity in the midst of a recession would strain a program already in need of adjustments, early in my tenure as Secretary, we began taking a number of actions to strengthen our balance sheet and better protect FHA for the future. Despite our ongoing efforts toward these ends, the substantial role FHA was forced to play—coupled with the strain of legacy loans made prior to 2010 that have generated significant losses—put considerable stress on the MMIF. As a result, at the end of FY 2013, HUD was required to take a mandatory appropriation to ensure that the Fund had sufficient reserves to pay expected claims over the next 30 years on this newly expanded book.

Yet, in spite of these short term challenges, the long term finances of the Fund have improved substantially, reflecting the clear impact of the steps we have taken. To improve revenues, we've adjusted pricing to accurately correspond to the risk incurred through new endorsements, while simultaneously righting the Fund's reserves. We've strengthened our underwriting standards to better ensure that the loans FHA insures today are made to qualified borrowers. We've also created an Office of Risk Management to provide enhanced monitoring and identification of potential risks to the Fund, enabling us to better protect and secure its health. And we continue to look for new ways to improve performance. That's why, in 2013, we made significant changes to our loss mitigation guidance for servicers and employed new strategies for disposition of properties, which together resulted in increased recoveries for the MMI Fund and better outcomes for communities and borrowers.

As this year's report shows—even while total originations continue to trend toward pre-crisis levels, allowing room for private capital to return to the market—the Fund's net worth improved $15 billion from last year's estimate, growing from n*egative* $16.3 billion to *negative* $1.3 billion. In addition, the Fund's capital reserve ratio improved from *negative* 1.44 percent to *negative* 0.11 percent. Furthermore, the Fund is expected to reach a 2 percent capital reserve ratio by FY 2015, significantly faster than the independent actuary's 2012 estimate.

The overall improvements to the performance and long term health of the Fund are good news for American families and the housing market as a whole. Although times have changed, FHA's commitment to providing opportunities to responsible families from all communities remains unshakable. As the independent actuary's review shows, FHA is delivering on its mission to provide access to homeownership for creditworthy borrowers, and as a result of the changes we have made, is doing so in a way that protects and enhances the health of the Fund. To keep this momentum going, we continue to take aggressive measures to protect the MMIF, including optimizing the new loss mitigation and recovery strategies we put in place this year – and furthering our commitment to incentivize the use of housing counseling as we expand its usage in FHA programs.

However, to completely stabilize the Fund for future generations, we will need help from Congress. We have called on both legislative bodies to act on a set of legislative proposals designed to place FHA in a stronger fiscal position over the next twelve months and into the future. These steps include:

- additional authority to ensure that FHA insured loans are being adequately serviced to reduce risks to the Fund while protecting borrowers;
- stronger and more flexible enforcement and monitoring authorities so that FHA can identify noncompliance and poor performance and take action to avoid losses; and
- eliminating barriers to more effective risk management by assuring that FHA has adequate tools and appropriate staffing resources.

We are grateful to have worked with Congress this past year to make important changes to the Home Equity Conversion Mortgage program. We also continue to work with Congress on a variety of reforms to create more transparency and stability in the housing market. We look forward to ongoing partnership with both chambers to enact final legislation that provides FHA with the tools it needs to build on the vital reforms already implemented by the Obama Administration.

Achieving all of these goals during these challenging fiscal times is difficult work. I want to thank Federal Housing Commissioner, Carol Galante and the entire FHA team for their tireless and continual efforts to protect and preserve FHA for the next generation of Americans.

As the gains outlined in this report show, we have made important strides in strengthening the Federal Housing Administration. This work enables us to continue to stabilize the housing market and provide needed credit access for creditworthy buyers of all backgrounds. Looking to the future, we remain committed to strengthening the MMIF so that ladders of opportunity are available to all Americans for generations to come.

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

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Executive Summary

This Administration has made a number of necessary and fundamental changes to strengthen FHA, and to address the challenges facing the agency, challenges made even more apparent during the recent severe recession. These changes have helped FHA to address the significant losses created by the 2007-2009 books of business while also putting FHA on a more sustainable path to fulfill its dual mission of providing access to mortgage credit for underserved borrowers and acting as a countercyclical force in times of economic stress. To date, this Administration has made numerous changes to protect and strengthen FHA, including:

- **Making major programmatic adjustments** (e.g., the elimination of the seller-funded down-payment program, the enhancement of the streamline refinance program, modifications to down-payment/credit score requirements, introduction of the HECM Saver product and adjustments to HECM borrowing limits, and consolidation of and updates to the agency's condominium policy)

- **Installing a new risk management framework** (e.g., creation of the Office of Risk Management, strengthening of FHA's underwriting requirements, implementation of a new loss mitigation waterfall, expanded use of REO alternatives, enhanced enforcement for FHA lenders, and updates to the agency's quality control requirements and surveillance capabilities)

- **Restructuring pricing to better manage risk and capitalize the fund** (e.g., increases to the required upfront and annual Mortgage Insurance Premiums (MIPs), and revisions to FHA's premium cancellation policy)

These changes are fostering a turnaround in the fundamental health of the Mutual Mortgage Insurance Fund (MMI Fund or Fund), improving the overall economic value of the Fund by $15 billion in just the last year alone, taking it from a value of *negative* $16.3 billion at the end of FY 2012 to *negative* $1.3 billion according to the FY 2013 independent actuarial estimate.

While the hard work undertaken by this Administration must continue, the changes made already have enabled FHA to both better serve borrowers who need FHA support – primarily first time homebuyers and low-wealth households – while simultaneously re-building the MMI Fund and preparing for future periods of economic stress when FHA may once again be called upon to play a crucial countercyclical role.

COMPOSITION AND PERFORMANCE OF FHA MORTGAGES

While many of the changes this Administration has made are leading to a stronger FHA, HUD also remains focused on delivering on FHA's core mission every day.

- The number of families with an FHA mortgage stood at more than 7.8 million at the end of FY 2013.

- In FY2013, FHA helped more than 500,000 families buy their first home. These are families that likely would otherwise not be served by the conventional mortgage market. The total number of first time homebuyers that FHA has supported over the past three years now totals 3.3 million.

- Through its streamline refinance option, FHA helped 500,000 families reduce their monthly housing costs by an average of $200 per month, for an annual savings of $2,400 per family.

- FHA also helped more than 450,000 families avoid foreclosure this past year through its loss mitigation home retention servicing tools.

In recent years FHA has sought to refocus on its core market while reducing its footprint in the overall mortgage market, enabling private sector credit sources to return to the mortgage market and FHA to recede from its expanded countercyclical role.

- FHA endorsements have now fallen from a peak of 1.8 million loans in 2009 to approximately 1.3 million in FY 2013. This is a 27 percent reduction, taking FHA closer to its historical activity levels seen prior to the housing bubble.

- Even as endorsements have dropped significantly since the peak in 2009, levels remained artificially elevated in FY 2013 due to a very high volume of FHA-to-FHA streamline refinancing activity. That activity represents FHA loans that have been refinanced into another FHA-insured mortgage at lower interest rates and payments. FHA endorsed more than 500,000 streamline refinance loans in FY 2013, representing nearly 40 percent of all endorsements in the fiscal year.

- More critical for the balance of FHA with conventional sources of mortgage credit, the volume of conventional-to-FHA refinancing (where FHA is insuring refinances of conventional loans) has fallen from its peak of 467,000 in 2009 to 92,000 in FY 2013, a decline of more than 80 percent.

As FHA’s market activity shifts back to its core market, overall portfolio credit performance continues to strengthen.

- Early Payment Defaults (defined as a loan 90+ days delinquent within the first six payment cycles) on newly endorsed loans are now at their lowest levels in 7 years, falling another 30 percent in FY 2013 to 24 basis points.

- FHA’s new loss mitigation waterfall has increased home retention activity by 30 percent, with HAMP activity increasing four-fold.

- Serious delinquency rates over the past year have fallen from 9.8 percent to 8.2 percent, on a seasonally adjusted basis, a decline of 16 percent.

STATUS OF THE MUTUAL MORTGAGE INSURANCE FUND

Playing its much needed countercyclical role during the recession came at a cost to FHA and its Mutual Mortgage Insurance Fund. While legacy losses (especially from the 2007-2009 books of business) continue to be a drag on the portfolio, this year's independent actuarial results confirm that the Fund is now on a positive trajectory.

- The independent actuary estimates that the Fund's overall Economic Net Worth has improved by $15 billion, from *negative* $16.3 billion to *negative* $1.3 billion, while the Capital Ratio has improved from *negative* 1.44 percent to *negative* 0.11 percent.

- The Forward loan portfolio, which accounts for more than 90 percent of total insurance-in-force, is showing clear improvements in credit quality, with 5 percent lower loss-on-claim rates, and 23 percent higher premium revenue compared to last year's report.

- The HECM portfolio's capital position has been significantly strengthened through the combination of a mandatory appropriation of $1.7 billion and a transfer of more than $4 billion from the Forward loan portfolio to the HECM portfolio. The enhanced capital position of the HECM portfolio provides a strong buffer to what is a highly uncertain future cash flow stream from loans endorsed during the recent recession. This buffer will allow HUD to focus on making further structural changes to improve the long-term health of the program.

- A second independent evaluation, using the same economic forecast assumptions but employing a different modeling approach, further affirms the overall improvement in the Fund value over the past year[1].

CAPITAL RESTORATION PLAN

The actions this Administration has taken have been vital to putting the Fund on solid footing for the future. Through a wide range of policy and pricing changes, newer cohorts have provided additional capital needed to cover losses on legacy books of business. As a result, going forward, the Fund is expected to accumulate capital at a much faster rate than was projected even last year. The independent actuary expects the Fund to reach the required 2 percent capital reserve ratio in FY 2015 instead of FY 2017, as was anticipated by the actuary in last year's actuarial report. The Fund is also expected to have an Economic Net Worth of $27 billion at the end of FY 2015, and more than $80 billion in FY 2019 – representing funds in excess of those required to cover projected lifetime claim expenses.

While this positive trajectory represents significant progress, the momentum must continue, and FHA is focused on sustaining the velocity of the changes for the Fund. Therefore FHA will center its attention on the following initiatives:

[1] See Appendix A for more information on the results of the second independent evaluation.

- Continued focus on aggressive loss mitigation and recovery actions to minimize legacy losses in the near term and reduce potential losses in the event of another economic downturn. FHA will continue to optimize REO alternatives and refine the utilization of its disposition strategies.

- Pursuing strategies that simultaneously increase value of the Fund and credit access. Toward these ends, HUD is developing a pilot to embed housing counseling in FHA programs, and is working to further enhance quality control and lender oversight mechanisms.

- Additional changes to the HECM program to ensure that it is able to continue meeting is primary objective of assisting senior homeowners to age in place, and doing so in a fiscally responsible manner.

In addition to the administrative actions that HUD will take, Congressional action is also necessary to further strengthen FHA for the long term. Those changes include:

- Authority to better monitor and enforce lender compliance, including enhanced indemnification authority, expanded authority to terminate lender approval, and the ability to establish refined compare ratio requirements.

- Authority to transfer servicing from poorly performing to higher performing servicers

- Reducing barriers to more effective risk management in areas such as aligning human capital management and other statutory operating rules with other financial regulators.

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After 80 years, FHA continues to deliver on its dual mission of providing access to credit for underserved borrowers and acting as a countercyclical force in times of economic stress. Positive progress in this past year strengthens FHA’s ability to continue delivering on this mission.

I. Composition and Performance of FHA Mortgages

As the nation's economy continued to emerge from the effects of the recent recession, FHA again provided vital support to the housing and mortgage markets throughout FY 2013. In FY 2013:

- FHA enabled more than 550,000 families to realize the dream of homeownership by becoming first-time homebuyers, and accounted for fully 54 percent of purchase mortgage financing for Black or African-American and Hispanic borrowers.

- Performance of newly endorsed loans improved even further, continuing the trend of annual year-over-year improvements, and exhibiting vast improvements compared to FY 2009 and earlier books of business. Serious delinquency rates over the past year have fallen from 9.8 percent to 8.2 percent, on a seasonally adjusted basis, a decline of 16 percent. Foreclosure starts have declined from a peak of ~30,000 in FY 2012 to less than ~15,000 at the end of FY 2013, for a 50 percent decline in the number of homes entering foreclosure.

- New loss mitigation and asset disposition approaches substantially reduced losses associated with defaulted legacy loans. The new loss mitigation waterfall has increased loss mitigation activity by 30 percent, with HAMP activity increasing four-fold. Recoveries on distressed assets have improved by 16 percent from a year ago.

A. NEW ENDORSEMENTS AND PORTFOLIO CHARACTERISTICS – FORWARD PORTFOLIO

FHA endorsed approximately $240 billion in single-family loans in FY 2013 (see Exhibit I-1). Through both purchase and refinance activity, FHA again played a critical role in providing access to affordable mortgage financing for Americans underserved by private markets.

The high level of activity this past year was primarily driven by large volumes of FHA-to-FHA refinance activity resulting from historically low interest rates (see Exhibit I-2). While refinance activity increased significantly in FY 2013, purchase loan volume decreased once again, continuing a three-year trend since hitting a peak in FY 2010.

Streamline refinance actions, whereby borrowers with existing FHA-insured loans are able to refinance into a new FHA-insured mortgage, comprise the majority of FHA refinance activity. The number of borrowers taking advantage of FHA options for streamline refinancing was at a historical high, and second only to FY 2003. For those borrowers who were able to take advantage of low interest rates, the average monthly savings in mortgage payments was $200, creating $2,400 in annual surplus income and providing improved financial margin for the low-and-moderate income homeowners who rely upon FHA for safe and affordable housing finance options.

During FY 2013, FHA home purchase activity declined marginally by approximately four percent. This tracks with a general trend in the industry, but for FHA, purchase activity is nearing levels which were the norm in the early 2000's.

Conventional-to-FHA refinance activity declined at a much faster rate, by approximately 29 percent between FY 2012 and FY 2013. Conventional-to-FHA refinancing is now nearing historical lows, falling from a high of 468,943 in FY 2009 to 91,508 in FY 2013, an 80 percent drop.

Exhibit I -1

FHA Single-Family Mortgage Insurance Endorsements[a,b]

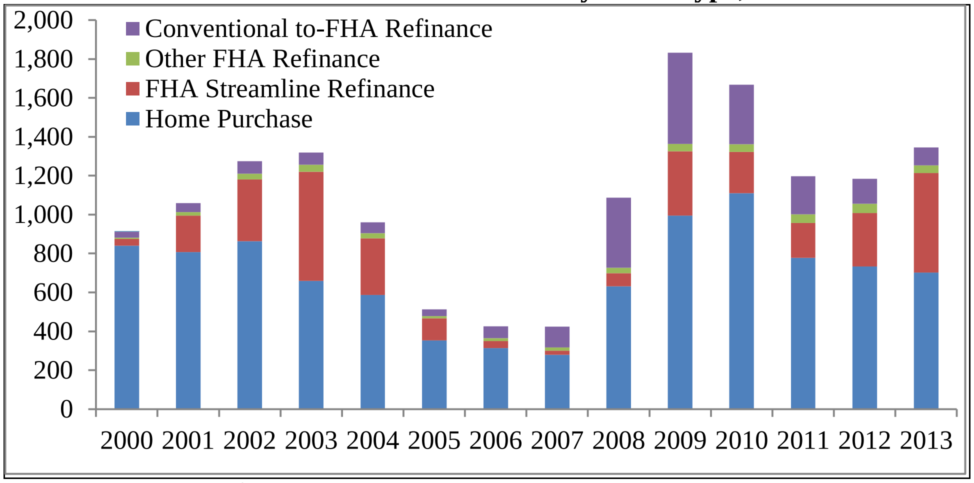
Fiscal Year	Counts by Loan Purpose					Volume $ Billion
	Home Purchase	FHA Streamline Refinance	Other FHA Refinance	Conventional to-FHA Refinance	All Loans	
2000	839,869	34,443	6,780	32,007	913,099	$94.2
2001	806,818	188,422	17,230	46,207	1,058,677	117.7
2002	862,898	318,245	28,525	64,475	1,274,143	148.1
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	278,395	22,087	16,504	107,739	424,725	59.8
2008	631,655	66,772	28,510	360,456	1,087,393	181.2
2009	995,550	329,437	38,069	468,943	1,831,999	330.5
2010	1,109,581	212,895	39,594	305,540	1,667,610	297.6
2011	777,428	180,266	44,560	195,559	1,197,813	217.8
2012	733,864	274,061	47,590	129,224	1,184,739	213.3
2013	702,418	511,849	39,081	91,508	1,344,856	240.1

[a]This table includes all single-family endorsements, including a small number of loans today that are not obligations of the MMI Fund. This includes the 203(k) purchase-and-rehabilitation program and the 234(c) condominium insurance.

[b] See Appendix C for expanded table with quarterly data.

Source: U.S. Department of HUD/FHA, November 2013.

Exhibit I-2
Distribution of FHA Endorsements by Loan Type, Thousands



Source: U.S. Department of HUD/FHA, November 2013.

1. FHA Market Share

Over the past several years, FHA has played a vital role in the housing market. Starting in 2008, FHA – as it has in past crises – stepped in to act on its mission to provide countercyclical support to the nation's mortgage markets.

Specifically, the tightening of private credit combined with congressional action that temporarily increased FHA's loan limits[2] drove volume to FHA, while FHA also kept underwriting standards constant. Additionally,

- Beginning in 2007, FHA stepped in to enable growing numbers of homeowners facing large interest rate resets from expiring teaser rates on conventional ARMs to avoid large payment shocks. These conventional-to-FHA "product refinances" helped hundreds of thousands of borrowers who met FHA's standard underwriting criteria to convert conventional mortgages facing (or which already had received) monthly payment increases into far more sustainable FHA-insured loans.

- In addition to providing help to homeowners with unsustainable conventional loans, FHA also enabled borrowers with existing FHA-insured loans to refinance through its streamlined FHA-to-FHA refinance programs. The assumption underlying a streamline refinance is that FHA, which already holds the default risk on the loan, would not be taking on new risk if it insured a rate or term refinance of the loan (with no cash out other than to cover closing costs), even if the loan were underwater, or if the borrower's credit history had deteriorated.

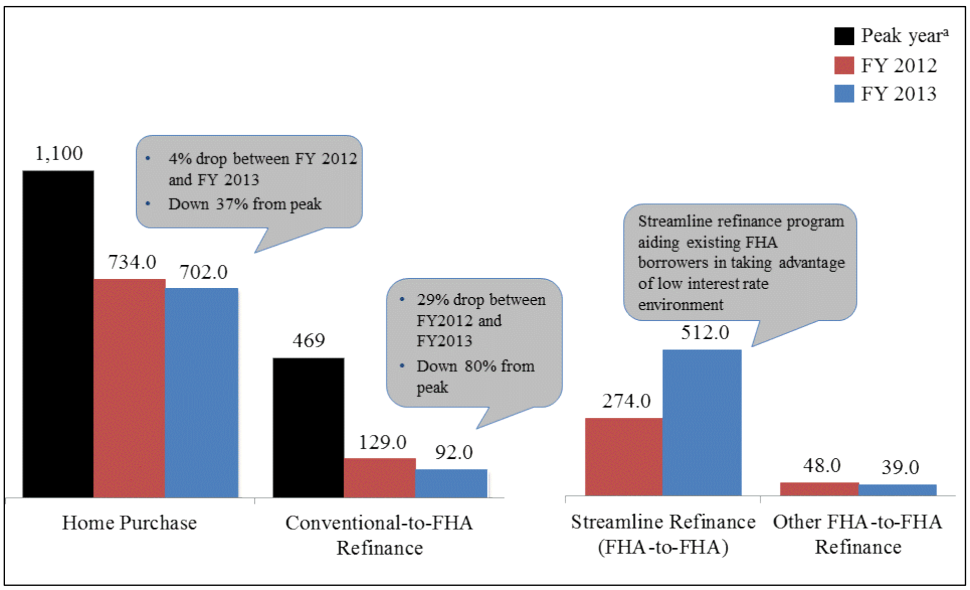
These actions were critical to supporting the housing market during the financial crisis. Experts have estimated that if it were not for FHA's countercyclical role, home prices would have declined even further than they did already.

[2] See Appendix D for description of loan limit history

As the housing market has recovered and private credit has begun to return, FHA's market footprint has steadily declined from its peak in 2009, as expected (see Exhibit I-3). Credit and pricing policies that FHA has instituted and continues to refine have facilitated the return of private capital sources while simultaneously strengthening FHA's own capital position and ensuring ongoing access to credit for qualified borrowers. FHA is now reaching volumes that are more consistent with historical levels experienced prior to the housing bubble.

A key measure of FHA's footprint in private credit, Conventional-to-FHA refinancing, has declined over 80 percent from its peak of 469,000 in FY 2009 to 92,000 in FY 2013. This significant decline is occurring despite the high loan limits that Congress established for FHA in recent years. Once the automatic reduction in loan limits occurs on January 1, 2014, FHA expects overall endorsement volumes to decline further, especially conventional-to-FHA refinance volumes.

Exhibit I-3
Change in Annual Endorsement Activity by Product Loan Count, Thousands



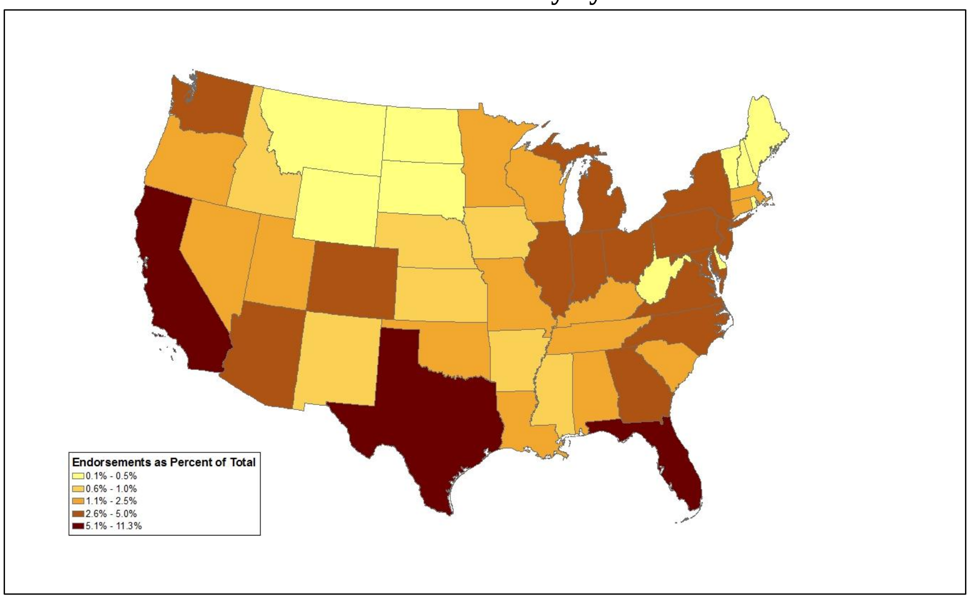
[a]Purchase peak occurred in FY 2010, Conventional-to-FHA Refinance peak occurred in FY 2008
Source: U.S. Department of HUD/FHA, November 2013.

2. Geographic Distribution

Exhibit I-4 shows FHA endorsements by property State. FHA is active in all 50 States, and in most U.S. Territories. However, California, Texas, and Florida accounted for twenty-five percent of all endorsement activity in FY 2013. Among home purchase loans, these same States accounted for 28 percent of borrowers served by FHA during this past year. While this distribution of activity is not surprising, California's share has been subject to large swings. In 2000, FHA insured 93,338 home-purchase loans in California. At the height of the housing boom in 2006, that number had dropped to just 2,316. Then, as conventional mortgage credit became more restricted during the recession, FHA's activity in California surpassed previous peak levels, with a high point of 135,643 homebuyers served in 2009. In 2013, with conventional sources of credit more readily available once again, FHA insured fewer than 78,817 home purchase mortgages in California.

FHA provided the opportunity to refinance for 42 percent more homeowners in 2013 than in 2012 (642,438 versus 450,875). Nearly one-third of all refinance activity in FY 2013 again came from States with large populations, including California, Florida, Texas, Ohio and Georgia. These five States account for 64 percent of the overall increase in refinance activity during the past year.

Exhibit I-4
FHA New Endorsement Activity by State in FY2013



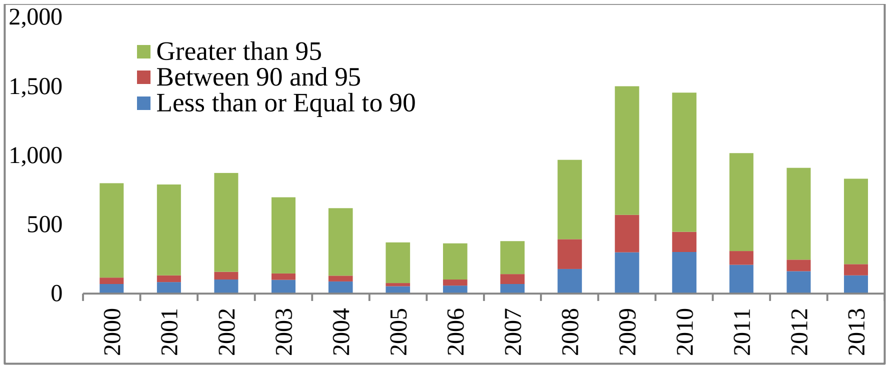
Source: U.S. Department of HUD/FHA, November 2013.

3. Borrower and Loan Characteristics

FHA-insured loans had an average loan-to-value (LTV) ratio of 94.2 percent in FY 2013, roughly equal to the FY 2012 average. Among FHA-to-FHA refinance loans, the average loan-to-value decreased from 88.2 percent to 86.9 percent. The average LTV ratio for conventional-to-FHA refinances was 84 percent. The average LTV for home purchase loans was 95.9 percent. It is important to note that first-time buyers, who are responsible for nearly 80 percent of all purchase loans, drive the high LTV ratios among purchase loans.

Exhibit I-5 shows the distribution of LTV ratios for new FHA endorsements. The share of FHA borrowers with LTV ratios above 95 percent increased this year, continuing a trend which began in FY 2008. In FY 2013, approximately 74 percent of FHA borrowers had LTV ratios above 95 percent. The share of FHA borrowers with LTV ratios below 90 percent declined from the previous year – the fourth consecutive year since FY 2010 that this share has fallen.

Exhibit I-5
Distribution of FHA Endorsements by Loan-to-Value Ratio by Loan Count, Thousands



Source: U.S. Department of HUD/FHA, November 2013.

The average credit score of FHA borrowers declined from 698 in FY 2012 to 693 in FY 2013. For each loan-purpose group, the average credit score was still in the 690-700 range, which remains very high by historical standards, and is consistent with the higher quality books of business insured since 2010. FHA experienced very little activity from borrowers with credit scores below 620. As a result of a number of policy changes, the share of those types of loans in new endorsement activity continued to decline and is now at its lowest point since FHA began to collect credit scores in 2004.

The distribution of FHA borrowers by credit score range is shown in Exhibit I-6. The primary change in credit score distribution this past year was a reduction in the 720-850 range, and an increase in the 680-719 and 620-679 ranges. Over the past two years, HUD has noticed such movement after each round of premium rate increases, indicating that FHA's pricing changes are prompting borrowers traditionally served by the conventional market to once again obtain such financing. Such movement is consistent with FHA's goals to create opportunity for private capital to return to the mortgage market and recapture its historical borrower segment.

Exhibit I-6
Distribution of FHA Borrower Credit Scores by Fiscal Year and Quarter

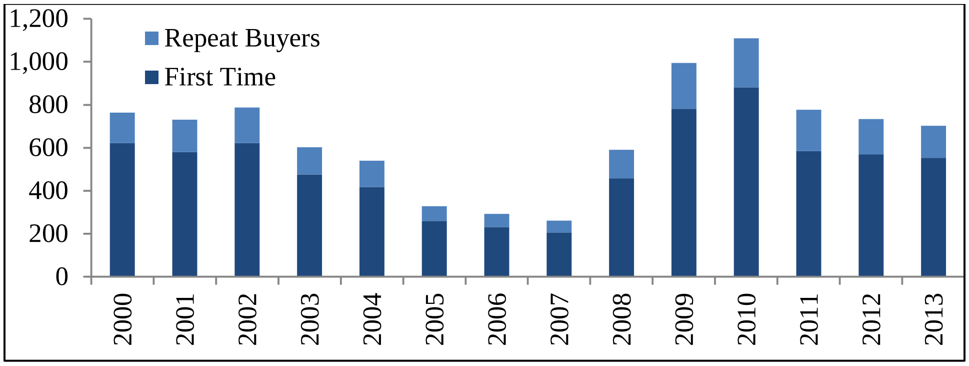
		Credit Score Categories[a]					
Fiscal Year	**Quarter**	**Greater than 720**	**680-719**	**620-679**	**580-619**	**Less than 579**	**MISS**
2008	Oct-Dec	8.85	8.91	31.05	24.12	23.39	3.68
	Jan-Mar	9.52	9.68	31.74	23.43	22.39	3.25
	Apr-Jun	14.69	13.01	35.69	21.15	13.13	2.34
	Jul-Sep	18.47	15.83	37.74	19.32	7.13	1.51
2009	Oct-Dec	20.49	17.19	37.54	18.63	5.21	0.94
	Jan-Mar	24.29	18.94	36.92	15.47	3.40	0.99
	Apr-Jun	29.66	21.19	38.18	8.45	1.54	0.99
	Jul-Sep	33.35	22.07	37.76	4.89	0.99	0.94
2010	Oct-Dec	33.50	22.47	38.49	3.97	0.68	0.90
	Jan-Mar	33.88	22.77	38.41	3.50	0.50	0.92
	Apr-Jun	34.96	22.65	38.45	2.73	0.36	0.86
	Jul-Sep	34.83	22.63	38.37	2.98	0.37	0.83
2011	Oct-Dec	37.07	23.22	36.07	2.50	0.34	0.80
	Jan-Mar	37.78	24.14	35.02	2.15	0.20	0.71
	Apr-Jun	35.38	23.81	37.50	2.57	0.15	0.57
	Jul-Sep	33.10	23.77	39.19	3.27	0.16	0.51
2012	Oct-Dec	32.95	23.87	39.30	3.20	0.23	0.45
	Jan-Mar	33.93	23.86	38.76	2.85	0.23	0.38
	Apr-Jun	33.23	24.21	39.50	2.54	0.22	0.31
	Jul-Sep	30.87	25.32	41.07	2.26	0.16	0.31
2013	Oct-Dec	29.90	26.01	41.56	2.07	0.17	0.29
	Jan-Mar	29.26	26.63	41.86	1.82	0.18	0.25
	Apr-Jun	26.86	27.38	43.94	1.45	0.13	0.24
	Jul-Sep	23.59	27.73	46.74	1.55	0.15	0.23

[a]Shares are based on loan counts.
Source: U.S. Department of HUD/FHA, November 2013.

4. First-time Homebuyers

FHA performs a vital role in ensuring access to homeownership for households not adequately served by the conventional market. In the last five years alone, FHA has enabled more than 3.3 million families to become homeowners. Exhibit I-7 shows the share of first-time homebuyers among FHA home purchase loans since 2000. In FY 2013, loans to first-time homebuyers comprised close to 79 percent of all home purchase loans, up slightly from FY 2012.

Exhibit I-7
FHA Home Purchase Endorsements By Status, Thousands



Source: U.S. Department of HUD/FHA, November 2013.

5. Minority Share

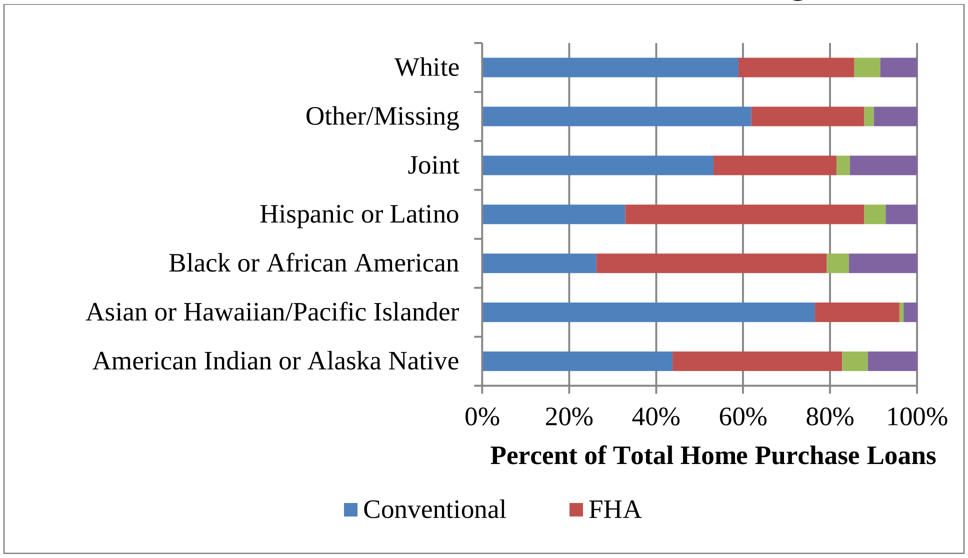
FHA continues to play a vital role in supporting minority homeownership. According to 2012 Home Mortgage Disclosure Act (HMDA) data, while FHA insurance was used for approximately 30 percent of all home purchase loans, FHA accounted for 53 percent of home purchases by Black or African American households and 55 percent of purchases by Hispanic households (see Exhibits I-8 and I-9).

Exhibit I-8
Home Purchase Loans and Racial Shares Across Market Segments in 2012[a]

Race or Ethnicity	Number of Loans	Market Segments (Shares in Rows Add to 100%)			
		Conventional	FHA	FSA/RHS	VA
All Borrowers	2,374,316	56.0	30.0	5.2	8.7
American Indian or Alaska Native	8,183	43.8	39.0	5.9	11.3
Asian or Hawaiian/Pacific Islander	127,823	76.6	19.4	0.9	3.1
Black or African American	120,430	26.2	53.0	5.1	15.7
Hispanic or Latino	202,059	32.9	54.9	5.0	7.2
White	1,676,948	59.0	26.6	6.0	8.5
Not Disclosed[b]	174,118	61.9	26.0	2.2	9.9
Joint[c]	64,755	53.2	28.3	3.0	15.5

[a] Race on the loan application is categorized by the first person listed on the loan application. The Home Mortgage Disclosure Act reports race separately from ethnicity.
[b] Includes Missing and Not Applicable
[c] Joint Race definition applies when one applicant reports a single racial designation of White and the other applicant reports one or more minority racial designation.
Source: FFIEC/HMDA Data 2012.

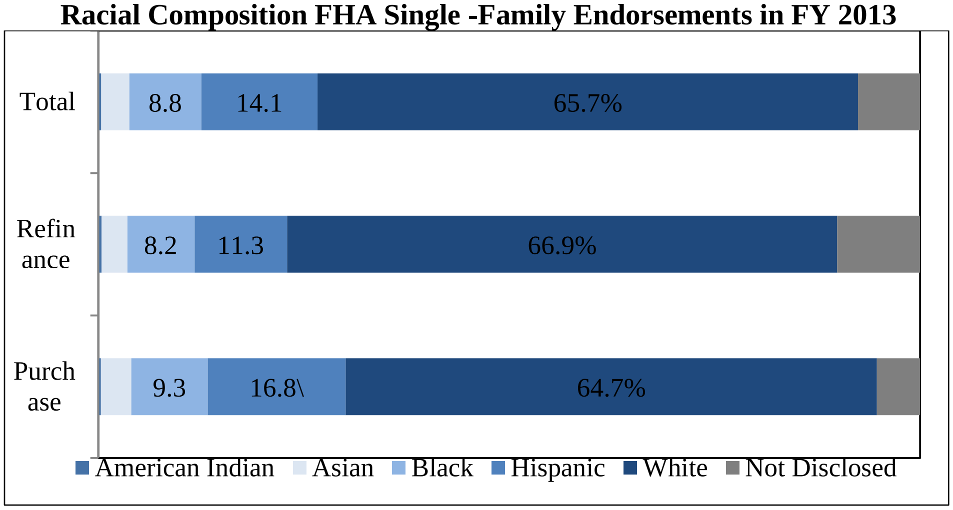
Exhibit I-9
Home Purchase Loans and Racial Shares Across Market Segments in 2012



Source: FFIEC/HMDA Data 2012.

Minority buyers were particularly active in first-time home buying activity in the 2013 cohort of loans. Nearly one in three FHA-insured first-time home buyers in FY 2013 was a minority household compared to one-in-five for repeat home buyers.

Exhibit I-10
Racial Composition FHA Single -Family Endorsements in FY 2013



Source: U.S. Department of HUD/FHA, November 2013.

B. LOAN PERFORMANCE – FORWARD PORFOLTIO

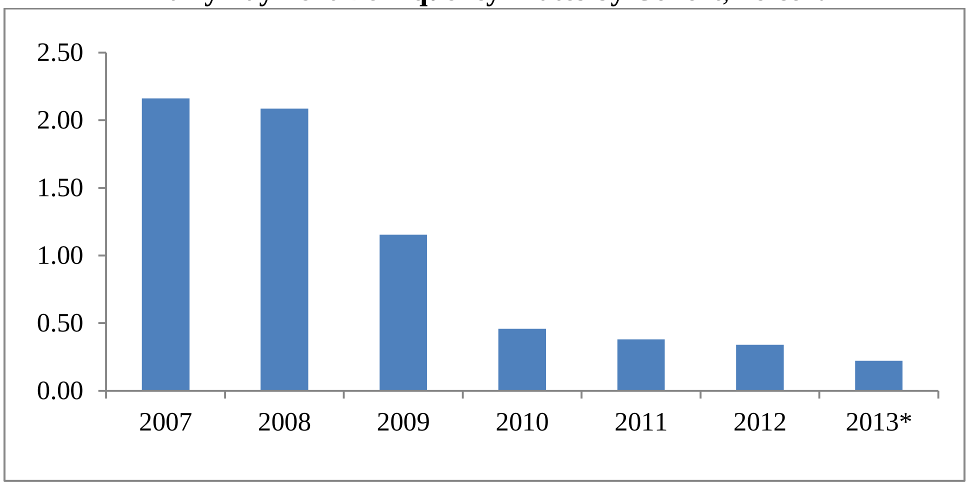
The performance of FHA's portfolio in FY 2013 continued trends seen in recent years, as newer books of business continued to vastly outperform those insured in prior years. The large books insured from 2007-2009 continued to place substantial strain on the MMI Fund while newer books of business show progressively better performance for each origination year.

1. Early Payment Delinquency Rates

Newly insured loans continued to show improvement in initial delinquency rates in FY 2013. Early Payment Delinquency (EPD) rates, defined as the percentage of loans that become 90-days or more delinquent within the first six monthly payment cycles, provide the first indication of potential credit performance of newly insured loans. The EPD rate is a leading indicator of the long-term claim risk of a particular book of business, relative to other vintages.

Exhibit I-11 shows EPD rates by cohort, from 2007 through the first half of 2013. Rates for the FY 2011 and 2012 cohort vintages are just one-sixth the size of EPD rates for the 2007 and 2008 vintages. Early performance of loans insured in FY 2013 is even better than that of 2011 and 2012 loans.

Exhibit I-11
Early Payment Delinquency[a] Rates by Cohort, Percent



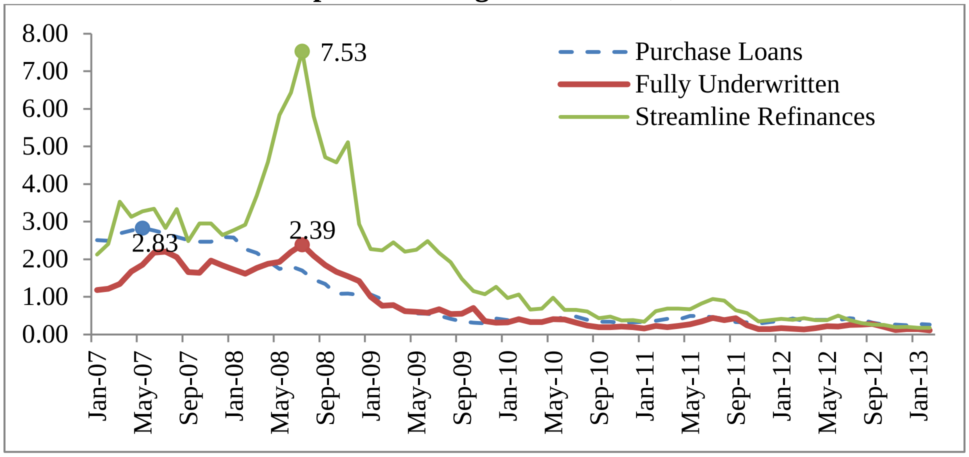
[a] Defined as 90-day delinquencies in the first 6 months of the portfolio's life
[b] FY2013 includes endorsements from Oct 2012 to Feb 2013.
Source: U.S. Department of HUD/FHA, November 2013.

Exhibit I-12 shows the decline in EPD rates by loan purpose, comparing home-purchase, streamline refinance, and other types of (fully underwritten) refinance loans. Streamline refinance originations in 2008, and even in 2009, had significant problems with early delinquencies. HUD believes that this was due to improper use of streamline actions for borrowers with financial difficulties, and where in many cases there was no long-term benefit to the borrower in terms of lower monthly payments.

HUD issued new guidance for streamline refinance actions in September 2009, requiring that a net-tangible benefit test be applied before a refinance could be approved. Streamline refinance loans are now performing at comparable levels to other types of loans.

Today, EPD rates across loan-purpose categories are very similar, and are at the lowest levels since HUD started computing them in 2007. Loans originated in FY 2013 Q2 had EPD rates of 0.22 percent, which is one-tenth the rate recorded for loans originated in FY 2008 Q1.

Exhibit I-12
Early Payment Delinquency (EPD) Rates by Loan Purpose and Origination Month, Percent



Source: U.S. Department of HUD/FHA, November 2013.

2. Portfolio Delinquency Rates

The past-due rate for FHA loans has declined measurably over the past year, down 2.25 percentage points, from 16.46 to 14.21 percent. This is the lowest point recorded since March 2008. Compared to the year-earlier period, delinquency rates are down in all categories, from initial 30-day delinquencies to cases in foreclosure processing. (see Exhibit I-13.)

The seriously delinquent rate, an indicator of future claim costs, is down 1.58 percentage points from its level at the end of FY 2012, as it has declined from 9.80 to 8.22 percent (seasonally adjusted).

Exhibits I-13 and I-14 show serious delinquency rates by cohort, and provide further evidence of the improving quality of more recent loan endorsements. At the end of their first year, all of the cohorts from 2007-2009 each had serious delinquency rates more than four times those of the 2010-2012 cohorts at the same point of seasoning. The 2007 and 2008 cohorts have had the worst serious delinquency rates as they have seasoned. Delays in foreclosure processing in many parts of the country contribute to those rates remaining high today.

Both exhibits show the 2009-vintage cohort in two parts, representing the first and second halves of the fiscal year. This highlights the dramatic changes taking place in FHA loan originations throughout that year, as the credit quality of borrowers improved monthly, and interest rates started their three year decline in December 2008. The decline in interest rates led to large volumes of refinance loans where existing homeowners were able to reduce their monthly payments by $100 or more and, thus, improve the overall stability of household finances. More importantly, the elimination of seller-funded down payment assistance loans substantially improved the performance of loans endorsed in the final three quarters of FY 2009.

Exhibit I-13
FHA Single-family Delinquency Rates By Month
(Seasonally Adjusted, End-of-month Loan Status)

Month	Active Insurance in Force	Delinquency Rates[a], %			Exceptions[b], %		Seriously Delinquent Rate[c], %
		30-day	60-day	90-day	In Foreclosure	In Bankruptcy	
Seasonally Adjusted							
Sep 2012	7,711,684	4.88	1.78	5.46	3.06	1.27	9.80
Oct	7,733,203	4.69	1.74	5.18	3.07	1.21	9.46
Nov	7,748,709	4.37	1.68	5.01	2.97	1.17	9.15
Dec	7,719,941	4.81	1.75	5.00	2.95	1.14	9.09
Jan 2013	7,781,633	4.53	1.69	4.78	2.86	1.20	8.84
Feb	7,795,726	4.72	1.78	5.04	2.69	1.19	8.92
Mar	7,801,713	4.71	1.72	5.07	2.61	1.23	8.91
Apr	7,803,709	4.27	1.59	5.08	2.48	1.23	8.78
May	7,803,213	4.10	1.55	5.02	2.34	1.21	8.57
Jun	7,810,825	5.01	1.70	5.16	2.44	1.22	8.82
Jul	7,802,970	4.79	1.68	4.82	2.50	1.21	8.53
Aug	7,810,207	4.36	1.70	4.62	2.54	1.22	8.38
Sep	7,810,422	4.37	1.62	4.57	2.47	1.18	8.22

[a]The 90-day category includes all loans that are at least 3 months delinquent excluding those loans in-foreclosure or in-bankruptcy processing. Included in the delinquency counts are loans under active consideration for loss mitigation foreclosure avoidance.
[b]Exceptions are counted separately from delinquencies, regardless of the length of the delinquency period.
[c]Seriously delinquent rates are the sum of 90-day delinquencies, plus in-foreclosures and in-bankruptcies.
Source: U.S. Department of HUD/FHA, November 2013.

Exhibit I-14
Serious Delinquency Rates by Loan Origination Year at Various Stages of Seasoning
(Excluding Streamline Refinances)

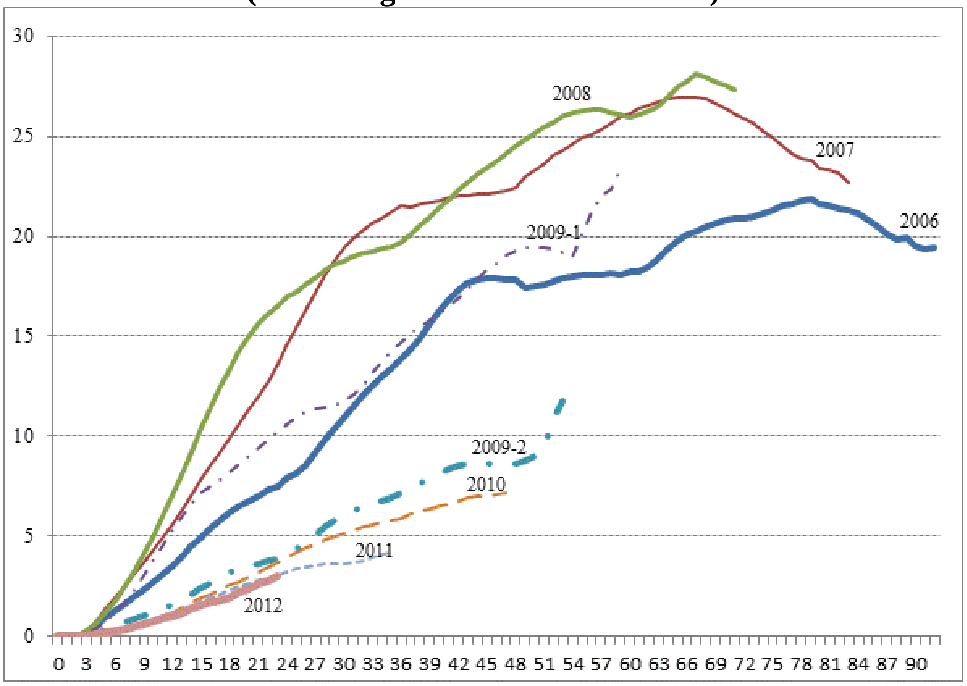
Age (Years)	2012	2011	2010	2009-2	2009-1	2008	2007	2006
1	1.02%	1.17%	1.24%	1.60%	5.41%	7.02%	5.67%	3.54%
2		3.23	3.97	4.09	10.54	16.99	14.49	7.86
3			5.91	7.15	14.71	19.72	21.50	13.87
4				8.60	19.27	24.50	22.45	17.79
5						25.94	26.17	18.22
6							25.90	20.91
7								21.13

Source: U.S. Department of HUD/FHA, November 2013.

Exhibit I-15 provides a graphical representation of the development of serious delinquency rates throughout this recent economic cycle, for cohorts 2006-2012. This view highlights again how loans endorsed in the first half of 2009 are performing more like earlier vintages endorsed near the peak of the housing cycle, while loans endorsed in the second half of 2009 are performing more like the 2010-2012 cohorts.

Importantly, the first quarter of FY 2009 still included loans utilizing seller-funded down payment assistance. Loans using seller-funded down payment assistance have had an extremely large impact on the overall performance of FHA's portfolio; while these loans accounted for only approximately 13.5 percent of the total origination volume in FY 2001-2008 books, they are responsible for 33.5 percent of the negative value for these cohorts. In total, these seller-funded down payment assistance loans are estimated to have cost the MMI Fund more than $16 billion in economic value. Congress prohibited the use of seller-funded down payment assistance beginning in January 2009.

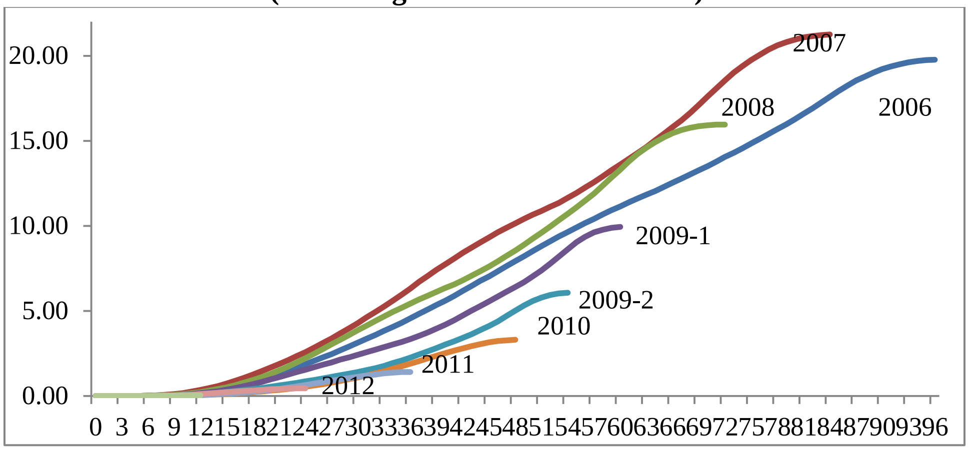
Exhibit I-15
Serious Delinquency Rates by Origination Vintage, Percent
(Excluding Streamline Refinances)



Source: U.S. Department of HUD/FHA, November 2013.

Exhibit I-16 shows "failure" rates of FHA loans by cohort vintage. A failure rate is defined here as the sum of to-date claims and active foreclosures, as a percentage of initial endorsements for each cohort. The significantly improved performance of the 2010 through 2012 books of business is a leading indicator of how those books of business should offset the financial strain placed on the MMI Fund by older books of business.

Exhibit I-16
Failure Rates by Seasoning and Vintage, Percent
(Excluding Streamline Refinances)



Source: U.S. Department of HUD/FHA, November 2013.

3. Controlling Claim Costs

FHA has launched a number of major initiatives to minimize and control claim costs, which have already demonstrated clear results. These include changes to home retention and loss mitigation activities and new approaches to claim resolution.

1. **Home Retention and Loss Mitigation.** FY 2013 marked a new high point in the use of FHA home retention loss mitigation options, with more than 466,000 homeowners assisted in retaining their homes through periods of financial disruption. (See Exhibit I-17.)

Exhibit I-17
FHA Home Retention and Loss Mitigation Activity

FY	Total Cures	FY Quarter			
		Q1	Q2	Q3	Q4
2007	175,745	26,900	59,918	37,482	51,445
2008	229,526	51,564	70,071	56,939	50,952
2009	192,438	47,490	64,061	45,193	35,694
2010	299,796	65,328	80,757	76,668	77,043
2011	384,170	90,426	116,548	87,851	89,345
2012	359,350	75,803	109,742	79,098	94,707
2013	466,160	97,917	137,258	112,314	118,671

Source: U.S. Department of HUD/FHA, November 2013.

The number of assistance actions increased in all categories. Most notably, the nearly 60,000 FHA HAMP cures is a four-fold increase from 2012, and represents approximately 13 percent of all assisted delinquency cures in 2013 (see Exhibit I-18). When the HAMP option first became available in 2010, it represented less than one percent of all assisted cures. FHA expects the HAMP option to continue playing an important role in the future, as new delinquency servicing guidelines established in 2013 require loan servicers to target assistance toward ensuring borrowers have affordable mortgage payments. That will lead to more HAMP actions, each of which includes a principal deferment element, as interest rates rise and rate-and-term modifications become less valuable in lowering monthly payment burdens.

The only other assistance type with an increase in share among all assisted cures is the Partial Claim. Though it is one of the least-used assistance types, its increased use and share in 2013 may represent improved employment conditions in many areas of the country. The Partial Claim option is most beneficial for borrowers with limited incomes, but whose monthly – and surplus – income have returned to their pre-default levels.

Exhibit I-18
Number of Assisted Delinquency Cures by Type and Fiscal Year of Cure, As of September 30, 2013

	Type of Loss Mitigation Home Retention Assistance				
Fiscal Year	Repayment Plans	Loan Modification	Partial Claim	FHA HAMP	Total
Assistance Counts					
2007	123,773	44,021	7,951	-	175,745
2008	164,830	59,425	5,271	-	229,526
2009	110,774	72,770	8,894	-	192,438
2010	132,087	154,062	11,349	2,298	299,796
2011	216,394	146,219	12,190	9,367	384,170
2012	254,777	82,743	6,862	14,968	359,350
2013	293,725	97,765	14,682	59,988	466,160
Usage Shares within each Fiscal Year					
2007	70.43%	25.05%	4.52%		100%
2008	71.81	25.89	2.30		100
2009	57.56	37.81	4.62		100
2010	44.06	51.39	3.79	0.77%	100
2011	56.33	38.06	3.17	2.44	100
2012	70.90	23.03	1.91	4.17	100
2013	63.01	20.97	3.15	12.87	100

Source: U.S. Department of HUD/FHA, November 2013.

2. **New Approaches to Claim Resolution and Asset Disposition.** It is not always possible for homeowners in default on their mortgages to re-establish the financial capacity to maintain their existing mortgage obligations. The traditional remedy available to FHA was to use the legal foreclosure process to obtain title to the property as satisfaction for the debt, and then to manage and sell that property via the "real-estate owned" (REO) process. REO sales, however, are typically the most expensive disposition method for FHA.

   During the course of FY 2013, HUD ramped up its ongoing efforts to control the net losses that result from what might be termed full loan default. The immediate results of these efforts can be seen in Exhibit I-19. While traditional REO actions are still the primary resolution type, FY 2013 marked a turning point away from heavy reliance upon REO.

The expansion of these programs, described below, has had a significant impact on overall net loss rates, as is clear in Exhibit I-19. Overall loss rates have improved from 63.1 percent in FY 2012 to 57.4 percent in FY 2013.

Exhibit I-19
Comparing Default Dispositions in FY 2012 and 2013

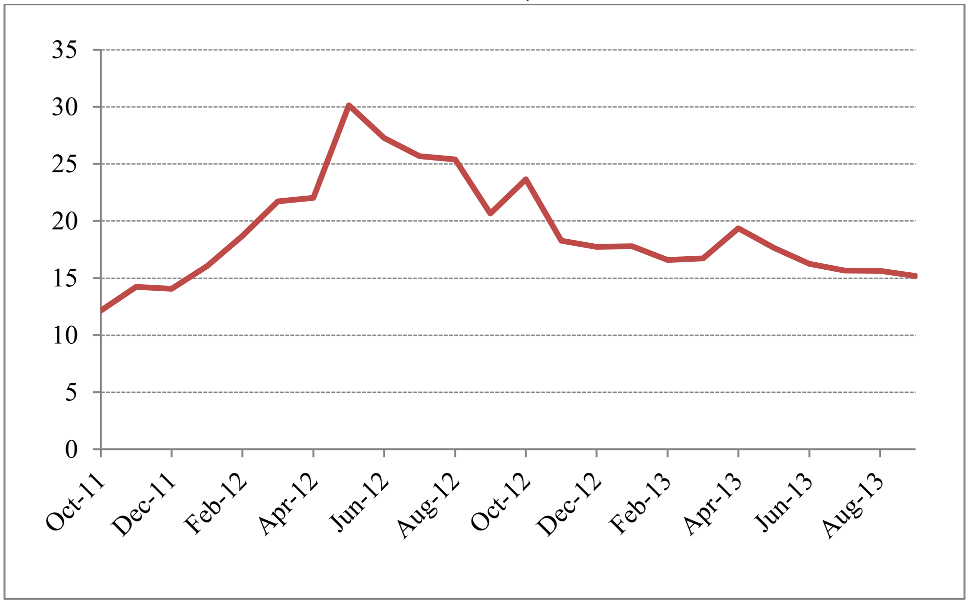
	2013			**2012**		
Disposition Type	**Loss Rate (% UPB)**	**Case Count**	**Share of Dispositions**	**Loss Rate (% UPB)**	**Case Count**	**Share of Dispositions**
REO	60.5	109,100	58.1	69.7	102,700	70.7
Note Sale (DASP)	63.9[a]	33,400	17.8	68.3[a]	1,200	0.8
Third Party Sales	41.1	10,700	5.7	39.3	4,600	3.2
Pre-foreclosure Sales	44.2	34,600	18.4	47.5	36,700	25.3
Total	**57.4**	**187,800**	**100.0**	**63.1**	**145,200**	**100.0**

[a]A high share of significantly aged properties, mostly located in judicial states and which experience delayed foreclosure actions, have driven the high loss rate for the Note Sale disposition path. The Note Sale program has been useful in clearing the backlog of foreclosed properties for FHA, and on average has experienced equal or better recoveries than would be expected from REO dispositions of like assets..
Source: U.S. Department of HUD/FHA; November 2013.

- **Distressed Asset Stabilization Program (DASP).** In the course of the fiscal year, HUD conducted a series of large-scale auctions of seriously delinquent FHA-insured loans under DASP. Through DASP, HUD sells non-performing mortgages to investors prior to the completion of a foreclosure, potentially providing alternatives to foreclosure for borrowers and enabling FHA to avoid costs associated with managing and marketing the underlying collateral as REO properties. Throughout FY 2013, HUD paid nearly 33,000 insurance claims in connection with its DASP sales, which were held in September 2012 and in March and June 2013.[3]

[3] Details on these sales can be found at: http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/comp/asset/hsgloan.

Exhibit I-20
Foreclosure Starts, Thousands



Source: U.S. Department of HUD/FHA, November 2013.

DASP has been critical for clearing a backlog of defaulted assets (see Exhibit I-20). In contrast to FY 2012, when the in-foreclosure inventory increased throughout the year, FY 2013 saw a steady decline. From a peak of 234,149 in October 2012, in-foreclosure inventory was down to 187,518 in September 2013, a 20 percent reduction across the fiscal year, and the lowest level since December 2011. Since mid-year 2012 and the signing of the National Mortgage Settlement, the addressing by lenders of residual delays caused by robo-signing issues, the apparent improvement in the processing of cases in judicial foreclosure states, and the implementation of DASP have all contributed to the decline in FHA's in-foreclosure inventory.

- **Third-Party Sales (TPS)**. The second major development initiated in the area of REO alternatives in FY 2013 was the formalization and expanded utilization of what had been a pilot program to encourage sales of foreclosed properties to third-parties at foreclosure auctions. Such sales allow FHA to avoid the costs associated with taking possession of properties and selling them as REO. Starting in February 2013, HUD authorized servicers of defaulted FHA-insured loans to use new foreclosure bidding instructions, and to employ auction houses to enhance demand and rates of sale of properties to third-party bidders, creating the so-called Third-Party Sales (TPS) program. The new bidding instructions align price offers of FHA loan servicers with expected recoveries in REO, and create opportunity for improved outcomes through TPS, as acceptable bid levels are aligned with property values rather than the outstanding loan amount of the FHA-insured loan.[4] The total number of TPS dispositions doubled in FY 2013, and by the end of the fiscal year they were accounting for close to 10 percent of all foreclosure auction outcomes. Many TPS bids have been high enough that no claim was filed with FHA for shortage of sale proceeds against the total indebtedness.

- **Pre-foreclosure Sales (PFS).** In FY 2013, HUD revised loan-servicing policies to encourage more pre-foreclosure (PFS) sales. These actions, which are also known as short sales, permit willing homeowners to market a property themselves, with HUD's agreement to pay an insurance claim for the shortage of sale proceeds against the mortgage debt. HUD expanded eligibility criteria to both increase the rate of PFS as a disposition type in the future, and to permit them in many cases to occur earlier in the delinquency period. Though the number of PFS actions should certainly decline in the future with delinquency rates and numbers decreasing, HUD expects that they will still continue to be a much larger share of total dispositions than was true in years past. Prior to 2008, PFS actions represented less than 10 percent of all default dispositions. In contrast the PFS rate for FY 2013 was 18 percent. HUD believes this share will continue in the future.

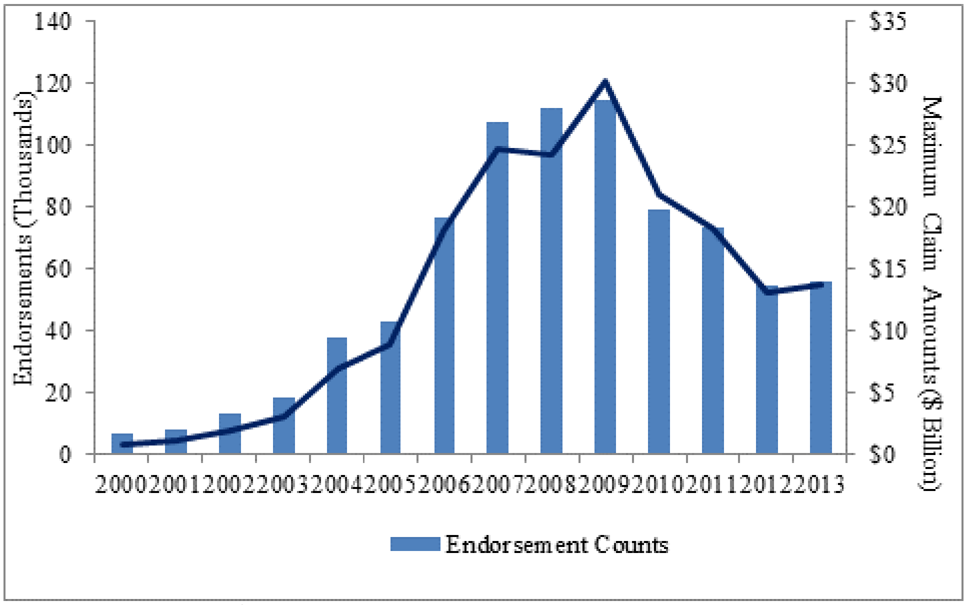
C. REVERSE MORTGAGES – HOME EQUITY CONVERSION MORTGAGE (HECM)

HUD assisted nearly 60,000 senior homeowners in ageing in place during FY 2013 through the Home Equity Conversion Mortgage (HECM) program. HECM permits owners above the age of 62, with accumulated home equity, to tap into that equity for a wide variety of financial needs. HECM loans accrue interest on outstanding balances, but there are no monthly payment requirements, and loans are not due-and-payable until the borrower exits the home. Many senior citizens use HECM loans to pay off outstanding home mortgages, substantially reducing their monthly housing expense and creating the financial margin needed to stay in their home on a reduced income.

HUD measures dollar volumes of HECM loan guarantees by the maximum claim (payout) amount (MCA). The MCA is the lesser of the property appraised value or FHA loan limit applicable at the time of loan origination. In FY 2013, FHA guaranteed $13.6 billion in HECM loans. This represents four percent growth over 2012, and indicates stabilization of program volumes after three straight years of decline from the 2009 peak of $30.2 billion. The median age of borrowers in 2013 was 69 years; single males made up 20 percent of borrowers, while single females accounted for 40 percent, and married couples the remaining 40 percent.

[4] Traditional bidding instructions require that loan servicers bid up to the amount of the expected claim payment by FHA, which is generally in excess of the outstanding loan balance, and includes interest payments and a share of foreclosure expenses. The new bidding instructions align net expected recoveries in REO with the appraised value of the property to provide at minimum break-even bidding prices for FHA's interest in the property. The defaulted loan balance is not material to that calculation.

Exhibit I-21
HECM Endorsement Counts and Maximum Claim Amounts

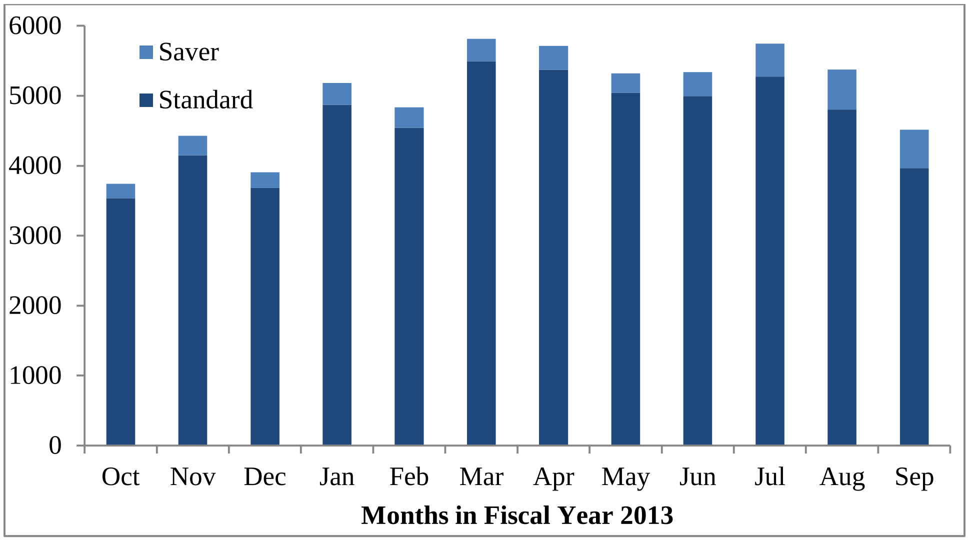


Source: U.S. Department of HUD/FHA, November 2013.

In April 2013, FHA limited access to fixed-interest-rate loans only to borrowers using the HECM Saver option. This was in response to lender requirements that fixed-rate loans also be full draw at loan origination. Large shares of fixed-rate, full-draw, Standard Option loans were jeopardizing the actuarial soundness of the HECM program. Mortgagors can still use the HECM Standard option to access larger amounts of home equity, but only with adjustable-rate mortgages that permit flexibility in the timing and total amount of cash draws.

Borrowers primarily continued to utilize the Standard Option after this change. Saver Option activity in FY 2013 continued at the same share as FY 2012 – approximately 7 percent by loan count. Initial cash distributions in FY 2013 continued the pattern of FY 2012 – approximately 37 percent were below $100,000; 35 percent in the $100,000-$200,000 range; 14 percent in the $201,000-$300,000 range; and, the remaining 14 percent above $301,000.

Exhibit I-22
HECM Standard and Saver Endorsement Counts



Source: U.S. Department of HUD/FHA, November 2013.

II. Status of the Mutual Mortgage Insurance Fund

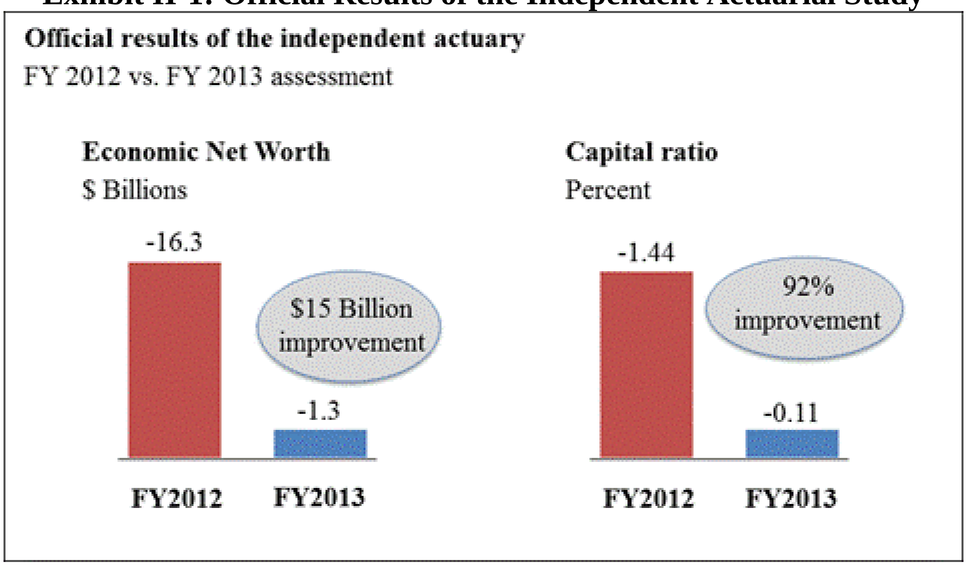
The independent actuary reports that the MMI Fund is on a positive trajectory.

- The Economic Net Worth (ENW)[5] of the Fund has improved by $15 billion this past year, driven especially by the quality of newer books of business and major policy changes.

- The trajectory of future ENW and the capital ratio will climb at a faster rate than was projected last year. According to the independent actuary's projections, the MMIF is expected to reach the required Capital Ratio of 2 percent by FY 2015 rather than FY 2017, as was anticipated in last year's report.

This chapter starts with a summary discussion of the findings of the actuarial study, and then provides details of both the Forward and HECM portfolios separately. The final written reports from the independent actuary are available online in the FHA/Office of Housing Reading Room.[6]

Exhibit II-1: Official Results of the Independent Actuarial Study



Source: FY 2013 Actuarial Reviews of the MMI Fund; analysis by U.S. Department of HUD/FHA.

A. FINANCIAL STATUS OF THE MMI FUND

The financial status of the Fund is first measured by the sum of net capital resources available today and the expected future cash flows from outstanding loan guarantees. That sum is divided by the amount of active insurance-in-force to arrive at the statutory capital ratio measure. The current actuarial assessment is that the MMI Fund capital ratio has risen this year from -1.44 percent to -0.11 percent.

[5] Economic Net Worth = Net capital resources plus projected MIP revenue, minus projected credit losses (see Appendix D for more detail)
[6] See http://www.hud.gov/offices/hsg/hsgrroom.cfm.

1. Account balances

At the end of FY 2013, the MMI Fund had net capital resources of approximately $29.68 billion, which is slightly lower than the $31.59 billion balance at the start of the fiscal year.

Exhibit II-2 details how capital resources have changed over the past year. The two largest items are negative net insurance income for forward loans, resulting from record claim payouts during the year, and a significant transfer of funds from Forward loans to HECM. That transfer to HECM resulted from the annual budget re-estimate process overseen by the Office of Management and Budget (OMB). The re-estimate required HUD to book an additional $5.517 in dedicated reserves against the potential for future losses on HECM cohorts 2009-2012.[7] Because HECM had only a net of $365 million of capital available, additional funds were needed. Those funds came from two sources:

- **Transfer of Forward Loans Capital.** A total of $4.263 billion was transferred from Forward loans capital to HECM loss reserves. This was the maximum amount available for transfer after booking the Forward loan re-estimate.

- **Mandatory Appropriation.** The residual of the re-estimate requirement, after using available HECM and Forward loan capital, came from a mandatory appropriation of $1.686 billion. Such a transfer is common for all Federal direct loan and loan guarantee programs having “upward” re-estimates in a given year. Reverse transfers are also possible, through “downward” re-estimates in the future.

[7] HECM joined the MMI Fund group of programs in fiscal 2009. All loans insured prior to that time are accounted for in the General Insurance Fund.

Exhibit II-2
FY 2013 MMI Fund Capital Resource Balances and Activity
$ Millions

	Forwards	HECM[a]	MMI Fund
Capital Resources at Beginning of FY (10/1/12)	29,099	2,496	31,595
Capital Resource Activity During Fiscal 2013			
Net Gain from Investments	939	352	1,291
Net Insurance Income	(6,368)	(38)	(6,407)
Net Change in Value of Property Inventory	670	328	998
Net Change in Accounts Receivable and Payable[b]	485	33	518
Mandatory Appropriation[c]		1,686	1,686
Transfer to HECM Financing Account	(4,263)	4,263	0
Capital Resources at End of FY (9/30/13)	20,561	9,119	29,680
Composition of Capital Resources at End of Fiscal Year 2013			
Cash[d]	39,629	8,725	48,353
Investments	0	0	0
Properties and Mortgages	2,735	458	3,193
Other Assets and Receivables	371	3	374
Total Assets	42,734	9,186	51,920
Liabilities[e]	(22,173)	(67)	(22,240)
Capital Resources at End of Year	20,561	9,119	29,680

[a]Annual endorsement volumes for HECM are smaller than forward endorsements

[b]The change in this category is primarily from $375 Million o in pending Single-Family note sale settlement receipts.

[c]Mandatory appropriations come from the U.S. Treasury, through approval of OMB, and under permanent and indefinite Budget authority provided by the Federal Credit Reform Act of 1990.

[d]The program-level balances reflect $797 million in net transfers from Forward to HECM in earlier years to effect required HECM budget re-estimates, plus the transfer shown in the Capital Resource Activity panel of this Table.

[e] Liabilities are cash transfers from the Treasury which act as cash management reserves, required as part of Federal Credit Reform Act rules, that account for future premiums. These are transferred back to the Treasury once premiums are collected.

Source: U.S. Department of HUD/FHA; HUD Accounting systems, and the FY 2009, FY 2010, FY 2011 and FY 2012 independent actuarial study final review reports.

2. Economic Net Worth and Assessment of the Independent Actuary

The National Housing Act requires that HUD procure an independent actuarial study of the MMI Fund each year in order to obtain an outside assessment of the Fund's long-term capital position.[8] The fundamental actuarial valuation of the MMI Fund is provided in Exhibit II-3. The overall value of the Fund is defined as the Economic Net Worth (ENW), as outlined in the National Housing Act[9], and consists of two elements:

- The current net asset position of the portfolio (net capital resources)
- Plus the actuary's estimate of the present value of future cash flows on outstanding insurance commitments. This is equal to the:

[8] See Appendix D
[9] See 12 USC 1711(f).

– Actuarial estimate of the present value of projected mortgage insurance premiums (MIP) expected to be generated by the current portfolio

– Less the actuarial estimate of the present value of projected credit losses for the current portfolio[10] over the life of the loans

The Capital Reserve Ratio is then the division of the ENW by the value of the outstanding, insured portfolio (the amortized insurance-in-force) at the end of the relevant fiscal year.

This fiscal year, the MMI Fund's Economic Net Worth improved by $15 billion from last year's actuarial estimate, increasing from *negative* $16.3 billion to *negative* $1.3 billion. The MMIF Capital Ratio also improved from a *negative* 1.44 percent to *negative* 0.11 percent. The overall insurance-in-force also increased slightly, growing by about 4 percent to $1.178 trillion from $1.131 trillion. Exhibit II-3 provides details regarding the changes from last year.

Exhibit II-3
Actuarial Assessment of the Financial Condition of the MMI Fund;
FY 2012 Versus FY 2013,
$ Millions

	FY 2012	**FY 2013**	***Difference***	***% Difference***
Capital Resources at end of fiscal year	30,362	29,680	*-682*	*-2.2*
Plus: Actuary's present value of future cash flows on outstanding insurance	-46,638	-31,010	*15,628*	*33.6*
Economic Net Worth (ENW)	-16,276	-1,330	*14,946*	*91.8*
Amortized Insurance-in-Force at end of fiscal year (IIF)	1,131,543	1,178,154	*46,611*	*4.1*
Capital Ratio in percent (ENW/IIF)	-1.44	-0.11	*1.33*	*92.4*

Source: FY 2012 and FY 2013Actuarial Reviews of the MMI Fund; analysis by U.S. Department of HUD/FHA.

The change in performance versus last year, according to the actuary, can be attributed to four general areas (further enumerated in the individual sections on the Forward and HECM portfolios; see also Exhibit II-4):

- **House price and interest rate forecasts.** Updated forecasts of house price appreciation and interest rate paths (see Exhibit II-5 and Exhibit II-6) produced mixed results this year. While house price appreciation and interest rate forecasts have helped the HECM portfolio, the more pessimistic economic outlook in the 2015 to 2019 forecast period hurt the Forward portfolio. Likewise, lower than previously expected interest rates across most of the forecast period also hurts the Forward portfolio. The net effect of updated economic assumptions is a *negative* $2.9 billion impact on the Economic Net Worth of the MMI Fund.

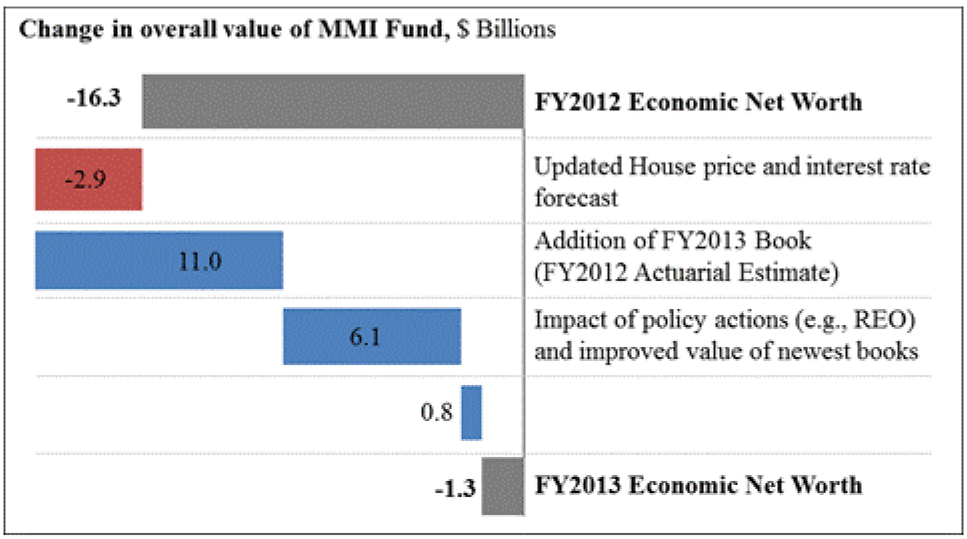
[10] It is important to note that the Economic Net Worth assumes no new business, but is rather a "wind-down" scenario. For example, new premium revenue generated from FY 2014 loan guarantees, and which could be used to cover legacy loan credit expense outlays, is not included in the FY 2013 Economic Net Worth calculation. Thus, the actuary's analysis essentially assumes that FHA stops endorsing new loans as of September 30, 2013.

- **Addition of the FY 2013 book-of-business.** The newest books in FHA's single family Forward portfolio, which, driven by FHA's policy actions, contain higher premiums and lower expected loss rates, continue to be the primary source of capital for dealing with legacy losses. The FY 2013 book alone added an additional $11 billion more in economic value than the actuary projected it would in last year's assessment, owing to a combination of higher volume and new, higher premium rates.

- **Additional impact of policy actions and increased value of newest books.** In addition to past policy actions, which are yielding healthier books-of-business, more recent policy actions are also contributing significant value to the MMIF. Specifically, actions FHA has taken to reduce claim costs, and better performance in the newest books, added an additional $6.1 billion in value to the MMI Fund.

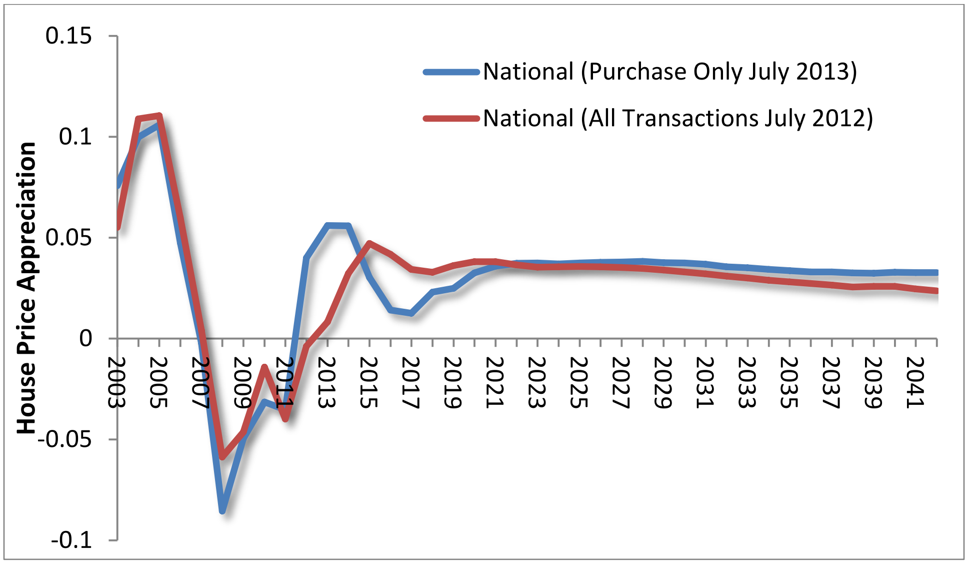
- **Other adjustments.** The net impact of model changes and other adjustments made by the actuary increased the ENW by $0.8 billion.

Exhibit II-4
Attribution of the Change in Economic Net Worth From Prior Year's Forecast, $ Billions



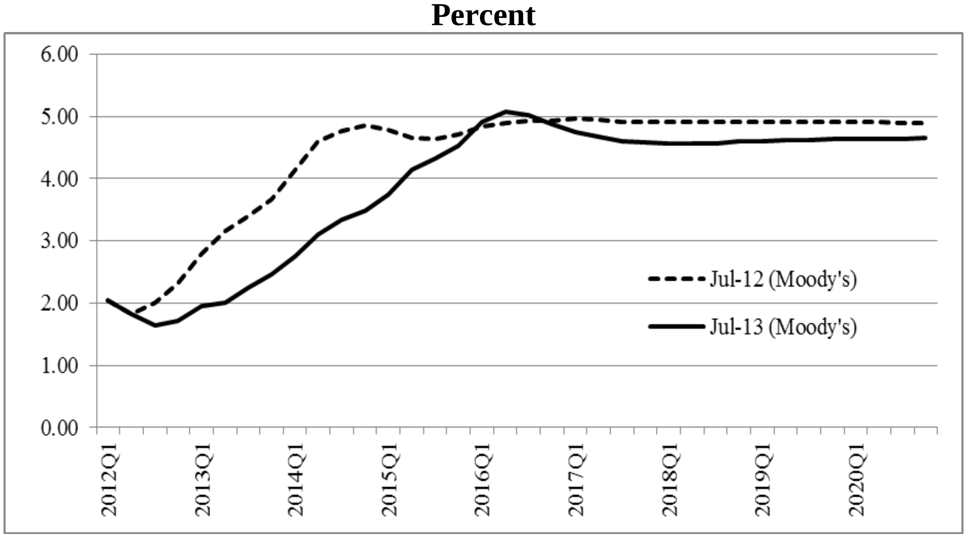
Source: FY 2013Actuarial Reviews of the MMI Fund; analysis by U.S. Department of HUD/FHA.

Exhibit II-5
Moody's National House Price Appreciation Rate Forecast – Comparison of Series Used in the FY 2012 and FY 2013 Actuarial Assessments, Percent



Source: FY 2013 Actuarial Reviews of the MMI Fund.

Exhibit II-6
Moody's 10-Year Treasury Rate Forecasts – Comparison of Series Used in the FY 2012 and FY 2013 Actuarial Assessments, Percent

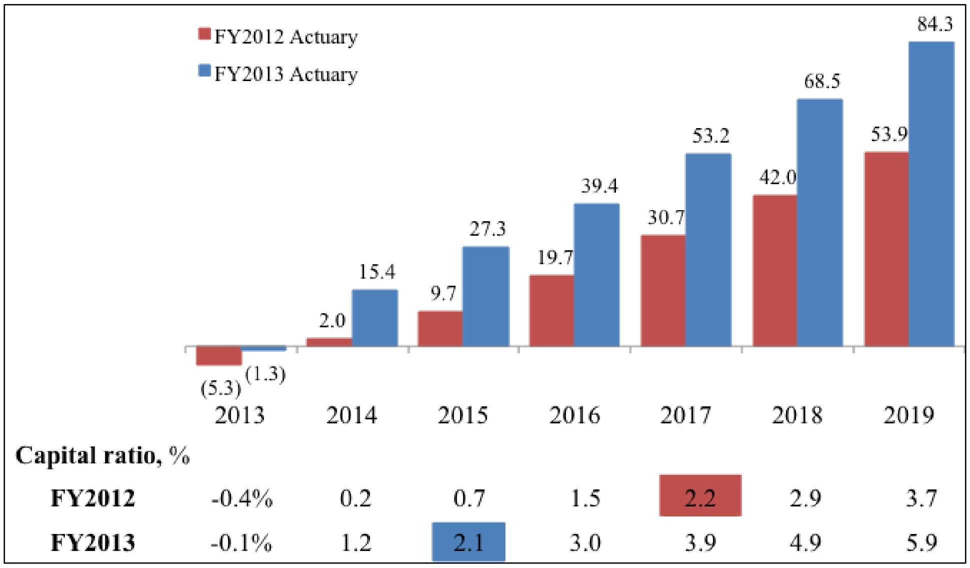


Source: FY 2013 Actuarial Reviews of the MMI Fund.

The actuarial assessment also concludes that the expected economic net worth of the MMI Fund will climb at a faster rate than was projected in FY 2012. The current projection is that ENW will grow at a rate of $13 billion per year, which compares with $8 billion per year in last year's projection of $8 billion per year projected in last year's assessment. By FY 2015, the Fund is now projected to have an ENW of $27 billion, $17 billion higher than was projected last year (see Exhibit II-7).

The most important implication of the more rapid growth in ENW is a faster climb to the 2 percent statutory capital ratio. The current actuarial assessment concludes that the 2 percent capital ratio will be reached in FY 2015, which is two years faster than last year's estimate of FY 2017.

Exhibit II-7
Annual Projections of MMI Fund Economic Net Worth and Capital Ratio under Base-Case Forecast Estimates, 2013–2017



Source: FY 2012 and FY 2013Actuarial Reviews of the MMI Fund; analysis by U.S. Department of HUD/FHA.

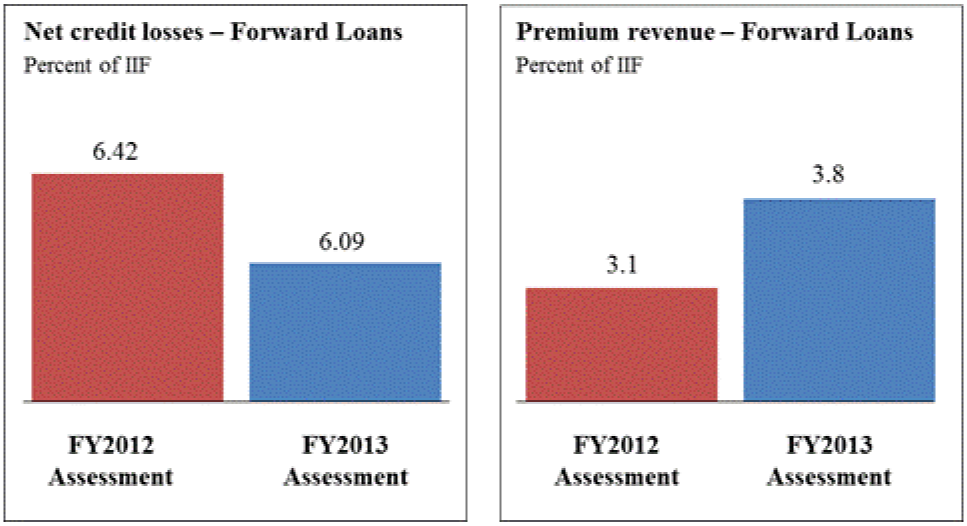
According to the assessment of the independent actuary, the more rapid growth in ENW is due entirely to policy changes, including changes to premiums and various loss mitigation initiatives. House price appreciation is forecasted to slow materially between 2015 and 2020 (see Exhibit II-5). While this by itself dampens outcomes compared to the FY 2012 forecast, recent policy changes make up the difference and give momentum to faster net growth in ENW and the capital ratio.

These forecasts assume no further changes in policy or other actions by FHA that might further accelerate growth in ENW, leading to an even more rapid path to meeting the 2 percent capital ratio requirement. Section III of this report outlines FHA's Capital Restoration Plan, which is designed to further accelerate the Fund's recovery.

B. ACTUARIAL ASSESSMENT OF THE SINGLE FAMILY FORWARD LOAN PORTFOLIO

Single Family "forward" mortgage loans comprise the vast majority of the active portfolio of the MMI Fund – accounting for more than 90 percent of insurance-in-force. This year, the actuary projects the present value of net future cash outflows in the Forward loan portfolio to be $10.6 billion better than in last year's forecast. This reflects the actuary's estimate of the improvement in projected credit losses, including a 27 percent improvement in loss-on-claim rates and an improving credit profile of new endorsements. It also reflects an increase in projected premium revenue of more than 23 percent from last year's forecast (see Exhibit II-8).

Exhibit II-8
Improvements in the Present Value of Future Cash Flows – SF Forward Loans
FY 2013 vs. FY 2012 Actuarial Assessments



Source: FY 2012 and FY 2013Actuarial Reviews of the MMI Fund; analysis by U.S. Department of HUD/FHA.

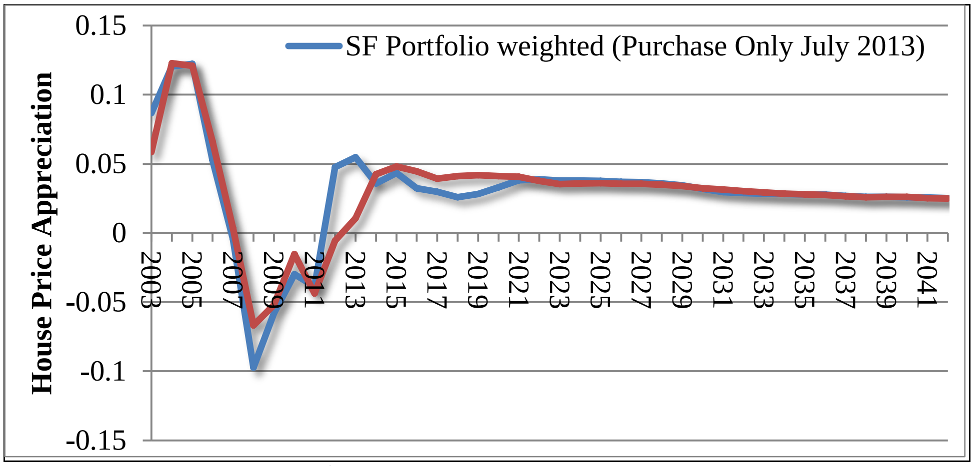
1. Attribution of change in economic value of Forward loans

The overall improvement of $10.6 billion in the net present value (NPV) of the Forward portfolio is after the $4.3 billion transfer to HECM mentioned earlier. Thus, the underlying improvement in economic value of the Forward portfolio is really closer to $15 billion. The principal factors resulting in net change in portfolio value this year are:

a. **Worse economic forecast.** The overall impact of a more pessimistic economic forecast than was projected last year is a reduction in value for the portfolio of more than $8.8 billion. This includes both a more pessimistic outlook on house price appreciation and depressed interest rates.

   i. **Less optimistic house price appreciation (HPA).** Moody's house price forecast can be described in three parts (see Exhibit II-9). First, is the immediate-term forecast, representing the first four to five quarters of the forecast period, where house price appreciation is expected to continue climbing at a rapid rate compared to the FY 2012 forecast. Second, is the out-year forecast beyond 2020 where house price appreciation is expected to track last year's forecast. The third part, and main driver of the negative impact on the portfolio, is the more pessimistic outlook between 2014 and 2020. Total house price appreciation during this time frame is expected to be about 20 percent worse than in the forecast used last year. The net impact of these revisions to Moody's house price appreciation forecast, especially the downward revision in over the 2014 to 2020 time frame, accounts for an estimated $4.0 billion in reduced economic value.

Exhibit II-9
Moody's Annual House Price Appreciation Forecast – Single Family Portfolio Weighted
FY 2013 Actuarial vs. FY 2012 Actuarial



Source: FY 2013 Actuarial Reviews of the MMI Fund.

ii. **Lower interest rate forecast.** Mortgage interest rates across most of the forecast period are expected to be lower than what Moody's forecasted last year (see Exhibit II-6). Specifically, interest rates in the 2014 to 2015 period are projected to be as much as1.5 percentage points lower than what was used in the FY 2012 actuarial study. While interest rates in the updated Moody's forecast are then expected to be slightly higher in 2016, they revert to being 25 to 30 basis points lower over the rest of the forecast period. This results in an estimated $4.8 billion reduction in economic value, which comes from two types of borrower actions.

First, according to the independent actuary, lower interest rates are projected to cause an increase in claim payments as borrowers with loans originated prior to FY 2012, and with above-market interest rates, consider their housing to be over-priced. For many with low or negative home equity, returning to renter status in order to lower housing expenses becomes a viable consideration, prompting higher numbers of these borrowers to default on their loans. The second factor at play with the lower interest rates of the early years of the forecast period is increased prepayment speeds. The actuary predicts that more borrowers with above-market mortgage interest rates will refinance their homes, leaving fewer active loans remaining from the current portfolio, and decreasing premium revenues accordingly.

b. **Policy actions and new books.** The performance of FHA's newest books and the impact of major policy actions continue to be the drivers of improvement in Fund value, even in the face of more pessimistic macroeconomic forecasts. Strong premium revenues from new books of business and new policy actions on the part of FHA are expected to make the newest books of business some of the best performing in FHA's history. These policy actions include higher premiums, changes to property disposition strategies and loss mitigation initiatives, and other programmatic changes. A list of the policy actions taken by FHA since 2009 can be found in Appendix B. Together, the addition of the FY 2013 book-of-business and the policy actions taken by FHA added $17.3 billion in economic value to the Fund.

c. **Other adjustments.** Other adjustments, including model refinements to improve the predictive power of the actuarial models contributed another $2.0 billion in economic value. These improvements to the actuary's model include the addition of new explanatory variables, new specifications of existing variables, and adjustments to the loss severity and volume forecast models.

2. Lifetime Economic Value by Book-of-Business

The low capital ratio today reflects an expectation that FHA's current pool of insured loans still has significant foreclosure and claim activity yet to occur as a result of the legacy portfolio. Projected losses are particularly large for the fiscal year 2007-2009 loans. Those loan cohorts were impacted by the severe recession and accompanying increases in unemployment, low premium revenue relative to expected losses, and large volumes of loans using seller-funded down payment assistance. The 2007-2009 books alone are expected to cost the MMIF more than $50 billion in credit losses.

In contrast to the strain caused by those older loans, the actuary expects fiscal years 2010 through 2013 endorsements to produce significant net revenues that can be used to offset mounting losses from earlier books of business. Exhibit II-10 demonstrates the contrast in quality between vintage eras. The addition of the FY 2014 book will continue the current trend of substantially improved economic value for the Fund.

Exhibit II-10
Lifetime Economic Value by Endorsement Vintage (Forward Loans)

Vintage	Original Loan Balances (billions)	Present Value of Premium Revenue	Present Value of Credit Losses	Economic Value	Economic Value (billions)
1992 – 2000	$653 billion	3.4%	2.2%	1.3%	$8.4 billion
2000 – 2006	600	2.8	5.2	(2.4)	(14.5)
2007 – 2009	564	3.7	9.0	(5.3)	(30.0)
2010 - 2013	969	6.2	3.0	3.2	31.3
2014	186	11.9	2.7	9.2	15.7
Total	**$2,971**	**4.8**	**4.4**	**0.4**	**11.0**

Source: FY 2013 Actuarial Reviews of the MMI Fund; analysis by U.S. Department of HUD/FHA.

From the 2000-2009 time period, the 2007-2008 books of business are expected to generate the most losses for the MMI Fund, accounting for twice the level of net losses as those from the 2000-2006 period. The peak book for losses-per-dollar of insured loans is 2007, the year that also has experienced the greatest total decline in home values. When that book is finally closed, its total cost is expected to exceed 22 percent of the initial dollar volume of loans insured. Though the 2008 book has a lower loss-per-dollar (17 percent), that book was three times as large as 2007, and therefore, has expected dollar losses that are more than twice those of the 2007 book ($30 billion versus $13 billion).

In addition to the impact of the housing crash, the 2007-2008 books were also heavily affected by loans using seller-funded down-payment-assistance (SFDPA). Those loans became ineligible for FHA insurance starting with originations in FY 2009, and they essentially disappear from new endorsements starting in January 2009.[11] However, their ongoing effect on the financial status of the MMI Fund is still measurable, as they are expected to result in 25 percent of the losses for the 2007-2008 vintages.[12] The actuary estimates that economic net worth of the MMI Fund would be higher by over $16 billion without SFDPA loans.[13] Thus, if FHA had not insured any SFDPA loans, the net economic value of the MMI Fund would be positive by more than $14 billion today.

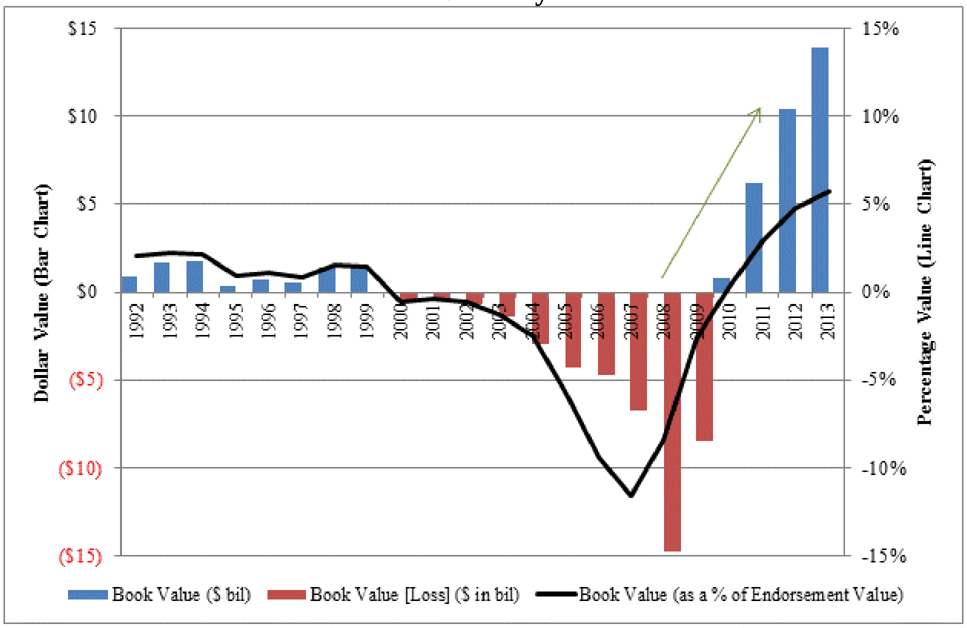
While credit losses are an important component of economic value, insurance premium revenue also plays a critical role in the recovery of the health of the MMI Fund. As is clear in Exhibit II-8, low premiums in the 2000-2006 cohorts contributed to the negative economic value for that time frame. If premium rates had been kept at the levels of the 1992-2000 period, the negative economic value would be half of the current level).

Given the importance of premium revenue as a key tool to balance risk, this Administration has put great emphasis on increasing premiums to adequately cover the risks associated with loans endorsed by FHA. Premium rate increases were among several measures taken by HUD to position FHA for quickly rebuilding the two percent required capital reserve ratio. With home prices still substantially below peak levels, and interest rates historically low, these premium rate increases have not unduly jeopardized FHA's role in providing an affordable mortgage financing option for low-to-moderate income home buyers. The six premium rate increases implemented by this Administration have, to date, bolstered the MMI Fund capital position by more than $23 billion.

Exhibit II-11 illustrates how actions taken to date with regard to credit policy and loan guarantee pricing have significantly improved the trajectory of the MMI Fund. Exhibit II-11 combines expected lifetime premium revenues and credit losses to depict the net economic value of each book, per the new actuarial estimates. This view further shows the improved trend of Fund finances. The 2010-2013 vintages have positive and increasing net economic value.

[11] Congress banned the use of FHA insurance on such loans in the Housing and Economic Recovery Act of 2008.
[12] Their ongoing effect is not only seen in the remaining home purchase loans from that era that could still result in an insurance claim, but also through streamline refinancing of those original loans that brought many of the 2005-2008 loans into new books.
[13] The net expected cost of those loans, as projected by the independent actuaries, grew over the past year to more than $16 billion.

Exhibit II-11
Lifetime Economic Value by Book-of-Business



Source: FY 2013 Actuarial Reviews of the MMI Fund; analysis by U.S. Department of HUD/FHA.

3. Forward Loan Performance Under Alternative Economic Scenarios

The realized economic value of the Fund will vary from the Actuary's estimate if actual drivers of loan performance deviate from base-case projections. This section compares the base-case economic value derived from Monte Carlo simulations with seven alternative scenarios. The base-case of the actuarial study is the mean, or average, expected economic value of the Fund across 100 randomly generated economic paths. The first five alternative scenarios reviewed here are percentile marks among the actuary's 100 simulated paths. They correspond to those economic paths that yield the 10th best, 25th best, 25th worst, 10th worst and the singular worst projected economic values. Exhibits II-12 and II-13 summarize the comparative results of the seven alternative scenarios.

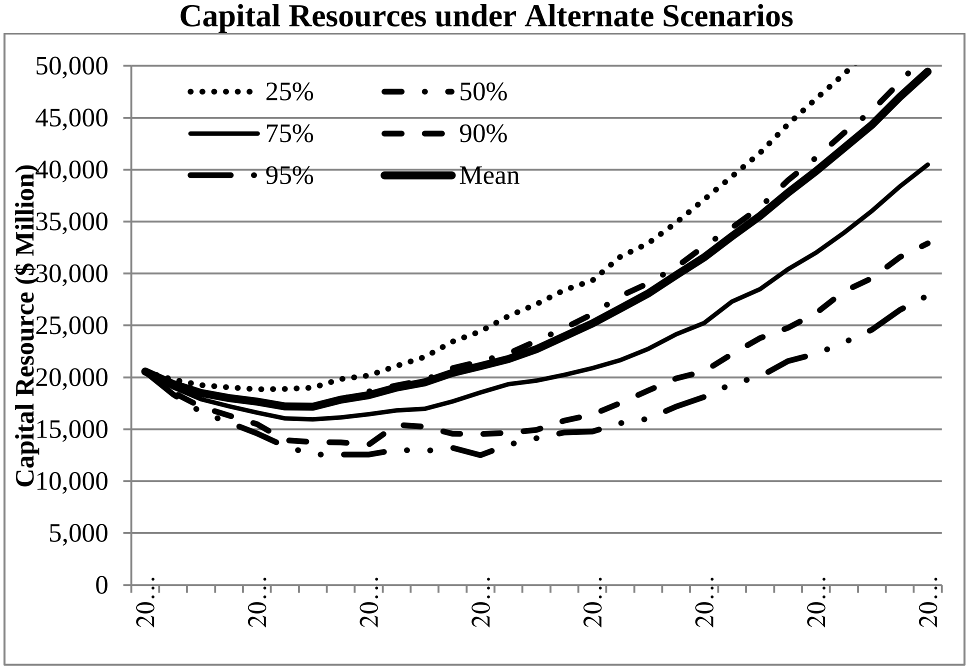
Exhibit II-14, which depicts forward loan capital resources under various points in the distribution of simulated economic values and includes new insurance endorsements, shows that between cash from operations, cash balances currently in the MMI Fund Financing Accounts, and the Capital Reserve Account balance, FHA would have resources to pay its claims even up to the 95th percentile scenario in the Actuary's simulation analysis. That represents the 5th worst outcome of the 100 random economic paths. To put this in perspective, this scenario projects that forward loans in the Fund, under current policies and premium rates, could lose an additional $19.4 billion in economic value over time (above and beyond the base case assumption of losses) and still not run out of capital resources.

Exhibit II–12
Projected MMI Fund Economic Values of Forward Loans – Comparing the Base-case to Seven Alternative Scenarios, $ Millions

	Results of Monte Carlo Simulations							
	Base-case	Best Path	10th Best	25th Best	Median	25th Worst	10th Worst	Worst Path
2013	-1,330	50,030	17,437	8,939	1,271	-9,430	-20,779	-103,310
2014	15,368	67,785	36,020	23,924	21,601	5,202	-6,040	-98,018
2015	27,282	79,475	48,245	34,333	32,850	20,227	3,862	-94,877
2016	39,395	92,004	58,512	42,908	44,634	34,875	15,270	-92,076
2017	53,272	110,989	70,097	56,086	57,587	49,223	26,045	-90,631
2018	68,501	139,772	83,624	74,758	71,136	62,716	37,606	-87,691
2019	84,337	171,268	97,082	93,911	83,872	76,239	51,799	-83,890
2020	100,666	203,256	110,623	110,932	95,637	89,354	73,037	-80,451

Source: IFE Group, FY 2013 Independent Actuarial Reviews of the MMI Fund portfolios, Forward Loans and HECM.

Exhibit II-13
Capital Resources under Alternate Scenarios



Source: IFE Group, Actuarial Review of the FHA MMI Fund Forward Loans for Fiscal Year 2013.

C. ACTUARIAL ASSESSMENT OF THE REVERSE MORTGAGE (HECM) PORTFOLIO

Loans in FHA's reverse mortgage program, the Home Equity Conversion Mortgage (HECM) program, are included in the MMI Fund beginning in 2009. They comprise a significantly smaller share of the total MMI portfolio than do Forward loans, $88 billion compared to $1.2 trillion. This year, the independent actuary projects the economic value of the HECM portfolio to be $6.5 billion, compared to *negative* $5.1 billion last year.

1. Attribution of Change in Economic Value Compared to FY 2012

Based on the independent actuary's assessment, the HECM portfolio's economic value improved by more than $9 billion from last year's result. This improvement is driven by three major factors:

a. **Economic forecast**. The updated forecast of economic assumptions is a significant contributor to the overall improvement in the HECM portfolio's economic value. Updates of the interest rate and house price appreciation forecasts together are worth $5.8 billion in added economic value.

   i. **Interest rates.** As outlined in Exhibit II-6, interest rates are projected to be lower than last year over the majority of the forecast period. Lower interest rates have a net positive effect on the HECM portfolio on the order of $3.6 billion. Most of this benefit is derived from the discounting effect. Specifically, HECM recoveries occur much later in the future than claims. The lower interest rate assumption has a larger impact on the cash inflows than outflows because major inflows from property recoveries occur later than do major outflow from loan assignment claim payments.

   ii. **House price appreciation.** Updates to house price appreciation assumptions are worth $2.2 billion in increased economic value. The HECM portfolio is more concentrated in states that had higher near-term house price growth rates than were were predicted by Moody's one year earlier. The high-volume states of California, Texas, Florida and New York had an average increase of 2.20 percentage points in this year's forecast versus 1.99 percentage points in last year's Moody's forecast.

b. **Mandatory appropriation.** As described at the beginning of this chapter, FHA was required to take a mandatory appropriation for HECM at the close of the 2013 fiscal year. to increase required loss reserves for the HECM portfolio. Consistent with this required transfer, the transfer of those funds was credited to the HECM portfolio in this year's actuarial review. This increased the economic value of the Fund by $1.6 billion.

c. **Capital transfer from Forward loan portfolio.** The amount of the mandatory appropriation was the net difference between the required re-estimate for HECM and available resources to fund that re-estimate. Initial funds came both from HECM budget receipts in 2013, and from capital account balances built from the Forward program and not required for the Forward re-estimate. The transfer from the Forward loan portfolio was worth $4.3 billion.

All of these changes and adjustments have resulted in a HECM portfolio with a significantly higher balance of capital than in prior years. This gives the program the needed stability to permit FHA to make more fundamental changes to the HECM program for long-term sustainability.

Exhibit II-14
Attribution of the change in Economic Net Worth, $ Billions

Capital Resources as of 10/1/2012	2.5	
Capital Transferred from Forward Loans	4.3	
Mandatory Appropriation	1.7	
Other Capital Adjustments[a]	0.7	
1. Capital Resources as of 9/30/2013		**9.1**
FY 2012 Actuarial PV of Future Cash Flows	(7.6)	
Improvements in PV of Future Cash Flows[b]	5.0	
2. FY2013 Actuarial PV of Future Cash Flows		**(2.6)**
FY2013 Economic Net Worth (1 + 2)		**6.5**

[a]Net Gain from Investment, Net Insurance Income, Net Change in Value of Property Inventory, Net Change in Accounts Payable
[b]Including improvements due to updates in macroeconomic forecasts (house price appreciation and interest rates)
Source: Actuarial Review of the FHA MMI Fund HECM Loans for FY 2013; analysis by U.S. Department of HUD/FHA.

2. Performance under alternative scenarios

The combination of better economic projections and transfers into the HECM financing accounts has created a substantial capital cushion. As seen in Exhibit II-15, the actuarial assessment concludes that there is slightly more than a 10 percent chance that deteriorating economic conditions could result in a negative capital position for the HECM MMI Fund portfolio. Even under the 10^{th} worst economic scenario generated by the actuary, HECM would return to positive capital in 2016.

Exhibit II–15
Projected HECM MMI Fund Economic Values – Comparing Base-case to Seven Alternative Scenarios, $ Millions

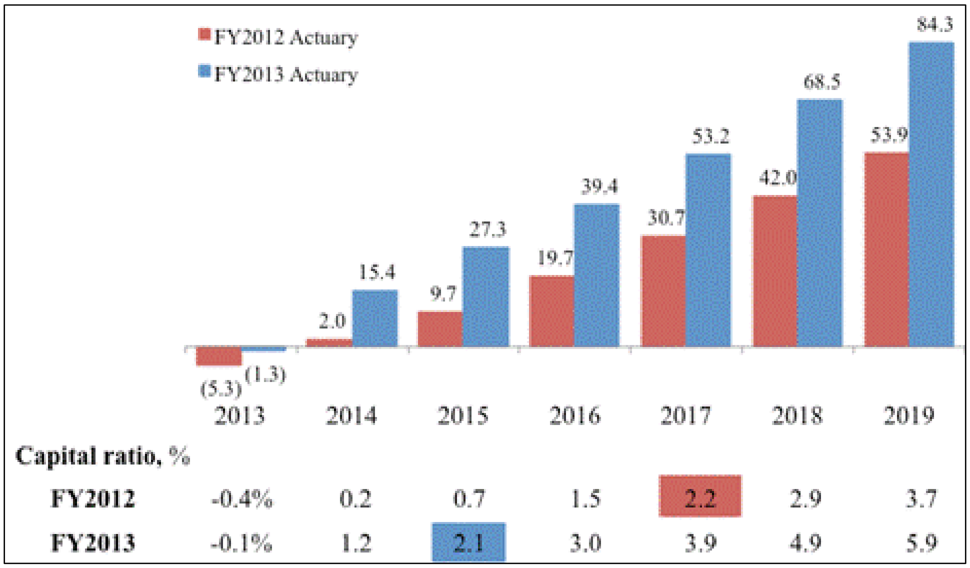
	Results of Monte Carlo Simulations					
	Base-case	10th Best	25th Best	25th Worst	10th Worst	Worst Path
2013	$6,541	$14,542	$9,914	$2,696	-$1,521	-$17,026
2014	7,523	15,238	10,904	3,724	-947	-16,485
2015	8,551	16,010	11,968	4,826	-446	-15,874
2016	9,643	17,003	13,229	5,920	214	-15,378
2017	10,870	18,264	14,653	7,052	953	-15,077
2018	12,260	20,018	15,870	8,274	1,867	-14,827
2019	13,765	21,922	17,240	9,399	3,125	-14,581
2020	15,378	23,763	19,086	10,830	4,503	-14,312

Source: IFE Group, FY2013 Independent Actuarial Reviews of the MMI Fund portfolios, Forward Loans and HECM.

III. Capital Restoration Plan

The independent actuary provides an estimate of the timing required to achieve a 2 percent capital ratio as part of its analysis. Illustrated in Exhibit III-1 are the results of the actuary's analysis. This year, the official results of the independent actuary project that FHA will reach the required 2 percent capital reserve ratio level by FY 2015 – two years sooner than the timing forecasted in last year's review.

Exhibit III-1
Annual Projections of MMI Fund Economic Net Worth and Capital Ratio under Base-Case Estimates, 2013–2019



Source: FY 2012 and FY 2013Actuarial Reviews of the MMI Fund; analysis by U.S. Department of HUD/FHA.

These projections assume no change in policy going forward. However, HUD will build on progress to date and continue to focus on recapitalizing the Fund and achieving the 2 percent capital reserve ratio.

A. ACTIONS TAKEN TO STRENGTHEN THE FUND

Over the past several years, FHA has made numerous changes in order to strengthen the value of the MMIF. Exhibit III-2 illustrates some examples of these changes [14]. The actions taken over the past five years have increased the revenues and quality in FHA's newest books while containing losses from the legacy portfolio. As a result of these steps, FHA is well positioned to continue providing access to credit for underserved borrowers while simultaneously securing the health of the Fund. All changes made to FHA policy since 2009 are projected to have improved the economic value of the Fund by more than $30 billion.

[14] A more complete list of actions taken under the current Administration to strengthen the MMI Fund can be found in Appendix B.

Exhibit III-2
Select Examples of Administration and Congressional Actions Taken to Strengthen the MMIF

Programmatic changes to focus on core mission	☑ Eliminated seller-funded down-payment program ☑ New appraisal standards ☑ Enhanced streamline refinance program ☑ Changed down-payment/credit score requirements ☑ Introduced HECM Saver and Adjusted HECM Principal Limit Factors ☑ Streamlined PFS ☑ Consolidated and updated condominium policy
More robust risk management	☑ Created Office of Risk Management ☑ Enhanced underwriting requirements ☑ Introduced new loan modification waterfall ☑ Expanded use of REO alternative, including note sales and claims without conveyance of title ☑ Increased enforcement for FHA lenders ☑ Updated quality control requirements
Restructured pricing to match risk and build capital reserve	☑ Increased upfront MIP ☑ Increased annual MIP ☑ Revised premium cancellation policy

Source: U.S. Department of HUD/FHA, November 2013.

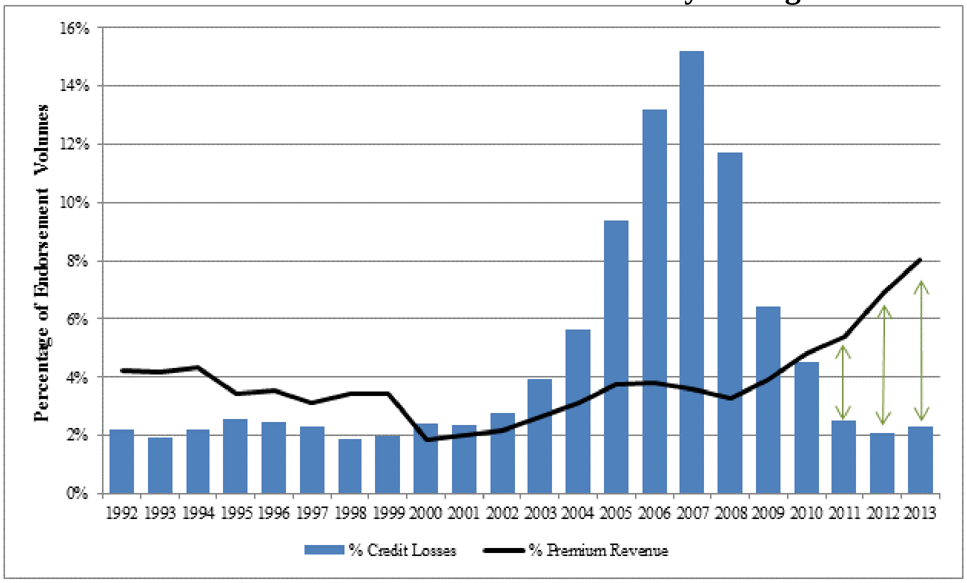
1. Restructured pricing to match risk and build capital reserve

This year, FHA aligned pricing and credit policies to promote sustainable lending by a) strengthening pricing to systematically contribute to a capital cushion at all risk levels, and b) putting in place prudent risk limits that continue to support the FHA mission.

a. **Adjust pricing framework to systematically contribute to a capital cushion.** FHA pricing in the past was structured to cover average claim losses. This pricing structure relied on lower risk loans to subsidize the cost of higher risk loans. While this break-even pricing approach may be appropriate for some government lending programs, it is not suitable for a program required to maintain a capital reserve. As shown in Exhibit III-3, average revenues remained at roughly the same level as historical average losses until around 2008.

   Further, this pricing approach exposed FHA to product mix risk. When the share of high risk loans increases to the levels attained in 2007 and 2008, average revenue was insufficient to cover expected losses, let alone the stress level losses experienced during that time. A pricing structure was needed that would instead allow every loan to cover its own expected losses and systematically contribute to a capital cushion that would protect the Fund during periods of economic stress.

Exhibit III-3
Premium Revenue and Credit Losses by Vintage



Source: U.S. Department of HUD/FHA, November 2013.

As shown in Exhibit III-3, price increases were implemented, beginning in 2009, to both cover average claims losses as well as contribute to a reserve. This includes pricing changes that came after Congress gave FHA authority to further alter annual premium pricing in 2010. Strengthened pricing was the first leg of a two-pronged strategy, as it is a necessary, but not sufficient, condition to establishing a sustainable, self-funding model for lending that is consistent with FHA's mission.

b. Establish claim loss limits consistent with continued access to credit

Establishing a pricing approach that corresponds to average loss expectations addresses sustainability over the long term and during periods of normal market conditions. However, it could still leave FHA vulnerable to extreme losses during times of economic stress if the amount of risk that can be absorbed is left unbound.

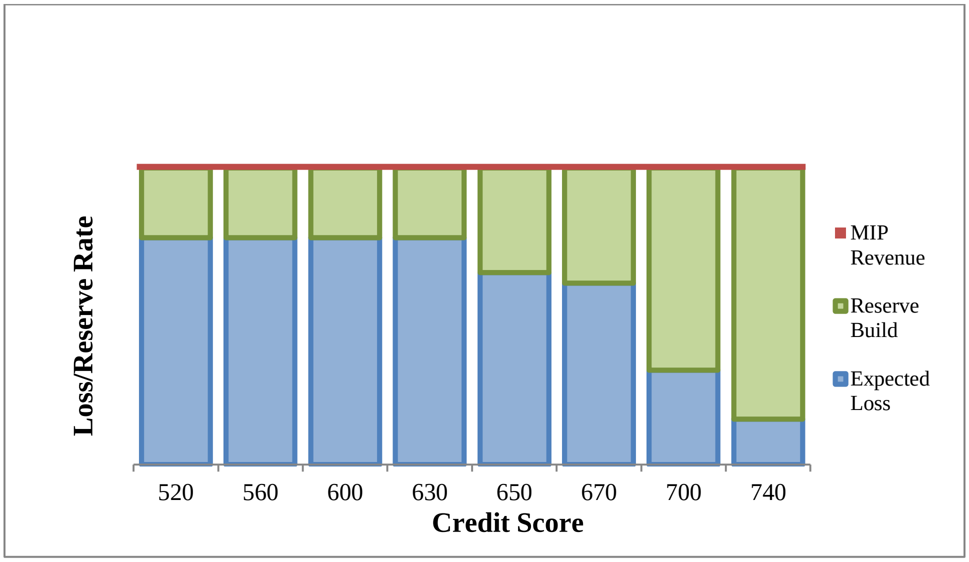
To address the added risk experienced in times of economic stress, FHA defined maximum claim loss tolerance at an individual loan level. Hard cutoffs (e.g., minimum credit scores) were not the dominant approach, and FHA instead relies on risk-based underwriting to discourage extreme risk layering for higher risk loans while still enabling the use of compensating factors, as appropriate. To accomplish this, FHA reset its Technology Open to All Lenders (TOTAL) Scorecard[15] tolerances to refer higher risk loans to manual underwriting, and its manual underwriting guidelines were strengthened to discourage extreme risk layering. For example, manual underwriting is now required

[15] FHA's TOTAL Mortgage Scorecard evaluates an applicant's overall credit worthiness. The Scorecard is based on several credit variables and, when combined with automated underwriting system functionalities, it recommends levels of underwriting and documentation to determine a loan's eligibility for insurance by FHA.

for loans where the borrower has a low credit score (under 620) and a high debt-to-income ratio.

This approach continues to promote access to credit while maintaining risk discipline at both the portfolio and loan level. Defining maximum claim loss tolerance at an individual loan level that is lower than projected revenue means that each loan that FHA insures will contribute to the MMI Fund capital cushion, as illustrated below.

Exhibit III-4
Portfolio Level Loss Reserves



Source: U.S. Department of HUD/FHA, November 2013.

Aligning pricing and credit policies to promote a sustainable business model allows FHA to focus on providing access to credit while also managing risks. For example,

- **The Fund is less vulnerable to shifts in risk mix.** Pricing supports the risk of all loans. By assuring that even the highest risk loans contribute to the capital reserve, the Fund is less reliant on subsidies provided by low risk loans.

- **FHA is positioned to prudently phase out of its countercyclical support role.** Current pricing promotes private capital's re-entry into the market, as is evidenced by the significant gain in market share for private mortgage insurers through FY 2013. The current price structure anticipates a natural shift of some lower risk borrower to private markets and the independent actuary has built this shift into its projections.

2. Contain losses from legacy books-of-business

The changes made since 2009 to FHA's credit policies and premium pricing have yielded substantial improvements in the quality of new loans endorsed by FHA. The second key strategy to increasing the value of the Fund is to reduce the impact of poorly performing legacy loans that were severely impacted by the recession.

The actuary projected over $40 billion in claims from seriously delinquent loans in the FY 2012 review. In response, FHA has made it a focus for FY 2013 to further reduce loss severities associated with the legacy book. FHA delivered on this commitment, in large part through execution of an overall asset management strategy aimed first at increasing the success rate of modification programs designed to keep borrowers in their homes. This was primarily accomplished through enhancement of existing loss mitigation tools such as short sales, modification programs, and streamlined refinancing.

If these remedies proved unsuccessful, newly expanded programs were utilized to provide an alternative to REO disposition. FHA expanded existing initiatives such as the Distressed Asset Stabilization Program (DASP) and Third Party Sales (TPS). The share of REO alternatives increased from 10 percent in 2009 to 43 percent by the end of FY 2013. Resulting improvements in loss severities are expected to add $5 billion to the Fund over the next several years.

The key elements of this broad asset management strategy are described below.

a. Re-design of FHA Modification Treatments to Better Assist Delinquent Homeowners

FHA revised standards for repayment plans, standard modifications, and FHA-HAMP loss mitigation products. The new loss mitigation policies increased payment relief for borrowers, targeting payment reductions of at least 20 percent for FHA-HAMP modifications; this yielded more sustainable payment outcomes and higher success rates for borrowers. As a result of these changes, FHA-HAMP activity increased four-fold in FY 2013.

b. Streamlining of the FHA Short-sale Policy

FHA is deeply committed to providing loss mitigation alternatives to borrowers which permit them to retain their homes. However, in some cases, home retention is simply not an option for some borrowers. For these borrowers, pre-foreclosure sales (short-sales) offer an opportunity for a "graceful exit" from their property that many borrowers deem preferable to foreclosure. FHA introduced a streamlined pre-foreclosure sale policy which removes certain barriers for borrowers in obtaining a short sale on their FHA-insured mortgage. This change is intended to increase the number of defaulted loans that end in short sales rather than foreclosures. Because losses from short-sales are substantially lower than from the traditional FHA REO process, the shift of greater numbers of distressed homeowners to short-sale dispositions rather than foreclosures yields better results for the MMI Fund, while allowing distressed borrowers to start anew without having to go through the difficult and costly foreclosure process.

c. Expansion of the Distressed Asset Stabilization Program (DASP)

FHA greatly expanded the DASP initiative in 2013, selling more than 35,000 non-performing loans through a competitive bidding process. Through DASP, defaulted notes are sold in bulk to third party purchasers without ever being conveyed to FHA.

FHA's analysis has shown that disposing of defaulted assets in this manner generally yielded lower losses for the MMI Fund than would have been realized by selling these same assets through FHA's normal REO disposition process, as carrying costs associated with preserving, managing, and marketing these assets as REO property were eliminated. In addition, DASP was instrumental in FHA's efforts to reduce the backlog of seriously delinquent loans resulting from foreclosure moratoriums instituted by servicers prior to the completion of the National Servicing Settlement.

d. Expansion of the Third Party Sale (TPS) Pilot Program

Similar to DASP, via the Third Party Sale (TPS) program, individual foreclosed properties secured by non-performing FHA-insured loans are offered for sale to third party purchasers without ever being conveyed to FHA (TSP auctions are of individual properties, unlike DASP, which are used to sell pools of loans in a bulk sale). As with DASP, FHA's analysis has shown that this method of disposing of these properties yielded lower losses for the MMI Fund than selling them through FHA's normal REO disposition process, as carrying costs associated with preserving, managing, and marketing an REO property were eliminated. The program was expanded in FY 2013 and comprised 5 percent of dispositions in FY 2013, displaying significantly lower severities than REO.

Prior to 2010, REO alternatives (primarily short sales) had comprised only about 10 percent of total dispositions per year, yielding average loss severities about 20 percent lower than REO. The share increased moderately to about 25 percent between 2010 and 2012, largely though increased usage of short sales. In FY 2013, FHA greatly expanded the menu of alternatives. As a result, over 40 percent of asset dispositions were executed through REO alternatives in FY 2013. The net effect of these efforts is summarized in Exhibit III-5.

Exhibit III-5
Asset Disposition Performance –
Loss Severity and Share of Disposition by Type of Disposition Strategy

	Loss Severity FY 2012	Loss Severity FY 2013	Share of Disposition 2012 (by count)	Share of Disposition 2013 (by count)
PFS/Short Sale	48%	44%	26%	18%
CWCOT	39%	41%	2%	5%
Note Sales[a]	69%	64%	1%	20%
REO	70%	61%	72%	57%
Total	61%	56%	100%	100%

[a]The Note Sale program was used to assist in clearing the big foreclosure backlog created during the robo-signing litigation. Hence, the majority of loans offered through DASP have unique characteristics compared to the average REO population, resulting in higher loss rates compared to the average, but equal or better when compared to similar assets.
Source: U.S. Department of HUD/FHA, November 2013.

B. PLANNED ACTIONS TO MAINTAIN MOMENTUM AND MANAGE RISKS

As described in Exhibit III-1, steps taken in 2013 (and prior years) have improved the Fund's trajectory over both the short and long term. The actuary now projects that the Fund will achieve a 2 percent capital ratio two years sooner than was projected last year. Planned actions for 2014 are expected to continue the momentum, and focus specifically on three areas: 1) continue to aggressively minimize legacy losses, 2) pursue actions that simultaneously increase access to credit and strengthen the MMIF, and 3) pursue further Congressional actions that strengthen FHA for the long run.

1. Continue to Work Aggressively to Minimize Legacy Losses

In addition to the policy and programmatic changes that were accomplished in FY 2013, FHA will also take several innovative and proactive steps to increase utilization of loss mitigation options and reduce unnecessary asset disposition losses. As discussed, FHA expanded its capabilities to execute on a number of alternate dispositions for distressed assets. These alternatives have provided better execution than REO in most cases. As FHA has expanded available disposition mechanisms, it has developed a better understanding of relative advantages of each execution path. FHA is focused on improving its overall performance in FY 2014 by more actively targeting individual loans for specific disposition paths. Enhancing FHA's capacity to utilize the best execution path available will help to reduce claim losses over and above improvements gained through house price appreciation alone. Toward this end, we have developed an analytical tool to use in directing assets to the best execution possible, which we will further refine throughout this fiscal year.

2. Pursue Actions That Simultaneously Increase Access to Credit and Strengthen the MMIF

In FY 2014, FHA will place significant focus on finding opportunities to simultaneously increase access to credit while also strengthening the fund. These include initiatives to further enhance quality control of endorsements and exploring ways to promote better loan performance.

a. Quality Assurance and Enforcement Initiatives

Over the past five years, FHA has significantly enhanced its Quality Assurance (QA) and enforcement policies and practices, increasing consistency of loans reviews and communication to lenders, and improving its risk-based targeting methodologies. However, FHA's current approach to QA and enforcement still yields challenges to the successful realization of FHA's mission. Lenders have indicated that they are electing to curtail their lending to some of the populations FHA has historically served due to a number of factors, one of which is the perceived enforcement risk posed by loans to such borrowers should they default. In addition, the current construct subjects FHA to potentially greater risks as FHA examines and seeks enforcement on only a subset of all loans endorsed and some lenders, who agree to indemnify FHA for loans with defects, cease to exist before it is time to collect on the indemnification.

Therefore, in July 2013, FHA sought comments from stakeholders on potential changes to its quality assurance framework via an Advanced Notice of Proposed Rulemaking. The commentary received through this process reflected a consistent desire for FHA to be clear and transparent in defining manufacturing defects and underwriting standards; to establish different severity levels with commensurate consequences; to consistently apply these standards and communicate results to lenders; and to consider adjustments to the compare ratio to allow for a more refined analysis of lender performance.

As a result, FHA is exploring potential options to address the concerns identified by lenders, and will pursue enhancements to its QA and enforcement framework and methodologies in FY 2014. Through these changes, FHA hopes to provide the clarity necessary for FHA-approved lenders to cease utilizing credit overlays that unnecessarily inhibit credit access for responsible borrowers who meet FHA's underwriting requirements.

b. Housing Counseling Initiatives

As discussed in the 2012 Annual Report to Congress, the Office of Housing has launched initiatives to incorporate housing counseling into FHA single family lending programs. These initiatives are intended to both strengthen the MMIF as well as contribute to the sustainability of home ownership for families using FHA-insured products. HUD supports a network of more than 2,000 independent non-profits whose trained housing counselors are available to help equip families to make informed housing decisions and overcome financial and other barriers to securing quality and affordable housing. The initiatives started in FY 2013 are known as FHA-HAWK (Homeowners Armed with Knowledge).

FHA has conducted an extensive review of the research available regarding the impact of housing counseling on mortgage performance and borrower behavior. Through this review, FHA has identified key opportunities where housing counseling is likely to have the biggest impact on loan performance and borrower behavior. As a result, specific HAWK initiatives have been developed to capitalize on the key opportunities identified.

During 2013, two initiatives were launched by FHA that incorporated housing counseling into the lending process. HUD is closely monitoring both programs.

- Mortgagee Letter 2013-26: Extenuating Circumstances/Back To Work – this policy recognizes that millions of people lost jobs and homes during the recession. Since that time, many have become re-employed and are seeking to return to homeownership. However, the effect of bankruptcy, short sales or foreclosure can keep these families from purchasing a home for up to seven years. Under this policy, a household which had a negative economic event but now can demonstrate evidence of 12 months of on-time credit payments can be considered for an FHA loan if they complete housing counseling.

- HECM Changes – In concert with changes made by FHA to the reverse mortgage program to reduce risk for borrowers, HUD's Office of Housing Counseling trained reverse mortgage counselors on the changes, and reminded them about their responsibilities to provide unbiased and detailed reviews of the features of reverse mortgage products.

In addition to the initiatives that have been launched already, FHA is working on several other elements of the HAWK initiative which will be rolled out in the coming year.

- HAWK for New Homebuyers– providing incentives for first-time homebuyers who complete housing counseling prior to making a decision about homeownership. Participants would also agree to participate in a housing counseling program during their first year of homeownership, and could receive additional incentives based upon the performance during the first twelve months of their loans.

- Mechanisms that will better enable FHA to connect distressed borrowers with housing counseling resources to assist them

- Incorporating housing counseling into FHA loan modification programs

3. Pursue Further Congressional Actions That Strengthen FHA for the Long Run

Over the past several years, Congress has moved in important ways to strengthen and protect FHA. Indeed, were it not for the flexibility granted by Congress to FHA in 2010 in setting premium pricing, the current economic value of the MMI Fund would be more than $10 billion lower than it is today. And the actions taken by Congress in FY 2013 were instrumental in FHA's ability to quickly stabilize the HECM program. However, it is clear that there is still much to do that can only be achieved via a concerted partnership between FHA and Congress. Since 2010, as FHA has worked to bolster the long term health of the MMIF, the agency has requested several tools from Congress to better manage the Fund, and many of these requests, which are vitally necessary to better protect the Fund, have yet to be granted to FHA.

The proposals outlined below will enhance FHA's ability to hold lenders accountable for non-compliance with FHA policy and provide greater flexibility for FHA to make changes to policies and procedures as emerging needs and trends are identified. As a result, FHA will better be able to avoid unnecessary losses before they occur.

a. **Indemnification Authority for Direct Endorsement Lenders** – This provision, which FHA has been seeking since 2010, would allow FHA to seek indemnification from Direct Endorsement lenders, which represent 70% of all FHA approved lenders. Currently, FHA only has authority to require indemnification from lenders participating in the Lender Insurance (LI) program. If granted this authority, FHA will be able to obtain indemnification from all of its approved lenders for loans that do not comply with its requirements.

b. **Authority to Terminate Origination and Underwriting Approval:** This legislation would give FHA enhanced ability to review lender performance, and if a lender is found to have an excessive rate of early defaults and claims, would provide greater flexibility in terminating the approval of the lender to originate or underwrite single family mortgages for FHA insurance. FHA has also been seeking this authority since 2010.

c. **Revised Compare Ratio Requirement:** This provision would revise the statute governing the Credit Watch Termination Initiative to provide greater flexibility in establishing the metric by which FHA compares lender performance so that it more effectively captures the true performance of a lender during all market conditions, Specifically, this legislation would allow the Secretary to compare the rate of early defaults and claims for insured single family mortgage loans originated or underwritten by a lender with those same rates for other lenders on any basis the Secretary determines appropriate, such as geographic area, varying underwriting standards, or populations served. Further, the provision would permit the Secretary to implement such comparisons via regulations, notice, or Mortgagee Letter. This will allow FHA to tailor the compare ratio such that it provides meaningful comparisons of lenders in varying market conditions, providing greater clarity for lenders and a more refined understanding of their performance for FHA.

d. **Authority to Direct Servicing:** In order to facilitate more effective loss mitigation, this change would give FHA the authority to require poorly performing servicers to engage a specialized sub-servicer that demonstrates better performance results with regard to assisting troubled borrowers. Such authority would permit FHA to more effectively avoid losses arising from poor servicing of FHA-insured loans, yielding improved results for both borrowers and FHA.

e. **Reducing Barriers to Timely Risk Management:** Despite many policy and organizational changes made by FHA since 2009, the ability to manage risk appropriately is still limited and continues to impact the FHA's long term fiscal health. Constraints faced by FHA include an increasingly complex mortgage market, aging FHA systems and infrastructure, a need for additional skills and expertise, and difficulty responding quickly to major risk issues as a result of contractual and statutory limitations, such as limited flexibility in contracting and constrained ability to hire and retain highly qualified staff. For FHA to manage risk and maintain operations as 21st century mortgage insurer, these constraints must be dealt with appropriately. For that reason, we would like to continue to explore with Congress tools and flexibilities which can be leveraged to allow FHA to minimize risk to the Fund and taxpayers while continuing to serve consumers.

Conclusion

According to the independent actuary, these efforts are working. The actuary reports that the economic value of the MMI Fund has improved by $15 billion dollars when compared to last year, and the Fund's capital reserve ratio has improved 92 percent and is expected to reach the required two percent level in 2015 – two years sooner than was projected last year. According to the actuary, policy changes made by FHA account for much of the improvement in key performance metrics, such as premium revenue, credit quality, and recovery rates. Many of these same policy changes have also helped to reduce FHA's footprint in the market place.

Throughout its nearly 80 year history, FHA has played an important dual role in the nation's housing finance system, helping more than 40 million American families own or refinance a home, and stepping in numerous times to stabilize regional and national housing markets during periods of economic crisis. During the most recent crisis – the most severe since FHA's creation in the wake of the Great Depression – the agency again played its vital countercyclical role, ensuring that liquidity and credit access remained when private capital sources receded from the market. Providing stability and continuity in a struggling economy necessarily included additional risk for FHA and its MMI Fund. Over the past five years, this Administration has worked tirelessly to protect and strengthen the MMI Fund and position FHA for a healthy and successful future.

As FHA enters its eighth decade of service to American households, it will continue to aggressively pursue strategies that simultaneously enhance credit access for underserved borrowers and limit losses to the MMI Fund. The past five years – some of the most challenging the agency has ever faced – have proven that FHA can and must accomplish both goals. Doing so will be vital to providing access to the American dream for future generations of responsible credit-worthy borrowers.

Appendix A: Alternative Views

The National Affordable Housing Act of 1990 requires that FHA conduct an independent actuarial analysis of the economic net worth and financial status of the Mutual Mortgage Insurance (MMI) Fund, and report the results to Congress. Integrated Financial Engineering (IFE) Group is currently the prime contractor qualified to perform the actuarial study.

FHA recognizes the benefit of utilizing multiple models and methodologies in evaluating the Fund and estimating its future performance. Therefore, as part of FHA's overall effort to create robust, transparent processes across all programs, and to more fully understand the current status and trends within the MMI Fund portfolios, FHA procured an additional independent expert analysis to review the financial health of the MMI Fund for Fiscal Year 2013. This additional analysis is provided by a collaboration of Summit Consulting, LLC and Milliman, Inc. Having their alternate view enables FHA to assess the health of the MMI Fund through another lens, as the agency also continues work to develop more sophisticated and refined internal capabilities which will enable it to perform similar analyses.

While FHA appreciates the additional view of its portfolio afforded by Summit-Milliman's evaluation this year, there are a number of limitations to this evaluation, including:

- The Summit-Milliman model is new, and unlike IFE's model, has not been validated by HUD's auditors or the Office of Management and Budget.

- Because Summit-Milliman utilizes an innovative and newly developed approach, FHA is still evaluating how to use these results to complement those of IFE Group.

- Many of the loan performance metrics used by Summit-Milliman are new to HUD and cannot be directly compared with those of IFE.

The IFE study continues to provide the official view of the MMI Fund capital position used to develop this Annual Report to Congress. That decision, which was made prior to either entity beginning its work, was based largely on the fact that only IFE Group was prepared this year to use a stochastic simulation approach. HUD had committed to such an approach in response to an earlier Government Accounting Office (GAO) recommendation, and IFE implemented that as part of the 2012 actuarial study. IFE's stochastic modeling approach results in a portfolio valuation based on the average result across 100 possible economic scenarios, or paths. Summit-Milliman utilizes a deterministic modeling approach, using one singular scenario, or path. To fully test for the difference in valuation resulting from choice of forecasting methodologies, Summit-Milliman used the same base-case house price and interest rate forecast as IFE used for the central tendency of its stochastic process.

The Summit-Milliman results support the conclusion that the MMI Fund is in the midst of an economic turnaround and that recent books of business are providing significant value to offset expected losses from earlier books. Although Summit-Milliman suggests a lower overall value for the MMI Fund, they believe FHA's credit loss exposure is materially lower than what IFE estimates. In the Summit-Millman view, however, the portfolio is also subject to faster projected prepayments, resulting in significantly lower revenues. The lower revenue projection more than offsets the lower credit loss projection, thus resulting in a lower overall valuation of the Fund.

1. Decomposition of the Alternative Views

Exhibit A-1 shows the overall results of Summit-Milliman and IFE Group compared by major portfolio, Forward and HECM loans. While both actuaries' results show an improvement from last year's economic net worth (ENW) estimate, the Summit-Milliman improvement is smaller, indicating a slower pace of recovery for MMI Fund capital. Summit-Milliman estimates a $5.7 billion lower value for the MMI Fund (Forward loans and HECMs) than IFE.

Exhibit A-1
Economic Net Worth by Major Portfolio – Comparing Estimates of IFE Group and Summit-Millman

	Capital, $Billion				
	PV of Cash flows		Capital		
	Forward	HECM	Resources	MMIF	MMIF
IFE-2012	-$39.1	-$7.6	$30.4	-$16.3	**-1.4%**
IFE	-$28.4	-$2.6	$29.7	-$1.3	**-0.1%**
Summit-Milliman	-$31.2	-$5.5	$29.7	-$7.0	**-0.6%**

Source: FY 2013 Actuarial Reviews of the MMI Fund; analysis by U.S. Department of HUD/FHA.

The bigger difference between the two valuations is in the projection of the HECM portfolio, where Summit-Milliman projects a value $2.9 billion lower than IFE Group. A more detailed review suggests that Summit-Milliman's termination speeds are much slower than IFE's. Slower termination speeds adversely impact cash flow for two reasons. First, the longer borrowers stay in the home, the greater FHA's exposure to potential loss-on-sale because of the growing loan balance. Second, HECM homes tend to appreciate at a slower rate than market averages suggest. Thus, longer stays increase the probability and size of loss-on-sale as lower house price growth means a faster, and widening gap between loan balance and property value. Moreover, the two actuaries use different discounting methods to derive their present value estimates. This variation in methodology itself accounts for a significant portion of the difference in values in the HECM portfolio because the large difference in time from claim payouts for loan assignment to recoveries upon borrower exit from the home and property sale.[16]

While the overall Summit-Milliman estimate is $2.8 billion lower for forward loans than the official actuary, credit concerns are not the main driver, as Summit-Milliman projects about $9 billion less in credit losses. Summit-Milliman believes that the improved credit quality of FHA's recent vintages, coupled with forecasted improvement of home prices will result in faster prepayments than FHA has experienced in previous periods of rising interest rates, resulting in

[16] IFE Group has traditionally used more current interest rates and follows the OMB basket-of-zeros discount rates used for recent budget projections. At the request of HUD, Summit-Milliman used the actual interest rates used by FHA to borrow and lend with Treasury. The former was chosen to provide more of an economic assessment. The latter provides a closer measure to the valuation HUD performs for its financial statements and budget re-estimates.

reduced revenue of approximately $12 billion relative to IFE's estimate. The results for the Forward loan portfolio are shown in Exhibit A-2.

Exhibit A-2
Present Value of Future Cash Flows – Forward Portfolio

	NPV ($Billion)			NPV (% Unamortized Portfolio)		
	NPV Projected MIP Revenue	NPV Projected Claims Losses	Present Value of Future Cash Flows	MIP Revenue	Claims Losses	NPV
IFE	$41.8	$70.2	-$28.4	3.8%	6.4%	**-2.6%**
Summit-Milliman	$30.1	$61.3	-$31.2	2.8%	5.6%	**-2.9%**

Source: FY 2013 Actuarial Reviews of the MMI Fund; analysis by U.S. Department of HUD/FHA.

The table suggests that the two independent experts differ in their view of emerging risks within the forward loan portfolio. IFE, the official actuary, projects higher credit costs. Summit-Milliman, on the other hand, sees significantly improved credit characteristics that translate into lower credit losses, but which also directly result in greater prepayment risk and corresponding lower revenues.

There are two main questions that arise from the differing views. First, will REO loss severities continue to improve in FY 2014? Second, will the improved credit quality of new books and new pricing policy result in faster prepayments?

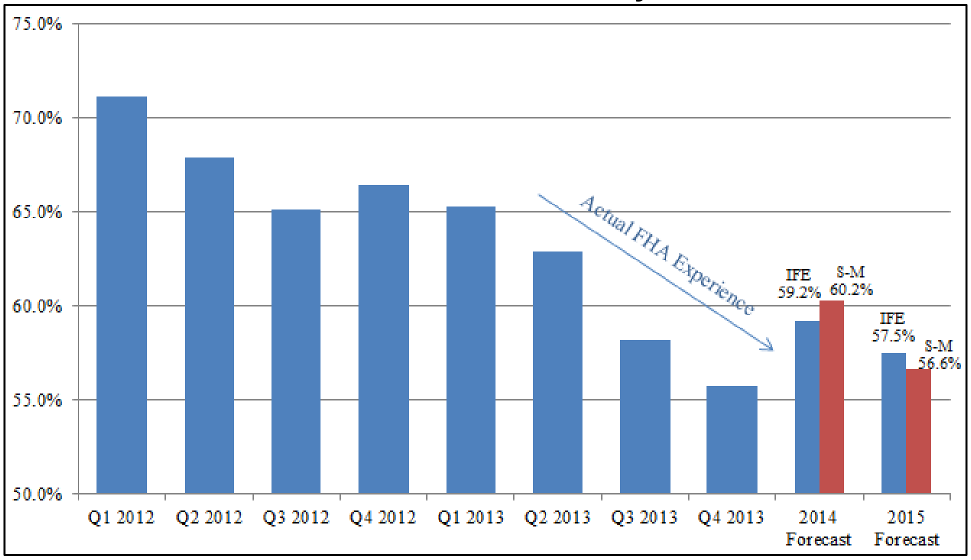
a. Will Real Estate Owned (REO) loss severities continue to improve in FY 2014?

Over the past year and a half, FHA has executed an overall asset management strategy aimed at ramping up REO alternatives. As REO alternatives expanded to a 40% share of asset dispositions in FY 2013, FHA also worked diligently to reduce REO costs. Exhibit A-3 illustrates that FHA's efforts to reduce REO claims costs yielded material improvement in FY 2013.

The chart also shows both independent experts' REO loss severity assumptions, which are projected to increase to a level higher than FHA experienced in FY 2013 in the upcoming year, and to remain at a higher severity the following year. These projections reflect a view that a continued decrease in loss severity will not continue at rates like those FHA has experienced in the past year.

While both Summit-Milliman and IFE present a view that REO loss rates will not continue to improve, FHA will maintain a focus on improving the REO process, and will further hone its policies to ensure that the improvements observed in the past number of months continues. Further discussion of these plans can be found in the Capital Restoration Plan included in this report.

Exhibit A-3
Loss Severities, Actual vs. Projected



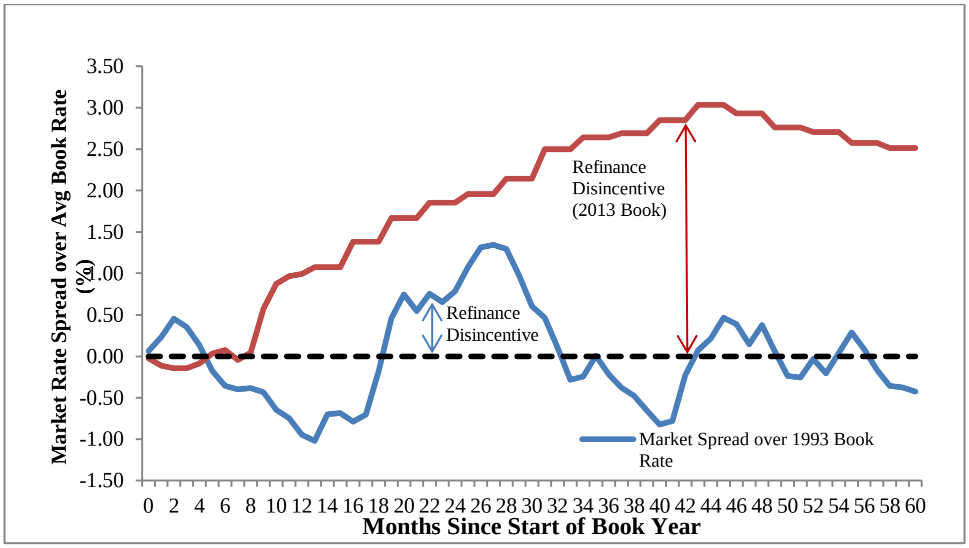
Source: FY 2013 Actuarial Reviews of the MMI Fund; analysis by U.S. Department of HUD/FHA

b. Will the improved credit quality of new books and new pricing policy result in faster prepayments?

Mortgage insurance premiums (MIP) are collected over time. The projected net present value (NPV) of MIP revenue is directly related to projected prepayment speeds, which determine the duration for which those premiums are collected for a particular loan. As stated previously, Summit-Milliman believes that the strong credit quality of the most recent FHA vintages, combined with improvements in home prices, will result in much faster prepayment than IFE projects, resulting in reduced revenue of approximately $12 billion relative to IFE's estimate.

Inconsistent with Summit-Milliman's view, a number of factors would suggest that the 2013 vintage, for example, should be among the slowest prepaying vintages in the last 30 years. Foremost among these factors, the 2013 vintage exhibits the lowest mortgage coupon in FHA's portfolio. Further, market rates already have risen since most of the book originated. Based on Moody's interest rate scenario, which project a rise in rates, the average 2013 mortgage rate is expected to be 200-300 basis points below market rates over the next four years. Exhibit A-4 compares the projected refinance incentive of the 2013 vintage to the actual experience of the 1993 book. The refinance disincentive is measured by the difference in average mortgage coupon minus projected market rates. The 1993 vintage was chosen for this comparison because Summit-Milliman projects 2013 to experience similar prepay speeds.

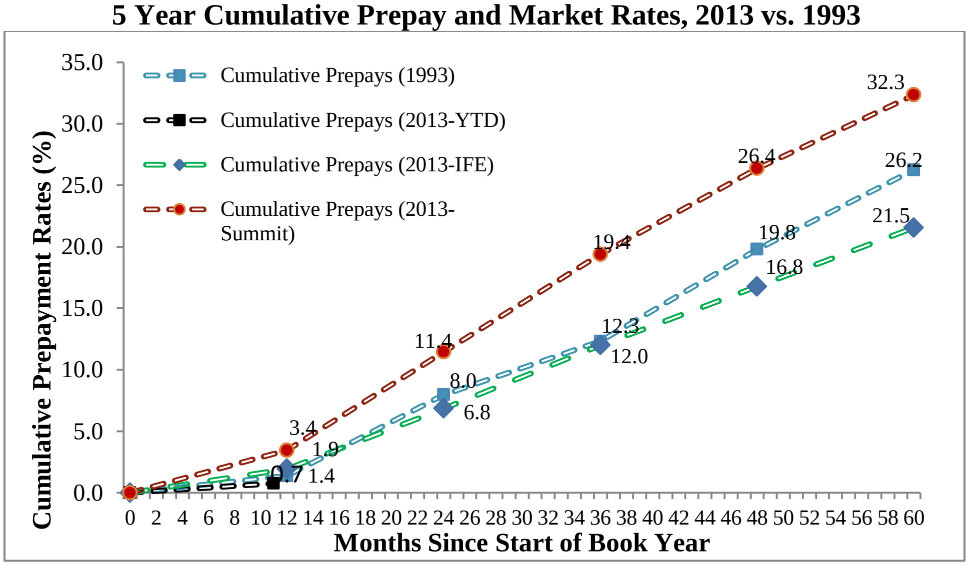
Exhibit A-4
Refinance Disincentive for First Five Years
2013 vs. 1993



Source: U.S. Department of HUD/FHA, November 2013.

All of these factors might suggest that the 2013 vintage would see slower prepayments than experienced by the 1993 vintage. Exhibit A-5 shows that Summit-Milliman expects faster prepayments than the 1993 vintage, due to superior credit characteristics.

Exhibit A-5
5 Year Cumulative Prepay and Market Rates, 2013 vs. 1993



Source: FY 2013 Actuarial Reviews of the MMI Fund; analysis by U.S. Department of HUD/FHA.

It should be noted that all prepayments do not necessarily cause a loss of revenue to the MMI Fund. The actuarial methodology requires the application of a runoff approach. This implies no future business, which by definition means prepaid loans leave the FHA portfolio permanently. In actuality, prepayments can and do recycle back into the FHA portfolio. For example, FHA encouraged streamlined refinancing to improve borrowers' ability to stay in their homes during the recent economic recession. These loans remained in the FHA portfolio with improved risk characteristics because of lower payments and yielded no loss of revenue for the MMI Fund.

As with the significant difference in views regarding projected loss severities between the two independent experts, divergent opinions in projected prepayment speeds suggests that surveillance needs to be expanded in the future to better capture underlying drivers of prepayments, particularly as it relates to the value of the projected revenue stream.

In summary, the results from each evaluation support the conclusion that the MMI Fund is in the midst of an economic turnaround. However, each independent expert differs in its views of emerging risks. IFE, the official actuary, projects higher credit losses for the portfolio than Summit-Milliman. Summit-Milliman, on the other hand, observes significantly improved credit characteristics that they believe translate directly into greater prepayment risk (and lower revenues) for the portfolio than anticipated by IFE.

The actuarial projections are based largely on extrapolation of historical trends and assume no proactive management actions that might change the trajectory of some of those trends. FHA's Capital Restoration Plan that includes further actions FHA plans to take that could materially affect the assumptions of the independent experts.

Appendix B: Summary of FHA Policy Changes Under the Current Administration

1. **Changes implemented via mortgagee letter with an implementation date of January 1, 2010:**
    a. Modifications to streamline refinance documentation requirements
    b. New appraisal standards
    c. Submission of audited financial statements required for supervised lenders

2. **Mortgage insurance premium (MIP) increases and adjustments to upfront/annual MIP relationship**
    a. 1/12/2010 – Increased Upfront MIP to 2.25%
    b. 10/4/2010 –
        i. Lowered up front MIP to 1%
        ii. Raised annual MIP by 30 basis points
    c. 4/18/2011 – Increased annual MIP by 25 basis points
    d. 4/9/2012 –
        i. Increased upfront MIP from 1% to 1.75%
        ii. Increased annual MIP by 10 basis points
    e. 6/11/2012 – Increased annual MIP for loans in excess of $625,500 by 25 basis points
    f. Mortgagee Letter published 1/31/2013
        i. Effective 4/1/2013 – Increased annual MIP by 10 basis points for loans below $625,500, and 5 basis points (maximum permitted by law) for loans at or above $625,500.
        ii. Effective 6/3/2013, eliminated the automatic cancellation of annual MIP for most loans when they reach 78% of their original value

3. **New down payment requirements**
    a. Mortgagee Letter effective October 4, 2010
        i. Loans to borrowers with a credit score of 579 or lower require a minimum 10% down payment
        ii. Loans to borrowers with a credit score of 580 or above require current minimum 3.5% down payment
        iii. Established minimum credit score of 500
    b. Federal Register Notice published February 6, 2013
        i. Loans to borrowers seeking loans above $625,500 require a 5% down payment
    c. Mortgagee Letter effective July 1, 2013
        i. Offered guidance on required documentation as evidence of borrower's minimum cash investment

4. **Enhanced underwriting requirements**
    a. Mortgagee Letter effective April 1, 2012
        i. Updated documentation requirements for self-employed borrowers

    ii. Offered new guidance on disputed accounts
    iii. Expanded the definition of family members for identity of interest transactions

b. Mortgagee Letter published January 31, 2013
    i. Required that borrowers with credit scores below 620 and debt to income ratios over 43% subject to manual underwriting
    ii. Final Federal Register Notice published December 11, 2013, outlining manual underwriting requirements

c. Mortgagee Letter effective October 15, 2013
    i. Amended guidance on collections and disputed accounts, and clarified guidance on judgments

d. Mortgagee Letter effective August 15, 2013 through September 30, 2016
    i. Provided guidance to ensure that borrowers who have experienced financial hardship due to extenuating circumstances and have recovered are given the opportunity to be fully evaluated if foreclosure was a direct result of the hardship. Borrowers are required to complete housing counseling and to be financially stable for more than 12 months. (Back-to-Work)

e. Mortgagee Letter effective January 1, 2014
    i. Provides notice of FHA's single family loan limits for Title II Forward Mortgages and Home Equity Conversion Mortgages and provides loan limit instructions for streamline refinance transactions without an appraisal.
    ii.

5. Changes to the HECM Program

a. Mortgagee Letter effective October 4, 2010
    i. Introduced HECM Saver, which provides a lower upfront premium (.01%) and a lower max principal limit
    ii. Increased annual MIP to 1.25%
    iii. Adjusted the HECM Principal Limit Factors, resulting in lower maximum principal limits

b. Mortgagee Letter published January 3, 2011
    i. Provided detailed guidance regarding the property charge loss mitigation requirements for HECM loans

c. Mortgagee Letter published January 30, 2013
    i. Consolidated the fixed-rate Standard program into the fixed-rate Saver, limiting the amount borrowers can draw

d. Congress passed the Reverse Mortgage Stabilization in August 2013 giving FHA the authority to make changes to help reduce risk

e. Mortgagee Letter published September 3, 2013
    i. Implemented a new limit on initial draws during the first 12 months of the loan term and a new single lump sum initial draw limit at origination (effective 9/30/13), a required financial assessment and required set asides for payment of insurance and taxes (effective January 13, 2014).
    ii. Eliminated the fixed standard and fixed HECM Saver programs and introduced a Fixed Rate and ARM product with a reduced Principal Limit

Factor and new upfront mortgage insurance premium structure based on percentage of initial draw under existing authority.

iii. Requested feedback on HECM Financial Assessment and Property Charge Guide that provides underwriting guidance and documentation requirements for completing the financial assessment.

6. Increased enforcement for FHA-approved lenders

a. Enforcement actions taken against lenders
   i. Heightened enforcement of HUD requirements for FHA-approved lenders has yielded over:
      1. 1,780 lenders withdrawn from FHA's program as a result of violations of FHA approval, origination, or servicing requirements.
      2. Imposition of more than $14.26 million dollars in civil money penalties and administrative payments for FHA-approved lenders
   ii. Issued notice to lending community that FHA will pursue directly or through Federal partners those who falsely advertise lax eligibility requirements for FHA-insured mortgages
b. Mortgagee Letter effective January 21, 2010
   i. Enhanced monitoring of lender performance and compliance with FHA guidelines and standards.
   ii. Expanded the Credit Watch Termination Initiative to include evaluation of lender underwriting performance in addition to origination performance
c. Implementation of statutory authority to enforce indemnification provisions for lender's using the Lender Insurance process
   i. Final rule published January 25, 2012, with an effective date of February 24, 2012
   ii. Mortgagee Letter and Lender Insurance guide issued to implement this rule.

7. Changes to FHA lender approval requirements

a. Final rule published week of April 20, 2010
   i. Increased net worth requirements for approved mortgagees. All new lender applicants for FHA programs must possess a minimum net worth of $1 million. Effective one year from enactment of the rule, current FHA approved lenders, with the exception of small businesses, must possess a minimum net worth of $1 million. Current FHA-approved small business lenders must possess a minimum net worth of $500,000. Effective three years after enactment of the rule, approved lenders and applicants to FHA single-family programs, regardless of size, must have a net worth of $1 million plus 1% of total loan volume in excess of $25 million
   ii. Eliminated independent FHA approval of mortgage brokers who originate but do not underwrite loans. FHA-approved mortgagees which underwrite loans retain strict liability for all loans, regardless of

origination via their retail operations or through their sponsored mortgage brokers
    iii. Codified requirements for submission of audited financial statements by supervised mortgagees
  b. Mortgagee Letter published on January 5, 2011
    i. Required mortgagees that possess NMLS IDs to provide those to FHA for both lender approval and loan origination processes
  c. Mortgagee Letter effective July 28, 2011, provided alternative financial reporting requirements for small supervised lenders to decrease burdens associated with FHA's lender approval and renewal processes

8. Updated Quality Control Requirements for Direct Endorsement Lenders
  a. Mortgagee Letter effective January 5, 2011
    i. Updated FHA's quality control requirements to include new requirements related to Sponsored Third Party Originators, reporting of fraud and material deficiencies, and recording of sales or transfers of FHA mortgages
  b. Mortgagee Letter effective November 13, 2013
    i. Clarified lender self-reporting requirements when in the course of required quality control activities lenders discover loans that violate FHA requirements.

9. Refinance Program Policy
  a. Mortgagee Letter published February 14, 2011
    i. Extensive guidance regarding requirements and changes for FHA Standard and Streamlined refinance programs
  b. Mortgagee Letter published March 6, 2012
    i. For borrowers who are current on their loans, FHA reduced the upfront and annual MIPs for Streamline refinances of FHA-insured loans endorsed on or before May 31, 2009 to permit these borrowers to take advantage of historically low interest rates, reducing their payments and decreasing risk to FHA

10. Consolidated and updated FHA condominium policy
  a. Mortgagee Letter issued June 30, 2011, and effective August 29, 2011
    i. Consolidated guidelines published in 2009;
    ii. Provided a single source of information for the Condominium Approval and Recertification Process;
    iii. Updated, consolidated and clarified existing condominium policy guidance; and
    iv. Expanded FHA's flexibility to consider exceptions at the individual project level
  b. Mortgagee Letter issued in summer 2012 to revise updated guidance

11. Reduction in allowable seller concessions
  a. Proposed policy change published in June of 2010

   i. Received over 1,000 comments, prompting extensive additional analysis which led to substantial revisions to the rule
   ii. New proposed rule published February 23, 2012
   iii. Final Rule to be published soon

12. Loss Mitigation

a. Mortgagee Letter effective July 1, 2013
   i. Issued guidance on subordinating partial claims for FHA Streamlined refinances
b. Mortgagee Letter effective July 1, 2013
   i. Issued guidance on the interest rates for loss mitigation home retention homes
c. Mortgagee Letter effective September 1, 2013
   i. Updated clarification regarding title approval (?)
d. Mortgagee Letter effective August 1, 2013
   i. Issues guidance on partial claim documentation and delivery requirements
e. Mortgagee Letter effective June 27, 2013 or October 1, 2013
   i. Extended unemployment special forbearance
f. Mortgagee Letter effective October 1, 2013
   i. Confirmed priority for mortgagor in default. Mortgagee must evaluate viability of a pre-foreclosure sale before a Deed-in-Lieu. Updated pre-foreclosure and Deed-in-Lieu of Foreclosure requirements including documentation requirements to verify assets, income and expenses; use of a Deficit Income Test; elimination of financial hardship requirement for service members with PCS's and validation requirements for appraisals. Requires arm’s length transaction.
g. Mortgagee Letter effective January 1, 2014
   i. Clarifies methods of communications with borrowers and addresses importance of early contact early in the delinquency. In addition to requiring standardized escalation procedures.
h. Mortgagee Letter effective January 1, 2014
   i. Clarifies loss mitigation requirements before foreclosure can be initiated and communication requirements during the foreclosure process

13. Housing Counseling Certification

a. Published a Proposed Rule regarding new certification requirements for housing counselors.

Appendix C: Additional Data Tables

Exhibit C -1
FHA Single-Family Mortgage Insurance Endorsements[a]

Fiscal Year	Counts by Loan Purpose: Home Purchase	FHA Streamline Refinance	Other FHA Refinance	Conventional to-FHA Refinance	All Loans	Volume ($ bil.)
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	64,475	1,274,143	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	278,395	22,087	16,504	107,739	424,725	59.8
2008	631,655	66,772	28,510	360,456	1,087,393	181.2
2009	995,550	329,437	38,069	468,943	1,831,999	330.5
2010	1,109,581	212,895	39,594	305,540	1,667,610	297.6
2011	777,428	180,266	44,560	195,559	1,197,813	217.8
2012	733,864	274,061	47,590	129,224	1,184,739	213.3
2013	702,418	511,849	39,081	91,508	1,344,856	240.1
2011Q1	196,801	93,196	16,253	65,316	371,566	$72.1
2011Q2	168,775	45,765	12,940	58,571	286,051	52.8
2011Q3	201,157	22,837	8,055	41,252	273,301	47.3
2011Q4	210,695	18,468	7,312	30,420	266,895	45.6
2012Q1	176,168	36,657	11,230	31,850	255,905	44.6
2012Q2	166,169	62,179	13,375	36,616	278,339	50.0
2012Q3	193,557	70,389	14,036	38,078	316,060	57.8
2012Q4	197,970	104,836	8,949	22,680	334,435	60.9
2013Q1	177,852	142,364	10,153	22,758	353,127	63.7
2013Q2	157,438	156,021	11,468	25,430	350,357	63.7
2013Q3	181,299	140,373	10,533	24,177	356,382	63.3
2013Q4	185,829	73,091	6,927	19,143	284,990	49.4

[a] This table includes all single-family endorsements. There are a small number of loans today that are not obligations of the MMI Fund. For providing a complete picture of those are included here. Prior to FY 2009, two measurable programs, the 203(k) purchase-and-rehabilitation program, and the 234(c) condominium insurance, were not obligations of the MMI Fund. They are included here to provide a complete picture of FHA activity.

Source: U.S. Department of HUD/FHA, November 2013.

Appendix D: Definitions and Clarifications

1. **Loan Limits.** In 2006, FHA was authorized to insure loans of up to $200,160 in all markets and up to $363,790 in high cost markets. In 2008, the Emergency Economic Stabilization Act (EESA) and later the Housing and Economic Recovery Act (HERA) granted FHA temporary authorization to insure mortgage loans of up to $271,050 in all markets and up to $729,750 in high cost areas. In fiscal year 2006, as the crisis was about to begin, FHA insured only 314,000 home purchase loans, but by fiscal year 2009 it had increased its volume of home purchase loans to 996,000 – and this in a year during which the overall size of the home purchase market was considerably smaller than in 2006.

2. **Structure and operation of the MMIF.** The Mutual Mortgage Insurance (MMI) Fund operates with two primary sets of financial accounts.[17] First, all business transactions related to insurance operations are maintained in a series of Financing Accounts at the U.S. Treasury.[18] 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 enacted 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." That provides access to the U.S. Treasury for any funds needed to pay extraordinary claim obligations. Thus, FHA programs are never in jeopardy of lacking sufficient funds to pay insurance claims. That would be true even in the absence of a Capital Reserve Account.

3. **Assessment of the Independent Actuary.** The National Housing Act requires that HUD contract for an independent actuarial study of the MMI Fund each year.[19] 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. The final written reports are available online in the FHA Office of Housing Reading Room at www.hud.gov.[20]

   The actuarial studies use statistical models to develop 30-year projections of default, claim, loss-on-claim, and prepayment rates on current and future books of business. Those models are estimated using 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

[17] 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.
[18] 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.
[19] See 12 USC 1708(a)(4).
[20] See http://www.hud.gov/offices/hsg/hsgrroom.cfm.

performance in the future. The resulting projections determine business-operation cash flows needed to estimate the economic value of the Fund.

The actuarial study applies a stochastic method to estimate the net present value (NPV) of future cash flows. The move to a stochastic method represents one of the advancements that have been made to the actuarial modeling process last year. In studies prior to last year, the net present value of cash flows was computed along a single path of house prices and interest rates. This year, like last year, 100 equally likely paths were generated to develop a wide variety of possible economic conditions, creating what is known as a Monte Carlo simulation. The discounted, net present value (NPV) of cash flows was computed for each path. They were then averaged to obtain an overall estimate of the expected NPV that provides the base-case estimate.

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.[21] 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.

[21] 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.