U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

ANNUAL REPORT TO CONGRESS
FISCAL YEAR 2012 FINANCIAL STATUS
FHA MUTUAL MORTGAGE INSURANCE FUND

NOVEMBER 16, 2012

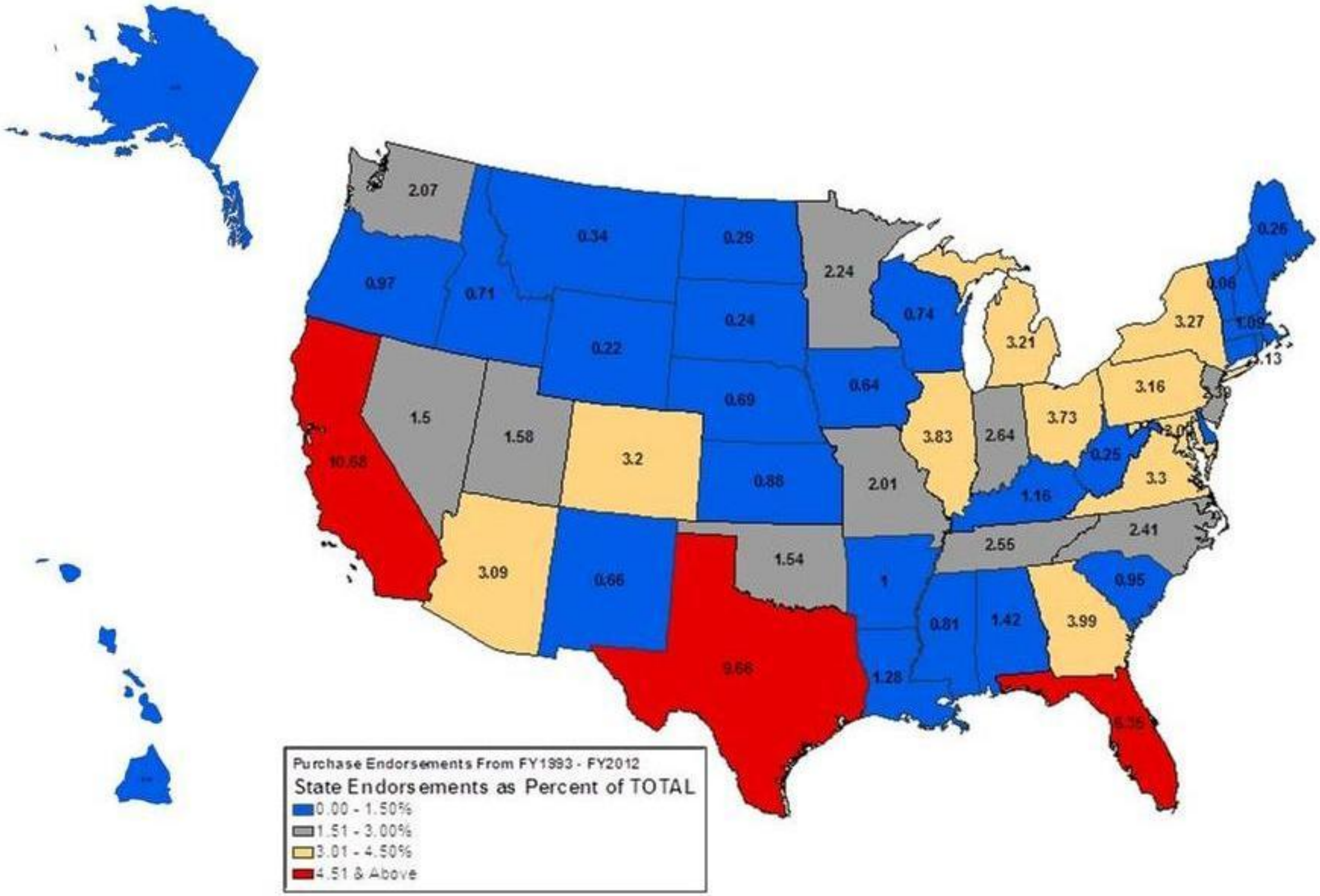
Your Door to FHA HOMEOWNERSHIP

Today’s Briefing

- Summary of the Independent Actuary’s Report and FHA’s Financial Outlook
- The Independent Actuarial Report vs. The President’s Budget Re-estimate
- Action Plan – Steps Taken, Steps in Progress, Steps Initiated

FHA in Historical Context

- FHA has now insured more than 41 million single-family mortgages.
- Over the past four fiscal years, FHA has made homeownership possible for 3.5 million families, including over 2.8 million first-time buyers.

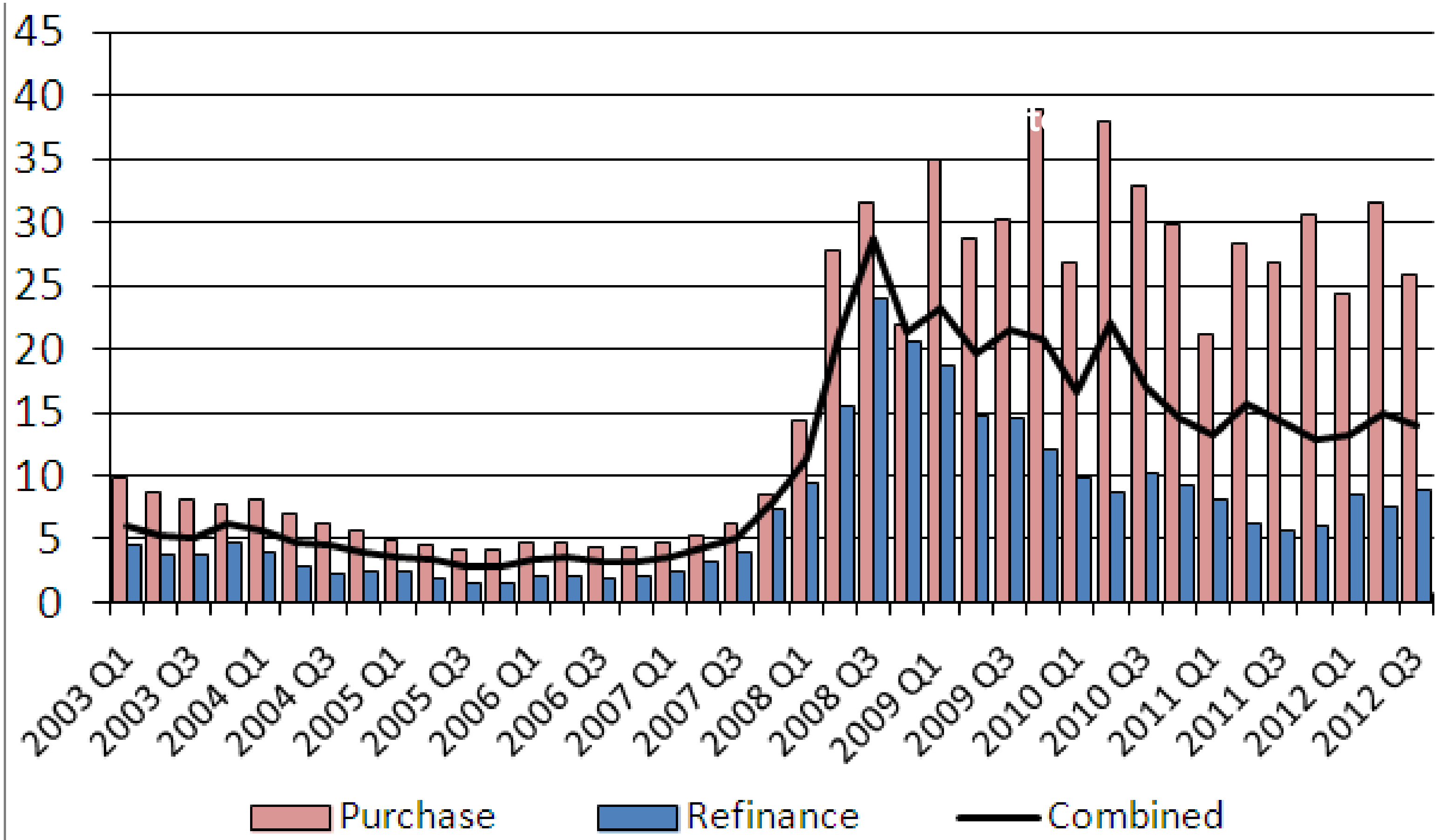


The Importance of FHA'S Continued Countercyclical Role

Over the past year, FHA has been:

- **Critical to our Housing Recovery.** Insured 1.2 million single-family mortgages with a principal balance of $213 billion. This was slightly less than activity in the prior Fiscal Year; purchase loan activity was down 7 percent and refinance activity up 7 percent.
- **An Essential Source of Credit for First-Time Homebuyers.** Endorsed approximately 734,000 purchase mortgages, with 78 percent to first-time homebuyers
- **Helping Families Refinance and Save.** Facilitated over 451,000 refinance transactions, allowing homeowners to take advantage of low interest rates and saving them $220/mo. while reducing risk of the fund
- **Providing Stability to Seniors.** Insured 54,000 reverse mortgage transactions for seniors seeking to age in place
- **Essential to Minority Homebuyers.** According to the most recent data available, FHA accounted for 50 percent of home purchase mortgages for African American borrowers and 49 percent for Hispanic/Latino borrowers.

FHA Market Share Continues to Decline as the Housing Market Recovers



Sources: MBA and HUD.

Continued Improvements in the Quality of FHA Business

- Performance of FHA-insured loans continued to exhibit strong performance in 2012; each successive year from 2010 through 2012 is projected to be more profitable than the year before. Collectively, this portfolio has shown dramatic improvement over loans originated through 2009.

- Loans endorsed between 2007-2009 are expected to result in $70 billion of future insurance claims.

- Seller-funded downpayment assistance loans continue to place significant stress on the MMI Fund. These loans account for only 4 percent of the outstanding portfolio but 13 percent of all seriously delinquent loans. Over the life of the loans, seller-funded downpayment assistance (SFDPA) loans are expected to cost the FHA MMI fund more than $15 billion. Without SFDPA, the independent actuary estimates that the economic value of the Fund would today be +$1.77 billion and the capital reserve ratio would be above zero.

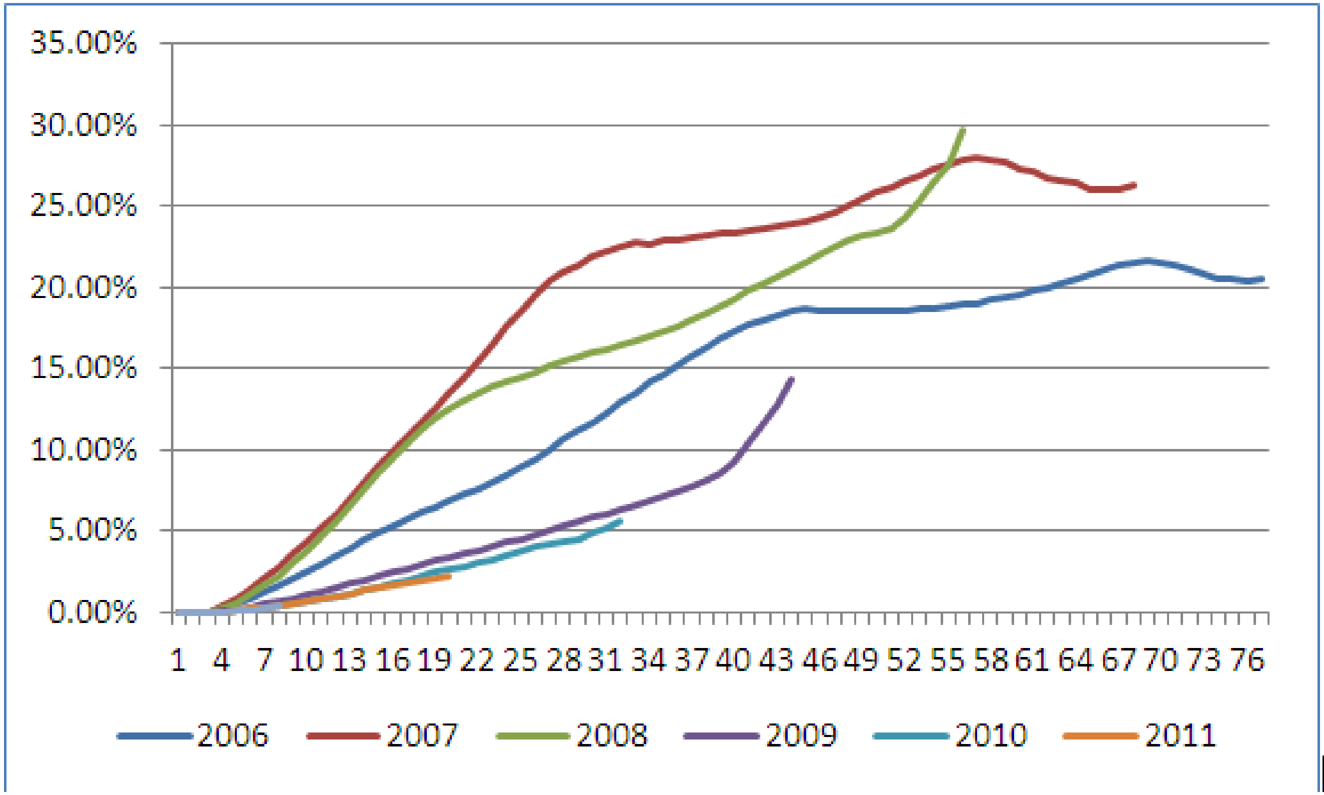
Lifetime Expected Economic Value by Groupings of Origination Cohorts (Forward Loans)

Cohorts	Original UPB ($billion)	Present Value of Premium Revenue	Present Value of Credit Losses	Economic Value (%)	Economic Value ($billion)
1992 - 2006	$1,190	3.5%	5.1%	(1.6%)	($19.5)
2007 - 2009	564	3.8%	11.0%	(7.2%)	(40.6)
2010 - 2012	721	6.0%	2.9%	3.1%	22.7

Serious Delinquency Rates Have Improved for Recent Books

Serious delinquency rates provide additional evidence that the quality of recent vintages has improved. Vintages starting in 2009 are performing dramatically better than those before at the same period of seasoning.

Seriously Delinquent Rates by Vintage (Excluding Streamline Refis)



Source: U.S. Department of HUD/FHA

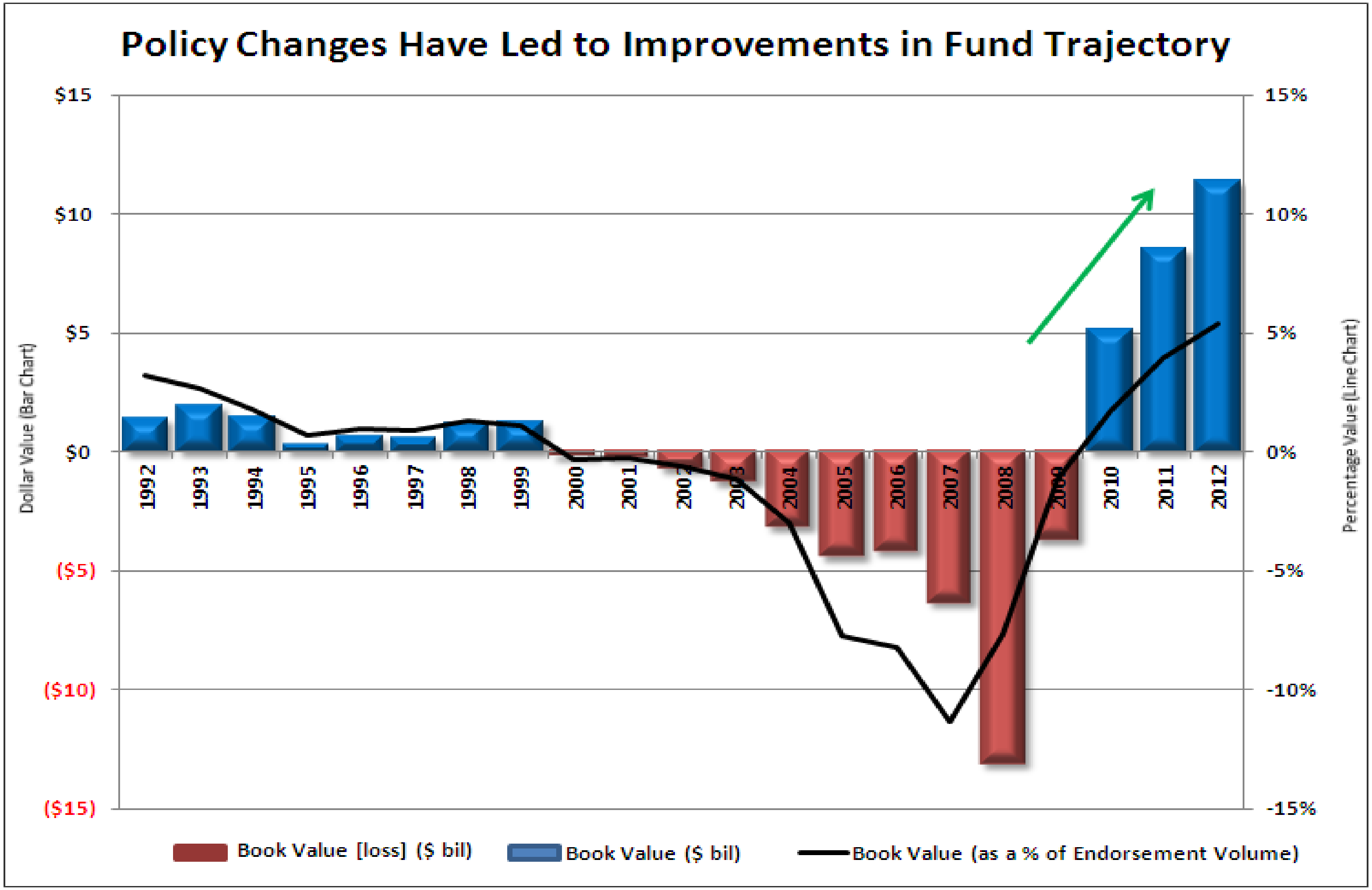
After one year of age, the 2009-2011 vintages are performing approximately four times better than those in 2007 and 2008.

After two years of age, the 2010 vintage is performing four times better than 2008 and five times better than 2007.

Early signs from the 2012 vintage indicate a continued improvement in seriously delinquency rate versus prior years, signaling an overall continued shift in the quality of the portfolio.

Overall Economic Value of Forward Portfolio

The Economic Value of New Books Continues to be Positive but the Fund Continues to be Impacted by Older Books.



Independent Actuarial Analysis of the Financial Position of the MMI Fund FY 2012

Summary of FY 2012 Independent Actuarial Review

- **State of the Fund.** The Independent Actuary has determined the Fund has a *negative* economic value of **$16.3 billion**, yielding a capital reserve ratio *negative* **1.44 percent**.

- **Does Not Account for New Economic Value.** This analysis does not take into consideration new economic value generated after FY2012, estimated by the actuaries to be $11 billion through the end of FY2013.

- **Does Not Mean FHA Will Have to Use Treasury Authority.** This report does not directly affect the adequacy of capital balances in the MMI Fund. Any required draw would be determined not by the economic assumptions of this review but those used in the President's budget released in February with a final assessment of a potential draw made in September.

- **Capital Resources.** The combined balances are referred to as the capital resources of the MMI Fund. At the end of FY 2012, the MMI Fund had **$30.4** billion in combined net capital resources. Of that total, **$27.1** billion was in the Financing Accounts and **$3.3** billion in the Capital Reserve Account. These funds represent readily available liquid assets.

Independent Actuarial Study vs. OMB Budget Re-estimate

Annual Independent Actuarial Study

- Forecasting model built by independent contractor selected through government procurement, for capital ratio estimation.
- ***Independent economic forecast*** as of July of the Fiscal Year under review, projecting future economic conditions
    - 2011, 2012- Moody's Analytics
    - 2010, 2009 – IHS Global Insight
- Valuation as-of September 30 of each year, based on projections of expected claims and premium revenue on outstanding cohorts over their remaining lifetimes (up to 30 years).
- The independent actuary also projects future valuations of the portfolio with new books of business. Cash flows on future books are *not* factored into calculating the economic value of the Fund for the current capital ratio calculation.
- Report delivered to Congress in mid-November.

Annual OMB Budget Re-Estimate

- Done each year, as part of the federal budget process; required for budget valuation of all federal direct loans and guarantees.
- Process uses a modified version of the actuarial study forecasting model, applying the ***economic assumptions common to the entire President's Budget***
- Valuation as of September 30 of each year, based on projections of expected claims and premium revenue on outstanding cohorts over their remaining lifetimes (up to 30 years).
- Any required transfer into loss reserves under the re-estimate need not be performed until the end of the fiscal year. Special assistance from Treasury is only necessary if FHA is unable to satisfy the budget re-estimate requirements by that time.
- Results of this evaluation are reported in the President's Budget, which is presented to the Congress in early February.

Use of permanent and indefinite budget authority is only necessary if, at the end of the new fiscal year, FHA is unable to satisfy requirements of the budget re-estimate.

Timeline and Milestones for FY 2013

November 16, 2012	February 2013	**September 30, 2013**
Actuarial Report Released	President's Budget Released	**Final Accounting for FY2013**
Announcement of New Actions to Protect Fund and Proposed Legislative Changes	Potential Announcement of Additional Actions to Protect Fund	**Decision on Whether Treasury Draw Is Needed**

Independent Actuary's Assessment of Where FHA Stands Today

Combined Economic Value of the MMI Fund as Determined by the Independent Actuary, FY 2012

	Forward Loans	HECM	Total
Net Present Value of Future Cash Flows	($39.1)	($7.6)	($46.7)
Capital Resources	$25.6	$4.8	$30.4
Net Economic Value	($13.5)	($2.8)	($16.3)
Insurance in Force	$1,053	$78	$1,131
Capital Reserve Ratio(%)	(1.28%)	(3.58%)	(1.44%)

This calculation does not consider $11 billion in expected economic value projected by the independent actuary for the FY 2013 cohort.

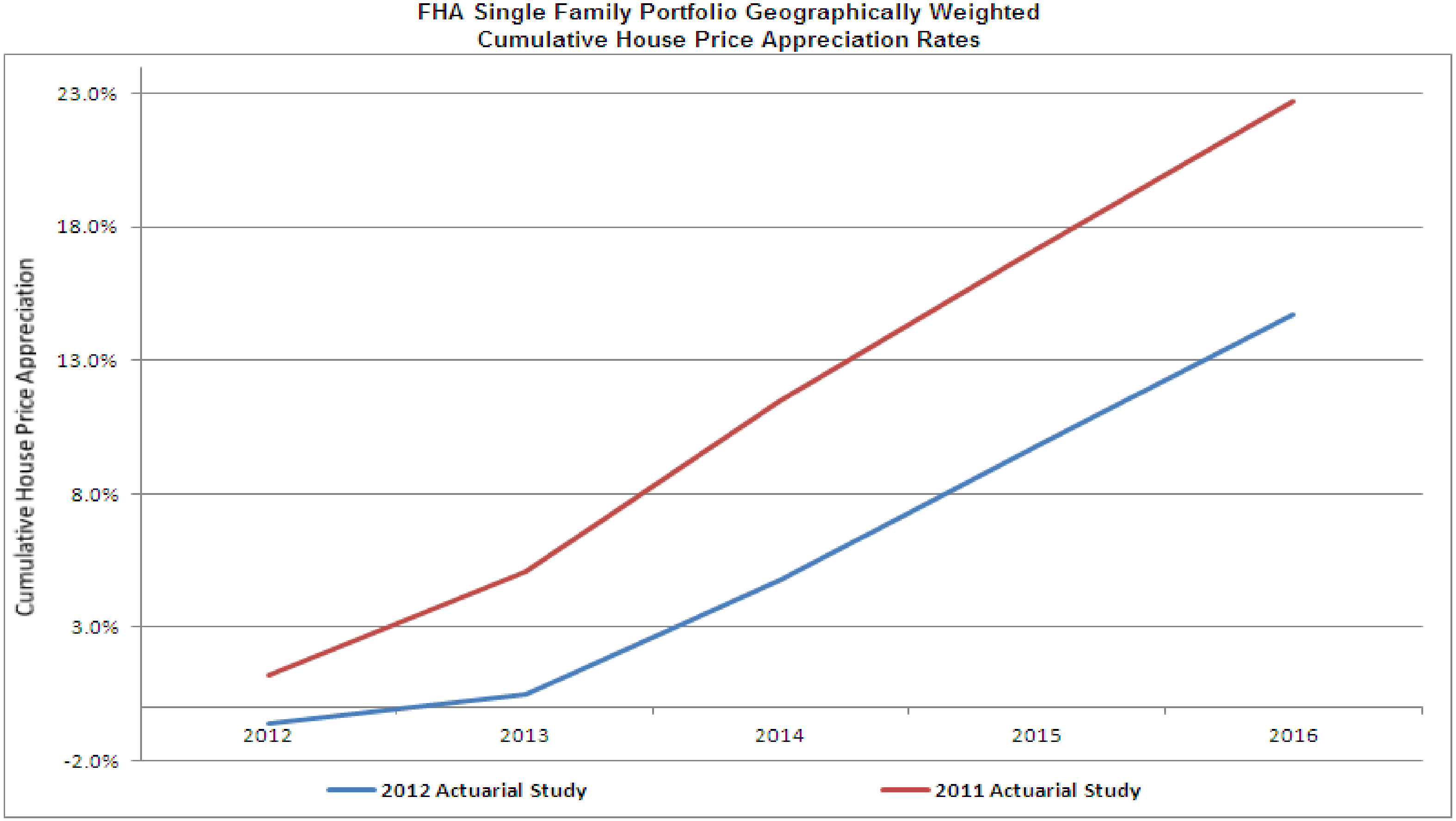
Drivers Impacting the Outcome of the Actuarial Estimates

1. **Less optimistic House Price Appreciation (HPA) forecast since last year**
   While FHA continues to have the most profitable new books of business in its history, the house price appreciation estimates used for this actuarial review were significantly lower than those used last year. This accounts for an estimated $10.5 billion in reduced value compared to the actuary's 2011 projection of what the Fund's economic value would be as of the end of FY 2012. In addition, they do not include improvements to home prices seen this calendar year , with house price appreciation increasing since July, as the actual price index used by the actuary (FHFA All-Transactions Index) has been depressed by high levels of refinance activity.

2. **Continued Decline in Interest Rates**
   The continued decline in interest rates, while good for the overall economy, is costly to FHA. First, more borrowers are projected to payoff their mortgages, which reduces future revenues on the current portfolio, and the actuary predicts that those unable to refinance into lower rates will then default at higher rates. These assumptions result in a reduction of $8 billion in estimated economic value for the Fund from what was anticipated in last year's report.

3. **Refinements to the Forecasting Model**
   Applying recommendations made by the GAO, HUD's Inspector General and others, the actuary changed the way it calculates losses on defaulted loans and reverse mortgages. This resulted in an estimated $13 billion in reduced economic value compared to last year's projections ($10 billion on the forward mortgage portfolio, $3 billion on HECM loans).

2011 vs. 2012 Projected House Price Appreciation



	2012	2013	2014	2015	2016
2011 Actuarial Study	1.20%	5.10%	11.50%	17.20%	22.70%
2012 Actuarial Study	-0.60%	0.50%	4.80%	9.80%	14.70%
Cumulative Difference	-1.80%	-4.60%	-6.70%	-7.40%	-8.00%

Source: Moody's Analytics, July 2011 and July 2012 forecasts of the FHFA All-Transactions HPI, metropolitan area series; analysis by the U.S. Department of HUD/FHA.

Projected Interest Rates – 2011 vs. 2012

10-Year Treasury Rate Forecasts for the Current and Prior Review

Summary of Changes in Estimate of 2012 Economic Value from Last Year's Expectation

	Impact ($billion)	Explanation
2012 volume	$3.3	The FY 2012 volume was higher than had been anticipated last year ($212 bil vs. $156 bil), primarily due to low interest rates spurring refinance activity into the FY2012 book.
Changes to loss severity rate model	($10.2)	Shares of Pre-foreclosure sale (PFS or short sales) and REO in claim predictions are now explicitly modeled, and each has its own loss rate forecast. PFS share of claims is now less than half of what was implied in past models. Also, model structure changes removed an artificial cap on REO loss rates.
Less optimistic House Price Appreciation (HPA)	($10.5)	HPA projections are 8% lower over the first five years than they were in the 2011 projections. This effect would be substantially reduced were the actuarial forecasts able to consider improvements already seen in home prices this year.
Lower interest rates	($8.0)	Rates are projected to be 1.5 - 2.5% lower over the next two years than they were in the 2011 projections. This results in $2.6 billion in lost revenue from faster loan prepayment as well as an additional $5.4 billion in claims costs due to higher projected defaults by borrowers who are unable to refinance their loans.
Miscellaneous	$2.6	Net impact of eleven other adjustments.
Net Change to Economic Value*	($22.8)	$22.8 billion represents about a 2.3% difference in portfolio value from last year's estimate of where we would be now.

* 2011 actuarial study projected a $9.4 billion capital position by 2012 compared to -$13.5 projected in this year's analysis.

Actuarial Projections of MMI Fund Economic Net Worth and Capital Ratio FY 2012 – 2019

Fiscal Year	Forward Economic Net Worth (billions)	Forward Capital Ratio	HECM Economic Net Worth (billions)	HECM Capital Ratio	Total Economic Net Worth (billions)	Total Capital Ratio
2012	($13.5)	(1.3%)	($2.8)	(3.6%)	($16.3)	(1.4%)
2013	(2.6)	(0.2%)	(2.7)	(2.9%)	(5.3)	(0.4%)
2014	4.2	0.4%	(2.2)	(2.1%)	2	0.2%
2015	11.5	1.0%	(1.8)	(1.5%)	9.7	0.7%
2016	21	1.7%	(1.3)	(1.0%)	19.7	1.5%
2017	31.4	2.5%	(0.7)	(0.5%)	30.7	2.2%
2018	42.5	3.3%	(0.5)	(0.3%)	42	2.9%
2019	54.3	4.2%	(0.4)	(0.2%)	53.9	3.7%

Actions to Continue Improving the Health of the MMI Fund

The Long Term Financial Health of the MMI is Substantially Better as a Result of Actions Taken Over the Past Four Years

Origination

Created the Office of Risk Mgt.

Raised the MIP 4 times

Eliminated loan correspondents

Improved lender monitoring and enforcement (e.g., revised and enhanced Post Endorsement Technical Review process)

Tightened credit box

- Eliminated seller funded down payment assistance
- Imposed 90% LTV for FICO<580

Asset management

Reached settlement with select originators and servicers

Expanded note sales under the DASP initiative

Total contribution from all actions to the Fund Balances to the MMIF = $32,200 billion

FHA Continues to Take Steps to Improve the Long Term Trajectory of the MMIF

Origination

Developing a uniform seller- servicer contract detailing lender and servicer performance standards

Further improving lender monitoring and enforcement (QC of all loans going to claim in the first 2 years, not just EPD)

Asset management

Redesigned FHA modification treatments to help delinquent homeowners

Streamlining FHA's short-sale Policy

Piloted and scaling up the Claim without Conveyance program to sell loans at foreclosure auction

Additional Policy Changes Planned to Improve the Health of the Fund

Origination

Reversal of MIP cancellation policy on new originations

Raise annual MIP by 10bps on new originations

Housing Counseling Initiative

Asset management

Launch large-scale proactive modification and short sale marketing campaigns for delinquent borrowers

Enhance servicer performance management and oversight, launch remediation at top servicers

Create alternative resolution process for negative-recovery loans

Build up loan level analytical framework to identify optimal note sales and auction pricing

Total estimated contribution from actions in progress and additional policy changes: $8-10 billion*

*This total represents combined contributions to the economic value of the fund for Fiscal Years 2013 and 2014

Beyond Administrative Changes, HUD is Seeking Additional Legislative Authorities to Protect the Fund

Origination and Enforcement

To Provide FHA Enhanced Indemnification Authority to Obtain Indemnification for Direct Endorsement Lenders: enabling FHA to treat both classes of FHA approved lenders equally with respect to non-compliant loans

Strengthen FHA's Indemnification Authority by eliminating the knew or should have known requirement for fraud

Authority to Terminate Origination and Underwriting Approval on a broader geographic basis for institutions with default rates significantly higher then their peers

Revise FHA's Compare Ratio to provide greater clarity and certainty for lenders while enabling FHA to more effectively minimize poor lender performance and resulting losses

Asset management

Transfer Servicing on a case by case basis to institutions better equipped to reduce losses to the fund by assisting borrowers

Additional authority to manage the reverse mortgage program so that consumers are better protected and able to sustain their reverse mortgage

Summary

According to the latest findings of the independent actuary, this fiscal year the capital reserve ratio of the MMI Fund used for FHA's single family mortgage insurance programs fell below zero to negative 1.44 percent.

FHA Has Done Its Job. FHA has played a central role in in the progress we've seen in the housing market. Our job now is to ensure FHA can continue be a source of opportunity and access to homeownership for future generations.

Older Books Of Business are the Prime Source Of Stress . Fully $70 billion in claims attributable to the 2007-2009 books of business alone. In contrast, the actuary attests once again to the high quality and profitability of books insured since 2010.

Does Not Mean a Draw on the Treasury. This report does not mean that FHA will have to draw from the Treasury—any draw would be determined by the economic assumptions used in the President's budget released in February with a final assessment of a potential draw in September — but we take its findings seriously.

Aggressive But Balanced Approach. The actions we are taking and others will allow FHA to continue its historic role of providing access to homeownership for underserved communities and supporting the housing market recovery, while also ensuring that the government's footprint in the marketplace recedes as private capital returns.