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On September 20, 2010, the PDF file was changed to revise two sentences. On page 5, the second and fifth sentences of the last paragraph were corrected to clarify the status of certain FHA policy changes.

September 14, 2010

The Honorable Christopher J. Dodd
Chairman
The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate

Subject: *Mortgage Financing: Opportunities to Enhance Management and Oversight of FHA's Financial Condition*

The Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA) has helped millions of families purchase homes through its single-family mortgage insurance programs. In recent years, FHA has experienced a dramatic increase in its market role due to the contraction of other mortgage market segments. FHA insures almost all of its single-family mortgages under its Mutual Mortgage Insurance Fund (Fund), which is reviewed from both an actuarial and budgetary perspective each year.[1] On the basis of an independent actuarial review, FHA reported in November 2009 that the Fund was not meeting statutory capital reserve requirements as of the end of fiscal year 2009, as measured by the Fund's estimated capital ratio (i.e., economic value divided by the unamortized insurance-in-force).[2] Additionally, although the Fund historically has produced budgetary receipts for the federal government, a weakening in the performance of FHA-insured loans has heightened the possibility that FHA will require additional funds to help cover its costs on insurance issued to date.

In light of FHA's changing market role and financial condition, you asked us to examine (1) how estimates of the Fund's capital ratio have changed since 2001, the primary factors contributing to recent changes, and the budgetary implications of changes in the Fund's financial performance; (2) how FHA and its actuarial review contractor evaluate the financial condition of the Fund, including the Fund's performance under different economic scenarios; (3) the steps FHA has taken to improve the financial condition of the Fund, and how it has interpreted statutory requirements pertaining to the Fund; and (4) the performance of FHA's

[1]In addition, the annual independent audits of FHA's financial statements review the Fund from a financial accounting perspective and provide information used in the actuarial and budgetary reviews of the Fund.

[2]The economic value of the Fund is the sum of existing capital resources plus the net present value of future cash flows. The unamortized insurance-in-force is generally understood as the initial insured loan balances. However, as we discuss later in this report, a legislative provision defines unamortized insurance-in-force as the remaining obligation on outstanding mortgages, a definition generally understood to mean the amortized insurance-in-force.

mortgage portfolio from 2005 through 2009, and the extent to which key characteristics of FHA-insured mortgages have changed in recent years.[3] In July 2010, we briefed your offices on the results of this work. This report provides a summary of those results, and enclosure I contains the more detailed briefing materials. We incorporated HUD's comments in this report where appropriate.

Background

FHA's single-family programs insure private lenders against losses from borrower defaults on mortgages that meet FHA criteria for properties with one to four housing units. FHA insures a variety of mortgages for initial home purchases, construction and rehabilitation, and refinancing. In 2009, FHA insured almost 2 million single-family mortgages representing more than $300 billion in mortgage insurance. The agency has played a particularly large role among minority, lower-income, and first-time homebuyers. In 2009, almost 80 percent of FHA-insured home purchase loans went to first-time homebuyers, 32 percent of whom were minorities. FHA also generally is thought to promote stability in the market by ensuring the availability of mortgage credit in areas that may be underserved by the private sector or that are experiencing economic downturns. As the recent housing and economic recession set in, FHA's share of the market for home purchase mortgages grew sharply, rising from about 5 percent in 2006 to nearly 30 percent in 2009.

Legislation sets certain standards for FHA-insured loans. FHA borrowers who are purchasing a home are required to make a cash investment of at least 3.5 percent of the current purchase price. This investment may come from the borrowers' own funds or from certain third-party sources. However, borrowers are permitted to finance their mortgage insurance premiums and some closing costs, which can create an effective loan-to-value (LTV) ratio—that is, the ratio of the amount of the mortgage loan to the value of the home—of close to 100 percent for some FHA-insured loans. Congress also has set limits on the size of the loans that may be insured by FHA, which can vary by county. In calendar year 2010, the limits range from $271,050 to $729,750 for one-unit properties in the continental United States.

The Fund is supported by borrowers' insurance premiums. FHA has the authority to establish and collect a single up-front premium (in an amount not to exceed 3.0 percent of the amount of the original insured principal obligation of the mortgage) and annual premiums of up to 1.5 percent of the remaining insured principal balance, or 1.55 percent for borrowers with down payments of less than 5.0 percent. As of September 1, 2010, FHA charged a 2.25 percent up-front premium and a 0.50 or 0.55 percent annual insurance premium, depending on the size of the down payment.

The Omnibus Budget Reconciliation Act of 1990 (Pub. L. No. 101-508) required the Secretary of HUD to take steps to ensure that the Fund attained a capital ratio of at least 2 percent by November 2000 and maintained at least a 2 percent ratio at all times thereafter. The act also required an annual independent actuarial review of the economic net worth and soundness of the Fund. The actuarial review estimates the economic value of the Fund as well as the capital ratio to determine whether the Fund has met the capital standards in the act. The analysis considers the historical performance of the existing loans in the Fund, projected future economic conditions, claim and loss rates, and projected mortgage originations. The

[3]Unless otherwise stated, the years shown in this report are fiscal years.

Fund met the capital ratio requirement from 1995 through 2008. The annual actuarial review is now a requirement in the Housing and Economic Recovery Act of 2008 (HERA), which also requires that the Secretary of HUD submit an annual report to Congress on the results of the review.

Under the Federal Credit Reform Act of 1990 (FCRA), FHA and other federal agencies must estimate the net lifetime costs (i.e., credit subsidy costs) of their loan insurance or guarantee programs and include the costs to the government in their annual budgets.[4] Credit subsidy costs represent the net present value of expected lifetime cash flows, excluding administrative costs. For a mortgage insurance program, cash inflows consist primarily of fees and premiums charged to insured borrowers and proceeds from sales of foreclosed properties, and cash outflows consist mostly of payments to lenders to cover the cost of claims. Annually, agencies estimate credit subsidy costs by cohort—the loans agencies commit to guarantee in a given fiscal year. When estimated cash inflows exceed expected cash outflows, a program is said to have a negative credit subsidy rate. When the opposite is true, the program is said to have a positive credit subsidy rate—and therefore requires appropriations. Historically, FHA has estimated that its loan insurance program is a negative subsidy program and, as a result, has generated budgetary receipts that reduce the federal budget deficit. On the basis of these negative subsidy estimates, FHA built up substantial balances over the years in a budgetary account known as the capital reserve account. The Fund's capital reserve account holds reserves in excess of those needed to pay for estimated credit subsidy costs and is used to help cover unanticipated increases in those costs—for example, increases due to higher-than-expected claims. Reserves needed to cover estimated credit subsidy costs are held in the Fund's financing account.[5]

Generally, agencies are required to produce annual updates of their subsidy estimates—known as reestimates—for each cohort on the basis of information on actual performance and estimated changes in future loan performance. Beyond changes in estimation methodology, each additional year provides more historical data on loan performance that may influence estimates of the amount and timing of future claims. Economic assumptions (such as house prices and interest rates) also can change from year to year. FCRA recognized the difficulty in making credit subsidy estimates that mirrored actual loan performance and provides permanent and indefinite budget authority for reestimates that reflect increased program costs. These upward reestimates increase the federal budget deficit, unless accompanied by reductions in other government spending or an increase in receipts.

Summary

After increasing earlier in the decade, the Fund's capital ratio dropped sharply in 2008 and fell below the statutory minimum in 2009, when a combination of economic and market developments created conditions that simultaneously reduced the Fund's economic value (numerator of the ratio) and increased the insurance-in-force (denominator of the ratio).

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[4]The credit subsidy cost can be expressed as a rate. For example, if an agency commits to guarantee loans totaling $1 million and estimates that the present value of cash outflows will exceed the present value of cash inflows by $15,000, the estimated credit subsidy rate is stated as 1.5 percent.

[5]The financing account records lifetime cash flows for loans insured in 1992 and thereafter. This account appears in the budget for informational and analytical purposes but is not included in the budget totals or budget authority or outlays.

According to annual actuarial reviews of the Fund, from 2001 through 2006, the capital ratio rose from 3.8 percent to 6.8 percent, but fell to 3.0 percent by the end of 2008 and to 0.5 percent by the end of 2009. Major factors contributing to the declines in 2008 and 2009 included the following:

- More pessimistic forecasts of economic conditions—house prices, in particular—which increased the number of predicted insurance claims and losses associated with those claims, thereby reducing the Fund's economic value. The economic value declined from $21.3 billion at the beginning of 2008 to $3.6 billion by the end of 2009.

- The contraction of other segments of the mortgage market and legislated increases in the loan amounts eligible for FHA insurance, which resulted in higher demand for FHA-insured mortgages and increased FHA's insurance-in-force. From the beginning of 2008 to the end of 2009, the insurance-in-force rose from $332 billion to $715 billion.

At the same time, the Fund's condition from a budgetary perspective also has worsened. In recent years, the Fund's capital reserve account has covered large upward reestimates of FHA's credit subsidy costs (through transfers to the financing account). As a result, balances in the capital reserve account have fallen dramatically. At the end of 2007, the balance stood at $22.0 billion, but it is estimated to drop to $3.5 billion by the end of 2010. If the reserve account were to be depleted—a scenario that an FHA budget official told us was a possibility within the next few years—FHA would need to draw on permanent and indefinite budget authority to cover additional increases in estimated credit subsidy costs.

FHA and its actuarial review contractor have enhanced their methods for assessing the Fund's financial condition but still are addressing other methodological issues that could affect the reliability of estimates of the Fund's capital ratio.[6] Annual actuarial reviews of the Fund use statistical models to estimate the probability that loans will prepay or result in insurance claims on the basis of certain loan and borrower characteristics (such as LTV ratios and borrower credit scores) and key economic variables (such as house prices and interest rates). In recent years, FHA and its contractor have enhanced these models by incorporating additional variables that are related to loan performance and developed an additional model to predict loss rates on insurance claims. Also, consistent with recommendations that we made in a prior report, the actuarial reviews began in 2003 to analyze the impact of more pessimistic economic scenarios—for example, nationwide declines in home prices—than they did previously.[7] However, FHA, its financial statement auditor, and mortgage market and budget analysts have identified a number of potential issues with the current review methodology. For example:

- The reviews rely on a single economic forecast to produce the estimate of the capital ratio (baseline estimate) that is used to determine whether the Fund is meeting the

[6]For the 2009 actuarial review, FHA used a second contractor to conduct an actuarial analysis of Home Equity Conversion Mortgages (HECM), which were added to the loans included in the Fund, starting with 2009 insurance commitments. Because HECMs currently have a small influence on the Fund's financial condition, we use the phrase "actuarial review contractor" to refer to the contractor that conducted the actuarial analysis of non-HECM loans.

[7]GAO, *Mortgage Financing: FHA's Fund Has Grown, but Options for Drawing on the Fund Have Uncertain Outcomes*, GAO-01-460 (Washington, D.C.: Feb. 28, 2001).

2 percent capital reserve requirement. This approach does not fully account for the variability in future house prices and interest rates that the Fund may face. As a result, baseline estimates of the capital ratio may tend to underestimate insurance claims and mortgage prepayments and therefore may tend to overestimate the Fund's economic value. In a 2003 report, the Congressional Budget Office (CBO) concluded that FHA could project the Fund's cash flows more accurately by using a methodological approach—known as stochastic modeling—that involves running simulations of hundreds of different economic paths to produce a distribution of capital ratio estimates.[8]

- The reviews impute initial LTV ratios for streamline refinance mortgages (refinancing from one FHA-insured loan to another) in a manner that may provide inaccurate starting points for assessing the default risk of this growing segment of FHA's portfolio, particularly in areas where house values fell substantially between the start of the original loan and the streamline refinancing.

- The reviews use forecasts of a national house price index, rather than more localized indexes, to capture the impact of future house price movements on loan performance. However, the geographic distribution of FHA's business may not always be representative of the nation as a whole and could change over time.

FHA officials told us that they were planning to require the actuarial review contractor to use a stochastic simulation model for the 2011 actuarial review. These officials said that the model would be used to examine the implications of extreme economic scenarios on the Fund but that decisions about whether to use the model to estimate the Fund's capital ratio had not been made. FHA officials told us that they plan to address the other two issues in the 2010 actuarial review.

To help improve the financial condition of the Fund, FHA has raised premiums and made or proposed policy and underwriting changes, but certain legislative requirements concerning FHA's administration of the Fund provide limited direction and have required interpretation by FHA. For example, FHA raised its up-front premiums, is planning to increase down-payment requirements for riskier borrowers, and has proposed reducing allowable seller contributions at closing. Additionally, to rebalance its premium structure while achieving a net increase in net premium revenue, FHA proposed raising the statutory ceiling on the annual premium and lowering the up-front premium. Consistent with this proposal, Congress enacted legislation in August 2010 raising the ceiling on the annual premium.[9] Budget estimates indicate that the rebalancing of the premium structure and the policy changes regarding down-payment requirements and seller concessions will, if implemented, increase the balance in the Fund's capital reserve account by $1.9 billion (according to a CBO estimate) or $5.8 billion (according to an FHA estimate) in 2011. Additionally, FHA has

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[8]Congressional Budget Office, *Subsidy Estimates for FHA Mortgage Guarantees*, a CBO paper (Washington, D.C.: November 2003).

[9]Congress enacted Pub. L. No. 111-229 on August 11, 2010, which increased the ceiling on the annual insurance premium from 0.5 percent to 1.5 percent for borrowers with initial LTVs of 95 percent or less, and from 0.55 to 1.55 percent for borrowers with initial LTVs above 95 percent. The legislation also states that the Secretary of HUD may adjust any initial or annual premium by publishing a notice in the *Federal Register* or by issuing a mortgagee letter (a written instruction to FHA-approved lenders).

increased enforcement against noncompliant and poorly performing lenders and sought legislative approval to expand its lender enforcement authority. However, some of the legislative requirements for FHA's management of and reporting on the Fund's condition provide limited directions to FHA. For example:

- The Omnibus Budget Reconciliation Act of 1990 requires FHA to maintain a capital ratio of at least 2 percent "at all times" after November 2000 but does not specify time frames for reattaining a 2 percent ratio should it fall below that level. FHA officials told us that while they have not set a deadline for restoring the ratio to the minimum level, they intend to do so as quickly as possible, consistent with FHA's statutory operational goals, such as providing mortgage insurance to traditionally underserved borrowers.[10]

- The same act defines the capital ratio as the economic value of the Fund divided by the "unamortized insurance-in-force" (generally understood as the initial insured loan balances) but then defines unamortized insurance-in-force as the remaining obligation on outstanding mortgages (generally understood to describe the amortized insurance-in-force). Although FHA has reported the capital ratio as calculated with the amortized and the unamortized insurance-in-force, it traditionally has emphasized the capital ratio calculated using the unamortized insurance-in-force (as generally understood) for assessing compliance with the 2 percent minimum requirement. However, for the 2009 review, FHA shifted emphasis to the amortized insurance-in-force—a measure that, as we noted in a prior report, better represents the Fund's potential liability.[11] This change makes little difference now, but as the large volume of recent FHA-insured loans matures and borrowers pay down their loan balances, using the amortized figure will result in a somewhat higher capital ratio than using the unamortized figure.

- A provision in HERA states that if the Secretary of HUD determines there is a substantial probability that the Fund will not maintain its "established target subsidy rate," the Secretary may make programmatic or premium adjustments.[12] However, neither HUD nor Congress has established a target subsidy rate for the Fund. FHA officials told us that the meaning of the term was not clear (indicating it could refer to a credit subsidy rate), but they have interpreted the term to mean the capital ratio.[13]

- HERA also requires FHA to provide quarterly reports to Congress that include "updated projections of [the Fund's] annual subsidy rates to ensure that increases in risk to the Fund are identified and mitigated…and the financial soundness of the Fund is maintained."[14] On the basis of its interpretation of this requirement, FHA has reported the credit subsidy rate for only the current loan cohort and, because credit subsidy rates generally are only updated annually, has reported the same rate each quarter in a

[10]Requirements for the Federal Deposit Insurance Fund provide an example of a deadline for restoring financial reserves to at least a statutory minimum if they should drop below that level. Congress originally set a 5-year deadline but extended it to 8 years in 2009. 12 U.S.C. § 1817(b)(3).

[11]GAO, *Mortgage Financing: FHA Has Achieved Its Home Mortgage Capital Reserve Target*, GAO/RCED-96-50 (Washington, D.C.: Apr. 12, 1996).

[12]12 U.S.C. § 1708(a)(6).

[13]FHA, like other agencies, estimates credit subsidy rates for individual loan cohorts.

[14]12 U.S.C. § 1708(a)(5)(E).

given fiscal year.[15] Because FHA's credit subsidy rates are already reported in the President's budget, FHA's interpretation does not provide new information. While FHA's quarterly reports do provide information on major factors affecting subsidy rates (such as claim, prepayment, and loss rates), the agency has other information that could provide insight into the future direction of the subsidy rates (such as cohort-level delinquency trends and economic forecasts).

In the absence of more explicit directions, the priority that FHA should place on restoring the capital ratio versus its operational goals may be unclear, and Congress may not be receiving all of the information that it would find useful to monitor the Fund's financial condition.

Data on the performance and characteristics of FHA-insured mortgages illustrate the challenges and uncertainties facing the Fund as well as improvement in certain risk factors. As in other segments of the mortgage market, the performance of FHA-insured mortgages deteriorated as the economy weakened and home prices fell in 2008 and 2009. More specifically, FHA experienced increases in serious delinquency rates (percentage of active loans 90 or more days delinquent or in foreclosure) beginning in 2008 and continuing through 2009 after seeing a more stable pattern from 2005 through 2007. As of the last quarter of calendar year 2009, FHA's serious delinquency rate reached a historical high of 9.4 percent, a figure moderated by the fact that a large proportion of FHA's active loans are relatively new and have had limited time to potentially experience performance problems.[16] Although making direct comparisons across market segments is complicated by a number of factors—including differences in the age and geographic distribution of the mortgages in each segment—FHA's serious delinquency rate was lower than the corresponding rate for subprime mortgages (30.6 percent) and higher than the rate for prime mortgages (7.0 percent) at the end of calendar year 2009. This pattern is consistent with FHA maintaining stricter underwriting standards than the subprime market but generally serving borrowers who would have difficulty in obtaining prime mortgages. In recent years, changes in key loan and borrower characteristics of FHA-insured mortgages suggested some improvement in credit quality at loan origination. For example:

- As the contraction of the conventional mortgage market reduced mortgage options, even for borrowers with favorable credit histories, the proportion of FHA borrowers with stronger credit scores (680 and above) increased from 28 percent in 2008 to 44 percent in 2009.

- The percentage of loans with down-payment assistance funded by home sellers fell from about 19 percent in 2008 to 0 percent as a legislative ban on this assistance took effect in 2009. As we discussed in a prior report, loans with this type of assistance have significantly higher-than-average insurance claim rates.[17]

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[15]Credit subsidy rates may be updated more than annually to reflect midyear policy changes. According to FHA officials, the credit subsidy rate included in their report for the third quarter of 2010 will be more favorable than the rate shown in prior reports because it will reflect FHA's April 2010 increase to its up-front insurance premium from 1.75 percent to 2.25 percent.

[16]In the first quarter of 2010, FHA's serious delinquency rate dropped to 9.1 percent.

[17]GAO, *Mortgage Financing: Additional Action Needed to Manage Risks of FHA-insured Loans with Down Payment Assistance*, GAO-06-24 (Washington, D.C.: Nov. 9, 2005).

FHA is closely monitoring the early performance of the 2009 loan cohort, which will have a major influence on the Fund's financial condition because of its large size (35 percent of the amortized insurance-in-force as of May 31, 2010). The 2009 cohort was projected to perform better than the 2006 cohort in the long run. However, it is unclear from the early performance of the 2009 cohort whether this projection will hold.

Conclusions

Because of the severe downturn in the nation's housing sector and FHA's expanded role in supporting the mortgage market, concerns about FHA's finances have grown. Of particular concern is the rapid decline in the Fund's estimated capital ratio to a level below the statutory minimum. Prior actuarial reviews have produced estimates of the Fund's capital ratio using economic forecasts that do not fully account for variability in the conditions the Fund may face. FHA is undertaking a number of enhancements to its modeling and estimation processes, including the use of stochastic simulation, that could help address this and other methodological issues. Prudent implementation of these enhancements could improve the reliability of future capital ratio estimates and produce useful information about the Fund's ability to withstand economic stresses and meet statutory capital reserve requirements.

Congress has enacted a number of statutory provisions concerning FHA's management of and reporting on the Fund's financial condition. These provisions are a key component of Congress's oversight of FHA but, in some cases, do not provide FHA with clear or specific directions. More specifically, the statutes do not specify a time frame for restoring the capital ratio to its required minimum level, define unamortized insurance-in-force in a way that is commonly understood, indicate what is meant by the term "target subsidy rate," or clearly stipulate the extent of the information FHA should include in quarterly reports. Enhancement and clarification of these legislative provisions may help reinforce FHA's accountability for restoring and maintaining the capital ratio at the statutorily required level and improve transparency of the Fund's financial condition. However, establishing a deadline for FHA to restore the capital ratio to 2 percent would require careful deliberation because it involves trade-offs. In particular, lawmakers would need to consider how FHA's actions to meet a deadline (e.g., through changes to insurance premiums, program participation, or underwriting standards) would affect the agency's ability to meet its statutory operational goals and support the mortgage market. In addition, clarifying the definition of unamortized insurance-in-force could have some effect on the size of the estimated capital ratio. Clarification of the other provisions would help to ensure FHA compliance and assist Congress in overseeing FHA's management of the Fund.

Matters for Congressional Consideration

To strengthen accountability and transparency in FHA's management of the Fund, Congress should consider

- establishing a minimum time frame for restoring the capital ratio to 2 percent should the ratio fall below that level, taking into account FHA's statutory operational goals and role in supporting the mortgage market during periods of economic stress, and
- clarifying (1) the definition of the Fund's capital ratio—specifically, whether the denominator of the ratio was intended to be the amortized insurance-in-force; (2) the definition of the phrase "established target subsidy rate" used in HERA; and (3) the nature and extent of information that FHA should be reporting on subsidy rates

pursuant to HERA, recognizing that subsidy rates are generally only reestimated once a year under current budget processes.

Recommendations for Executive Action

To enhance actuarial assessment of and reporting on the Fund, we recommend that the Secretary of HUD (1) require FHA's actuarial review contractor to use stochastic simulation of future economic conditions, including house prices and interest rates, to estimate the Fund's capital ratio and (2) include the results of this analysis, whether used as a replacement for or supplement to the current methodology, in FHA's annual report to Congress on the financial status of the Fund.

Agency Comments

We provided a draft of this report to the Department of Housing and Urban Development for its review and comment. HUD provided technical comments, which we incorporated into the report where appropriate.

Scope and Methodology

To examine how estimates of the Fund's capital ratio have changed since 2001, we analyzed information from the actuarial reviews for 2001 through 2009. To determine the primary factors contributing to recent changes in the capital ratio, we examined the 2007, 2008, and 2009 actuarial reviews and interviewed FHA officials and the actuarial review contractor about the results of these reviews. We also reviewed FHA's audited financial statements for 2008 and 2009 to understand key financial inputs used in the actuarial reviews. To examine the budgetary implications of changes in the Fund's financial performance, we reviewed relevant circulars and guidance from the Office of Management and Budget and analysis from CBO to describe the functions of and relationships between the FHA budget accounts and to understand the requirements and budgetary treatment of federal credit programs. We also reviewed the HUD appendixes to the President's budget (for 2004 through 2011) and federal credit supplements (for 1994 through 2011) to analyze trends in the balance of the capital reserve account and credit subsidy estimates and reestimates for the Fund.

To evaluate how FHA and its actuarial review contractor assess the financial condition of the Fund, we reviewed the 2007, 2008, and 2009 actuarial reviews and the last two actuarial review contracts to characterize the methodology used to estimate the Fund's capital ratio and economic value. We also reviewed existing studies and reports evaluating the methodology, including the independent auditor's report accompanying the audit of FHA's financial statements for 2008 and 2009. We also interviewed housing market researchers; an actuarial consultant to FHA's independent financial statement auditor and private mortgage insurers; and staff from FHA, FHA's actuarial contractor, FHA's independent financial statement auditor, HUD's Office of Inspector General, and CBO about the methodology. To assess the extent to which actuarial reviews of the Fund have evaluated the impact of different economic scenarios on the Fund's financial condition, we analyzed the baseline and alternative economic scenarios in the 2004 through 2009 actuarial reviews and the associated estimates of the capital ratio. We also compared the 3-year house price assumptions used in these scenarios with recent housing market experience, as measured by changes in the Federal Housing Finance Agency's national house price index.

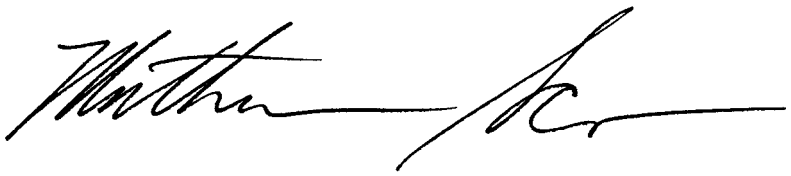
To assess the extent to which FHA took steps to improve the financial condition of the Fund, we reviewed the agency's mortgagee letters, budget submissions, regulatory proposals, and actuarial reviews to identify FHA's actions to manage the Fund. For actions taken or proposed after the 2009 review, we examined FHA and CBO estimates of the budgetary impact of these measures. We also interviewed knowledgeable FHA and CBO officials to ensure that we understood key assumptions behind their estimates. To assess how FHA has interpreted requirements regarding the management of and reporting on the Fund, we reviewed and summarized laws and regulations that were pertinent to these requirements. We also interviewed knowledgeable FHA officials to obtain their interpretation of these requirements.

To describe the performance of FHA's mortgage portfolio from 2005 through 2009 and the extent to which key characteristics of FHA-insured mortgages have changed in recent years, we analyzed data from the Mortgage Bankers Association's National Delinquency Survey, FHA's Office of Evaluation, FHA's reports to Congress on the status of the Fund, and the 2009 actuarial review of the Fund. We analyzed descriptive statistics and identified trends in the performance of FHA-insured mortgages (e.g., serious delinquency rates); loan characteristics (e.g., loan type and loan purpose); and borrower characteristics (e.g., credit score and down-payment assistance). We also reviewed other relevant FHA reports and analysis and interviewed knowledgeable FHA staff to identify major reasons for any observed changes in the performance and characteristics of FHA-insured loans.

We conducted this performance audit from September 2009 to September 2010, in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the date of this letter. At that time, we will send copies of this report to the appropriate congressional committees, the Secretary of Housing and Urban Development, and other interested parties. In addition, the report will be available at no charge on GAO's Web site at http://www.gao.gov.

If you or your staffs have questions about this report, please contact me at (202) 512-8678 or sciremj@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in enclosure II.



Mathew J. Scirè
Director, Financial Markets
and Community Investment

Enclosures – 2

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Financial Condition of FHA's Mutual Mortgage Insurance Fund

Briefing to the Committee on Banking, Housing, and Urban Affairs United States Senate July 2010

For more information, contact Mathew J. Scirè at (202) 512-8678 or sciremj@gao.gov

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Overview

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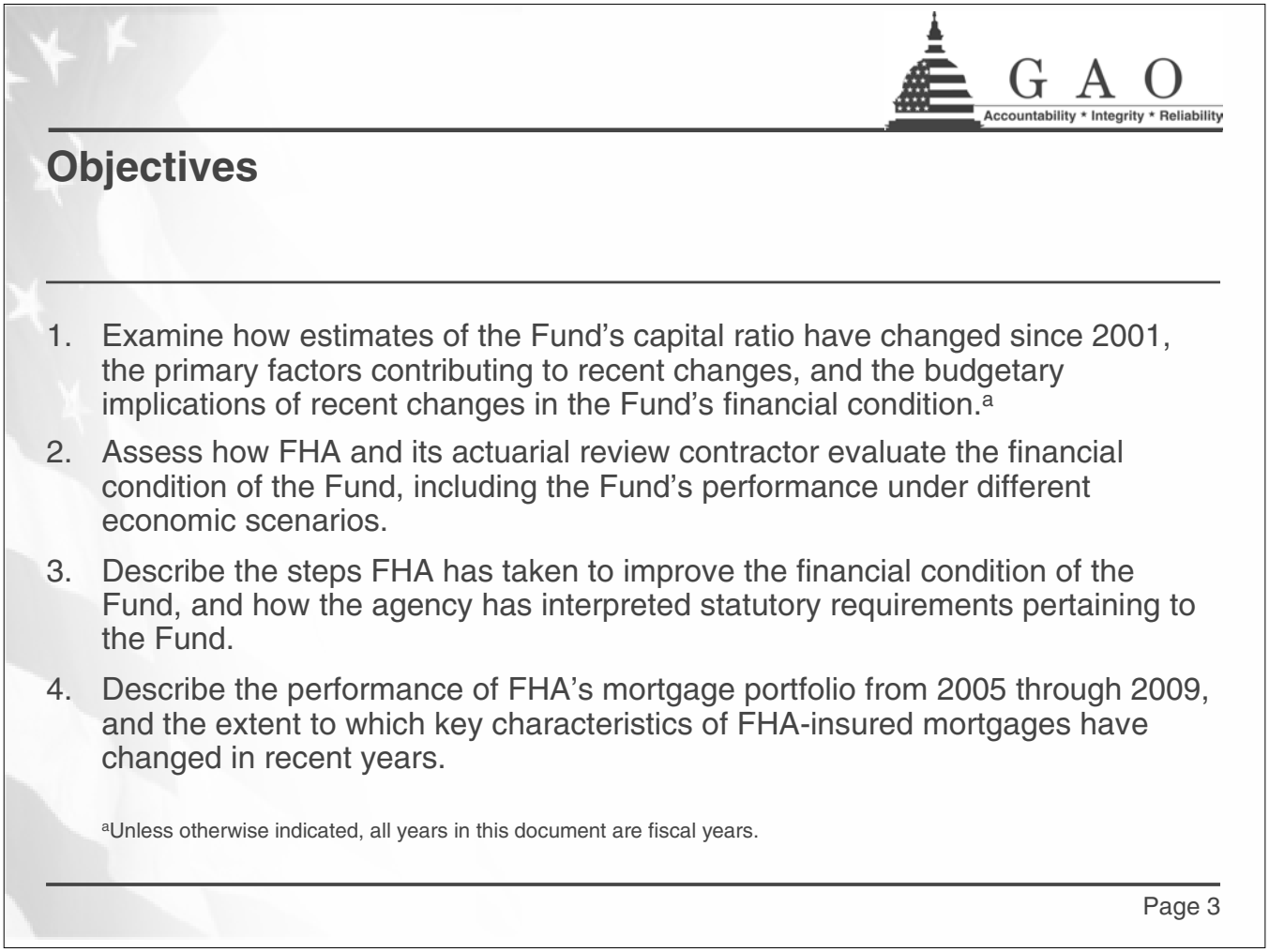
Enclosure I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Objectives
1. Examine how estimates of the Fund's capital ratio have changed since 2001, the primary factors contributing to recent changes, and the budgetary implications of recent changes in the Fund's financial condition.[a]
2. Assess how FHA and its actuarial review contractor evaluate the financial condition of the Fund, including the Fund's performance under different economic scenarios.
3. Describe the steps FHA has taken to improve the financial condition of the Fund, and how the agency has interpreted statutory requirements pertaining to the Fund.
4. Describe the performance of FHA's mortgage portfolio from 2005 through 2009, and the extent to which key characteristics of FHA-insured mortgages have changed in recent years.
[a]Unless otherwise indicated, all years in this document are fiscal years.
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Scope and Methodology

- To address our review objectives, we:
  - analyzed actuarial reviews of the Mutual Mortgage Insurance (MMI) Fund for 2001 through 2009.
  - analyzed federal budget documents, including Department of Housing and Urban Development (HUD) budget appendixes and federal credit supplements for 1994 through 2011, and reviewed relevant Office of Management and Budget (OMB) circulars.
  - reviewed relevant Congressional Budget Office (CBO) studies and estimates.
  - reviewed laws and regulations pertinent to FHA's administration of the Fund, as well as FHA policy changes and regulatory and legislative proposals.
  - analyzed FHA and industry data on the characteristics and performance of mortgages insured by FHA, focusing on the period from 2005 through 2009.
  - interviewed officials from FHA, FHA's actuarial review contractor, HUD's Office of General Counsel, HUD's Office of Inspector General, the independent financial statement auditor of FHA's financial statements, CBO, and OMB. We also interviewed selected housing market researchers and an actuarial consultant to FHA's independent financial statement auditor and private mortgage insurers.

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Summary

- After increasing earlier in the decade, the Fund's capital ratio dropped sharply in 2008 and fell below the statutory minimum in 2009, as economic and market developments created conditions that reduced the Fund's economic value (numerator of the ratio) and increased the insurance-in-force (denominator). At the same time, balances in the budgetary account that records the Fund's capital reserves (reserves in excess of those needed to cover FHA's estimated long-term insurance costs) fell dramatically.
- FHA and its actuarial review contractor have enhanced their methods for assessing the Fund's financial condition but still are addressing other methodological issues that could affect the reliability of estimates of the Fund's capital ratio. For example, the current method does not fully account for variability in economic conditions the Fund may face.
- To help improve the financial condition of the Fund, FHA has raised insurance premiums and made or proposed policy and underwriting changes, but certain legislative requirements concerning FHA's administration of the Fund provide limited direction and have required interpretation by FHA.
- As in other mortgage market segments, the performance of FHA-insured mortgages deteriorated as the economy weakened and home prices fell in 2008 and 2009. At the same time, changes in key loan and borrower characteristics of these mortgages suggested some improvement in credit quality at loan origination. FHA is closely monitoring the performance of the large 2009 loan cohort, which will have a major influence on the Fund.

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Background

- Through its single-family mortgage insurance programs, FHA insures lenders against losses from defaults on mortgages that meet FHA criteria.
  - FHA borrowers who are purchasing a home are required to make a cash investment of at least 3.5% of the contract sales price.
  - Limits on the size of the loans FHA may insure can vary by county. They currently range from $271,050 to $729,750 for one-unit properties in the continental U.S.
- FHA has played a large role among minority, lower-income, and first-time homebuyers and is thought to promote market stability by ensuring the availability of mortgage credit in areas that may be underserved by the private sector or are facing economic downturns.
  - In 2009, 79% of FHA-insured home purchase loans went to first-time homebuyers, 32% of whom were minorities.
- FHA insures nearly all of its single-family mortgages under its MMI Fund.
  - FHA currently charges a 2.25% up-front insurance premium and a 0.5% annual premium (0.55% for borrowers with down payments of less than 5.0%).
  - The Fund's cash inflows include borrower premiums and proceeds from sales of foreclosed properties, and cash outflows include insurance claims paid to lenders and holding costs for foreclosed properties.

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Background

- The Omnibus Budget Reconciliation Act of 1990
  - defined the Fund's capital ratio as the Fund's economic value divided by the unamortized insurance-in-force.
  - required HUD to take steps to achieve a 2% ratio by November 2000 and maintain a ratio of at least that level at all times thereafter.
  - required an annual independent actuarial review of the Fund to determine if the Fund was meeting the capital standards in the Act.[a]
- The Federal Credit Reform Act of 1990 (FCRA) requires federal agencies to estimate the expected net lifetime costs, known as credit subsidy costs, of their loan guarantee programs and report them in their annual budgets.
  - The credit subsidy cost is the net present value of all expected cash flows, excluding administrative costs, and can be expressed as a rate (net present value of cash flows divided by the dollar amount of loans insured). Negative subsidy costs (i.e., net cash inflows) are counted as offsetting receipts that reduce the federal budget deficit.
  - Credit subsidy costs are separately estimated for each annual cohort of loans and are reestimated each year based on information about the actual performance of the loans and estimated changes in future loan performance.

[a]The annual actuarial review is now a requirement in the Housing and Economic Recovery Act of 2008.

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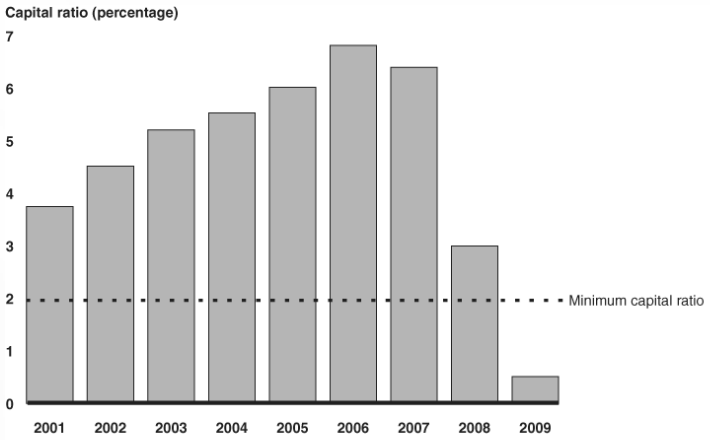
Changes in the Fund's Financial Condition
Annual Estimates of the Capital Ratio

- The Fund's capital ratio increased earlier in the decade—reaching a peak of 6.8% in 2006—but declined sharply in 2008 and fell below the statutory minimum in 2009 to about 0.5%.



Source: GAO analysis of FHA data.

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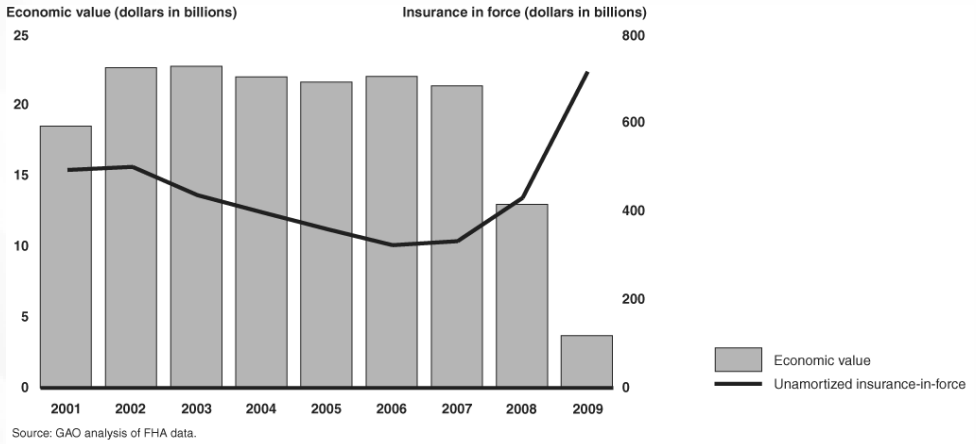
Changes in the Fund's Financial Condition

Annual Estimates of the Economic Value and Insurance-in-Force

- The combination of a relatively stable economic value (numerator of the ratio) and a declining insurance-in-force (denominator) over much of the decade increased the capital ratio. In 2008 and 2009, the economic value fell as the insurance-in-force rose, dramatically lowering the ratio.



Source: GAO analysis of FHA data.

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Changes in the Fund's Financial Condition
Reasons for Decline in Economic Value

- The economic value of the Fund declined by
  - $8.4 billion from 2007 to 2008
  - $10.2 billion from 2008 to 2009
- For both periods, major reasons for the declines included
  - more pessimistic economic forecasts—house prices, in particular—which increased the likelihood that FHA borrowers would end up in a position of negative home equity, thereby resulting in higher projected insurance claims.
  - less favorable assumptions about FHA's net losses on loans that result in insurance claims (loss severity). As discussed later in this briefing, part of the increase in projected loss severity rates in the 2009 review stemmed from an enhancement in estimation methods.
- Another major reason for the decrease in the economic value from 2007 to 2008 was greater loan volume than originally estimated for the 2008 loan cohort, which is currently projected to be unprofitable.

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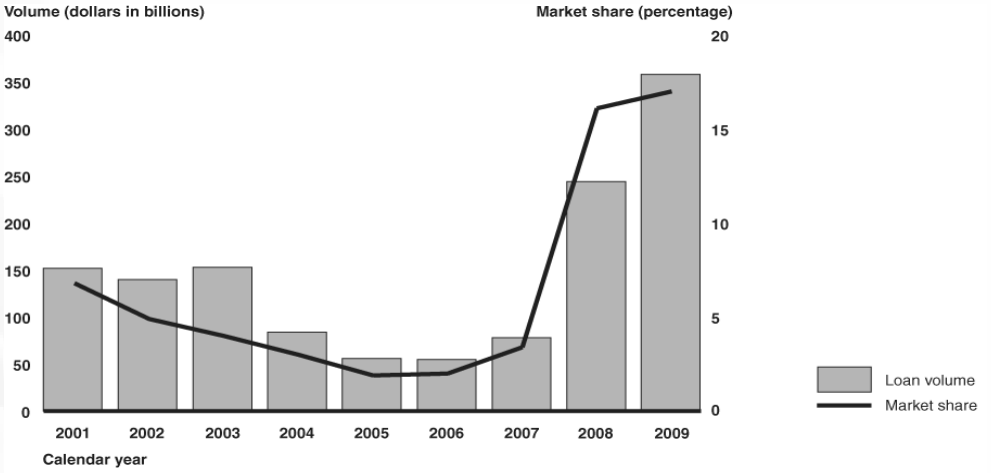
Changes in the Fund's Financial Condition

Reasons for Increase in the Insurance-in-Force

- After dropping substantially from 2003 through 2006, the dollar volume of loans FHA insured grew dramatically in 2008 and 2009 as a result of the sharp contraction of other segments of the mortgage market and legislated increases in the loan amounts eligible for FHA insurance. FHA's share of the mortgage market followed a similar trend.



Source: GAO analysis of FHA data.

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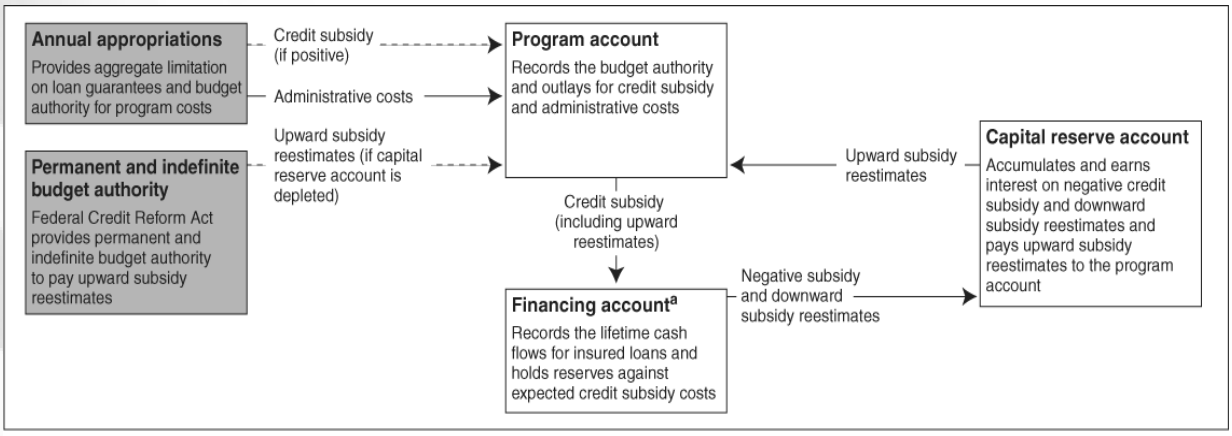
Changes in the Fund's Financial Condition
Budget Accounting for the Fund

- Budget information for the Fund appears in three accounts: program, financing, and capital reserve.



Source: Federal budget documents and OMB guidance.

[a]The financing account appears in the budget for informational and analytical purposes, but is not included in the budget totals for budget authority or outlays. The financing account is required to record lifetime cash flows for loans insured in 1992 and thereafter.

Note: When the present value of cash inflows exceeds cash outflows, a loan guarantee program is said to have a negative subsidy cost. When the present value of cash outflows exceeds cash inflows, the program is said to have a positive subsidy cost and therefore requires appropriations. Upward subsidy reestimates reflect higher-than-expected program costs, while downward subsidy reestimates reflect lower-than-expected costs.

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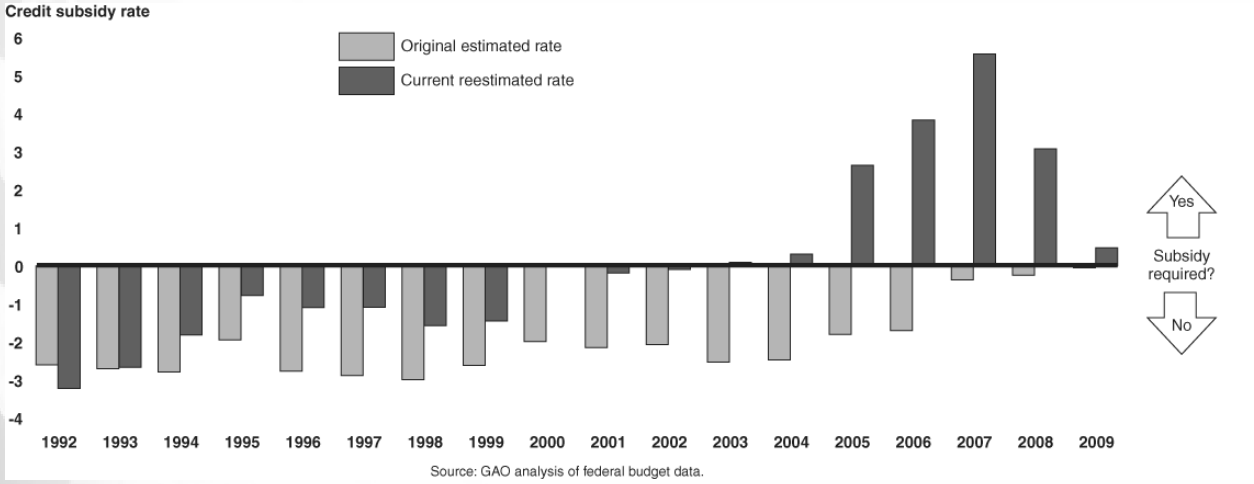
Changes in the Fund's Financial Condition
Original Versus Reestimated Subsidy Rates

- Comparing FHA's original estimates of credit subsidy rates with the most recent reestimates of these rates shows that the reestimates have been in the upward (i.e., less favorable) direction for all annual loan cohorts after 1992. For the 2003 through 2009 cohorts, the current reestimated rate is positive, meaning that the present value of expected lifetime cash outflows exceeds expected lifetime cash inflows.



Source: GAO analysis of federal budget data.

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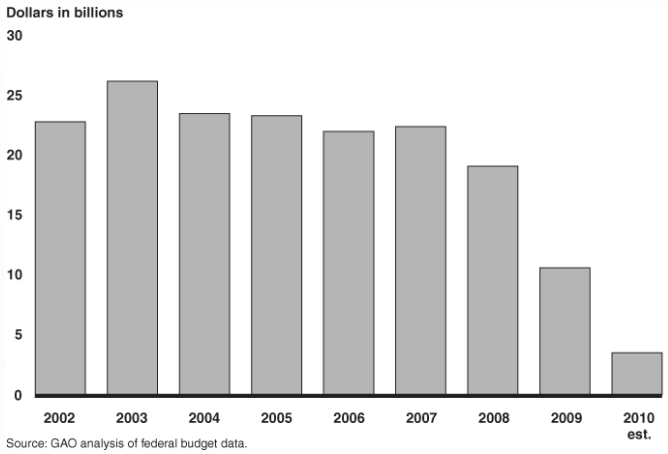
Changes in the Fund's Financial Condition

End-of-Year Balances in the Fund's Capital Reserve Account

- In recent years, the capital reserve account has covered large upward reestimates of FHA's credit subsidy costs (through transfers to the financing account). As a result, balances in the capital reserve account have fallen dramatically. If the account were to be depleted, additional increases in credit subsidy costs would require FHA to draw on the permanent and indefinite budget authority granted to federal credit programs.



Source: GAO analysis of federal budget data.

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FHA's Methodology for Assessing the Fund

Approach Used in Actuarial Reviews

- Annual actuarial reviews use econometric models to estimate the probability that loans will prepay or result in insurance claims
  - Explanatory variables that are part of the model include:
    - loan characteristics (e.g., loan-to-value ratio, loan size)
    - borrower characteristics (e.g., credit score, source of down-payment assistance)
    - key economic variables (e.g., house prices, interest rates)
- Modeling results are used as inputs to a cash flow model to estimate the net present value of expected cash flows of existing and future loan cohorts over a 30-year period.[a]
  - The cash flow model calculates four types of cash flows: (1) up-front insurance premiums, (2) annual insurance premiums, (3) claim losses, and (4) premium refunds.
  - The Fund's economic value is the sum of the net present value of expected cash flows and the Fund's existing capital resources (e.g., Treasury securities, cash, and property assets).
- The estimates of the economic value and FHA data on the insurance-in-force constitute the two components of the Fund's capital ratio.

[a]The net present value of future cash flows is the present value of estimated future cash inflows minus the present value of estimated future cash outflows.

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FHA's Methodology for Assessing the Fund

Key Enhancements to Actuarial Reviews Since 2004

Year implemented	Enhancement
2004	• Switched from cohort-level to loan-level econometric model • Implemented method for estimating the dispersion of individual house price appreciation rates around the market average
2005	• Included source of down-payment assistance in the econometric model
2007	• Incorporated borrower credit scores at the loan level in the econometric model
2009	• Implemented additional econometric model to predict loss severity rates based on different loan, borrower, and economic variables rather than assuming loss severity rates were constant over time and different economic environments

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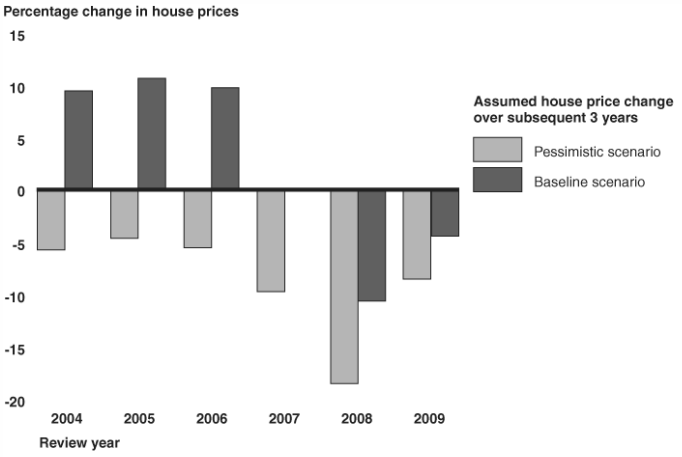
FHA's Methodology for Assessing the Fund
Baseline and Pessimistic Economic Scenarios

- The actuarial reviews estimate the Fund's capital ratio under both baseline and alternative (optimistic and pessimistic) economic scenarios. Even before the recent recession, the reviews considered the impact of adverse scenarios on the Fund's financial condition.
- However, the actuarial reviews do not provide the likelihood of the alternative scenarios, and the scenarios were developed primarily to evaluate the sensitivity of the actuarial model to different assumptions rather than to run economic stress tests on the Fund.



Source: GAO analysis of FHA and FHFA data.

Note: The baseline figure for the 2007 review year was 0.2 percent. The actual change in the FHFA national house price index was 12.0% for 2005-2007, -5.9% for 2006-2008, and -10.3% for 2007-2009.

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FHA's Methodology for Assessing the Fund
Potential Limitations to FHA's Methodology

- FHA, its financial statement auditor, and mortgage market and budget analysts have identified a number of potential limitations with the methodology used in recent actuarial reviews.

Variability of Key Economic Variables Not Fully Incorporated into Estimates

- The estimate of the capital ratio made using baseline economic assumptions is used to determine whether the capital ratio is meeting the statutory minimum. However, significant uncertainty surrounds the baseline assumptions, especially for a period as long as 30 years.
- Under the current actuarial review methodology, the baseline estimates of the capital ratio use a single economic forecast and, as previously noted, incorporate estimates of the dispersion of individual house prices around this forecast. However, this approach does not fully account for the variability of future house prices and interest rates that the Fund may face.
- As a result, baseline estimates of the capital ratio may tend to underestimate insurance claims and mortgage prepayments and therefore may tend to overestimate the Fund's economic value.

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FHA's Methodology for Assessing the Fund
Potential Limitations to FHA's Methodology

Variability of Key Economic Variables Not Fully Incorporated into Estimates (continued)

- An alternative to the current methodology, known as stochastic simulation, involves running simulations of hundreds of different economic paths (in contrast to the current approach, which focuses on a limited number of selected scenarios). The simulations would produce a distribution of capital ratio estimates.
- The distribution would provide information that could help FHA assess the Fund's vulnerability to severe economic scenarios and manage its financial risk. For example, information on the percentage of simulations that produce a capital ratio of less than 2%, could help FHA decide whether premium or policy changes were warranted.
- Additionally, the middle value of the distribution of estimates could be used for determining FHA's compliance with the 2% capital ratio requirement.
- In a 2003 report, CBO concluded that FHA could project the Fund's cash flows more accurately by using stochastic simulation. Additionally, an actuarial consultant to a number of private mortgage insurance companies told us that stochastic simulation was a common practice within that industry.

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FHA's Methodology for Assessing the Fund
Potential Limitations to FHA's Methodology

Variability of Key Economic Variables Not Fully Incorporated into Estimates (continued)

- FHA has recognized the value of this approach and taken some initial steps toward implementing it.
  - FHA's actuarial review contracts since 2004 have identified stochastic simulation as an area for further research. However, FHA officials told us that other research priorities had prevented them from pursuing this issue further.
  - For the 2010 review, the actuarial review contractor will examine alternative economic scenarios that include third-party forecasts of multiple house price paths.
  - FHA officials told us that they were planning to require the actuarial review contractor to develop a stochastic model for the 2011 review. The officials said that model would be used to examine the implications of extreme economic scenarios on the Fund but that decisions about whether to use the model to estimate the Fund's capital ratio had not been made.
- Despite the potential advantages of stochastic simulation, the results may be more difficult to explain than the results of FHA's current approach. Additionally, the quality of the results from a simulation model is highly dependent on the reasonableness of the assumptions used for the potential volatility of economic variables.

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FHA's Methodology for Assessing the Fund
Potential Limitations to FHA's Methodology

Reliance on National House Price Index

- To capture the impact of future house price movements on loan performance, past actuarial reviews have used forecasts of a national house price index.[a] However, the geographic distribution of FHA's business may not always be representative of the nation as a whole and can change over time.
  - The proportion of FHA's business in California rose from 2% in 2005 to 12% in 2009. Over that period, home prices in California dropped more sharply than the national average.
- Recognizing this limitation, FHA officials told us that they would be using forecasts of house prices at the metropolitan statistical area level in the 2010 actuarial review.

[a]As previously noted, the reviews estimate the dispersion of individual house price appreciation rates around the market average.

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FHA's Methodology for Assessing the Fund
Potential Limitations to FHA's Methodology

Imputation of Loan-to-Value (LTV) Ratios for Streamline Refinances

- In recent years, streamline refinance mortgages (expedited refinancing from one FHA-insured loan into another) have constituted an increasingly large share of FHA's annual business volume, growing from 5% (about 20,000 loans) in 2007 to 18% (about 330,000 loans) in 2009. These mortgages generally do not require an appraisal—thus, the LTV ratios at loan origination are not known.[a]
- Prior actuarial reviews have imputed initial LTV ratios for these loans based on average LTVs ratios for non-streamline FHA mortgages originated in the same time frame and geographic location. However, these imputed values may not provide an accurate starting point for assessing the default risk of these loans, particularly in areas where house values fell substantially between the start of the original loan and the streamline refinancing.
- FHA officials told us that to address this issue, the actuarial review contractor will match streamline refinances to their predecessor loans and use metropolitan area-level house price indexes to adjust the LTV ratios for the streamline refinances to reflect any changes in house value that were not captured by the imputation method.

[a]The LTV ratio is the amount of the loan divided by the appraised value of the home. The higher the LTV ratio, the less cash borrowers will have invested in their homes and the more likely it is that they may default on mortgage obligations.

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FHA's Methodology for Assessing the Fund

Potential Limitations to FHA's Methodology

Other Concerns

- The independent auditor of FHA's financial statements and some mortgage market researchers have expressed additional concerns about the actuarial review methodology but FHA generally has disagreed with their conclusions. These concerns include the following:
  - The actuarial reviews do not use the current delinquency status of loans as a predictive variable and therefore may not be capturing the impact of rising delinquency rates on insurance claim trends in the near term. While acknowledging that delinquencies could be useful for short-run forecasts, FHA has questioned their value as a variable in a long-range actuarial analysis.
  - The actuarial reviews do not use unemployment data (e.g., trends in initial unemployment claims) for making near-term projections of insurance claims. FHA has indicated that there is little evidence that unemployment data are useful in predicting future claims, partly because unemployment effects are captured by the effects of house price and interest rate changes.

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FHA Actions to Strengthen the Fund and Interpretation of Statutory Requirements

Steps Taken or Proposed by FHA

- FHA has taken or proposed a number of steps to improve the Fund's financial condition.

Action or proposal	From	To	Implemented through	Status as of July 2010
Increase up-front insurance premium for most mortgages	1.75% (of original principal balance)	2.25%	Mortgagee letter[a]	Effective April 5, 2010
(Note: Proposal below, if implemented, would supersede this action.)				
Rebalance premium structure				
Raise annual premium	0.50% or 0.55%[b] (of remaining principal balance)	0.85% or 0.90%[b]	Legislation (needed to raise premium ceiling)	Passed by the House in June 2010.
Lower up-front premium	2.25% (of original principal balance)	1.00%	Potential mortgagee letter[a]	To accompany increase in annual premium
(Note: Rebalancing would increase net premium revenue.)				
Raise minimum credit score to qualify for loan with a 3.5% cash investment	500 (as measured by FICO score)	580 (borrowers with scores from 500-579 must make a cash investment of 10% or greater[c])	Administrative action requiring 30-day notice	HUD published notice on July 15, 2010, seeking public comment
Reduce allowable seller concessions at closing	6% (of the home price)	3%	Administrative action requiring 30-day notice	HUD published notice on July 15, 2010, seeking public comment

Source: FHA.
[a]Mortgagee letters are written instructions that FHA periodically issues to all of its approved lenders (mortgagees).
[b]The lower percentage applies to 30-year loans with initial LTVs of 95% or less, and the higher percentage applies to 30-year loans with initial LTVs above 95%.
[c]Borrowers with FICO scores below 500 would be ineligible for FHA financing.

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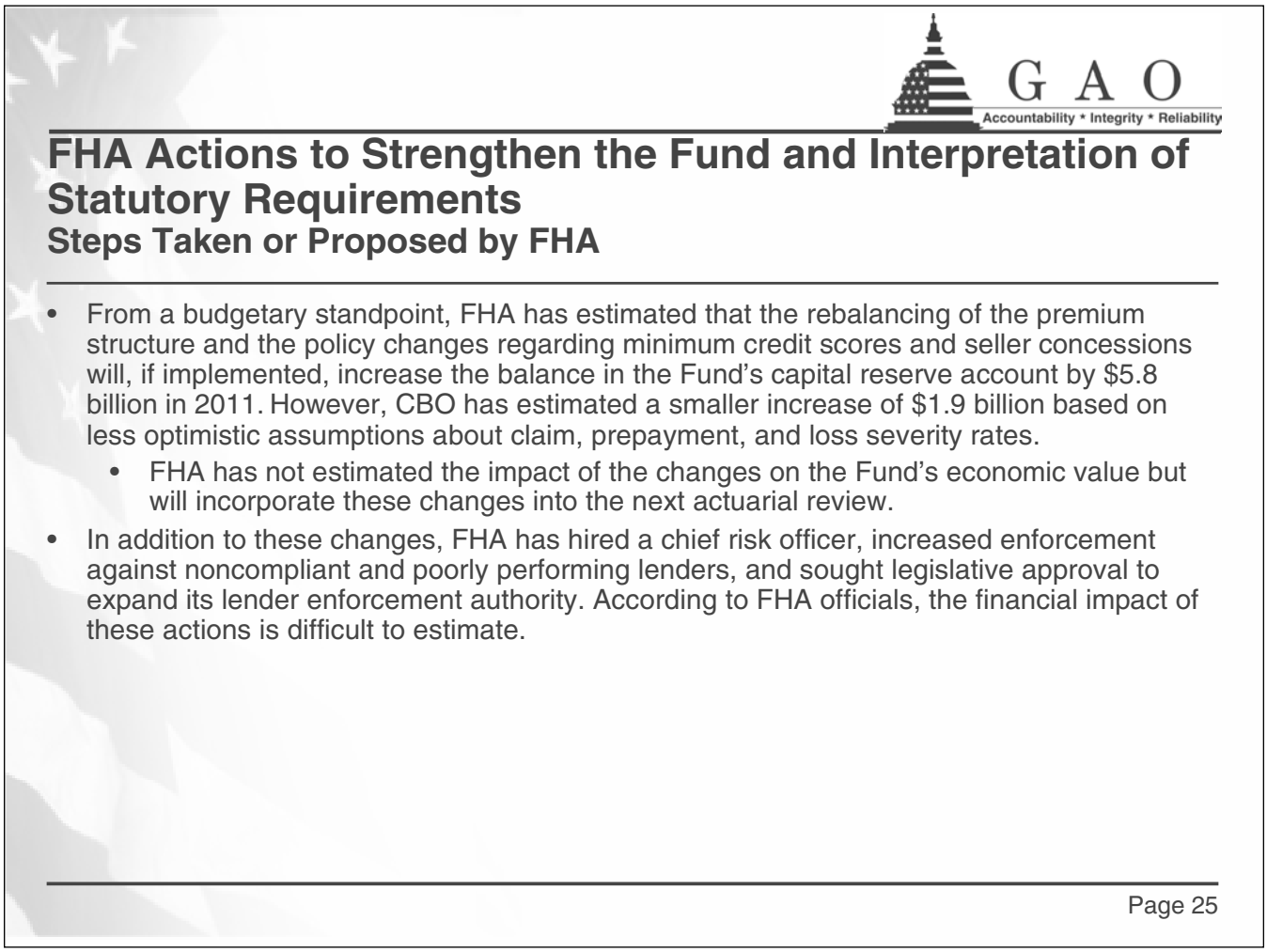
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FHA Actions to Strengthen the Fund and Interpretation of Statutory Requirements
Steps Taken or Proposed by FHA
• From a budgetary standpoint, FHA has estimated that the rebalancing of the premium structure and the policy changes regarding minimum credit scores and seller concessions will, if implemented, increase the balance in the Fund's capital reserve account by $5.8 billion in 2011. However, CBO has estimated a smaller increase of $1.9 billion based on less optimistic assumptions about claim, prepayment, and loss severity rates.
• FHA has not estimated the impact of the changes on the Fund's economic value but will incorporate these changes into the next actuarial review.
• In addition to these changes, FHA has hired a chief risk officer, increased enforcement against noncompliant and poorly performing lenders, and sought legislative approval to expand its lender enforcement authority. According to FHA officials, the financial impact of these actions is difficult to estimate.
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FHA Actions to Strengthen the Fund and Interpretation of Statutory Requirements

Interpretation of Capital Ratio Requirements

- Certain legislative requirements relating to FHA's management of and reporting on the Fund's condition provide limited direction and have required interpretation by FHA.

Statutory requirement	How FHA has interpreted the requirement
The Omnibus Budget Reconciliation Act of 1990 required FHA to maintain a capital ratio of at least 2 percent "at all times" but did not specify time frames for the agency to reattain a 2 percent ratio should it fall below that level.	FHA officials told us that while they have not set a deadline for restoring the ratio to the minimum level, they intend to do so as quickly as possible, consistent with FHA's statutory operational goals such as providing mortgage insurance to traditionally underserved borrowers.
The Act defined the capital ratio as the economic value of the Fund divided by the "unamortized insurance-in-force" (i.e., the original insured loan balances) but then defined unamortized insurance-in-force as the remaining insured loan balances (generally understood to describe the amortized insurance-in-force).	FHA has traditionally emphasized the capital ratio using the unamortized insurance-in-force, but for the 2009 review shifted emphasis to the alternative definition. The effective difference between the two definitions currently is insignificant because FHA's insurance portfolio is predominantly made up of recent loans that have had little time to amortize (making the difference between the amortized and unamortized loan balances small). However, the difference may grow over time as the loans mature and borrowers pay down their balances.

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Enclosure I

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FHA Actions to Strengthen the Fund and Interpretation of Statutory Requirements

Interpretation of Capital Ratio Requirements

(Continued from previous slide)

Statutory requirement	How FHA has interpreted requirement
The Housing and Economic Recovery Act of 2008 (HERA) states that if the HUD Secretary determines that there is a substantial probability the Fund will not maintain its "established target subsidy rate," the Secretary may make programmatic or premium adjustments.	FHA officials told us that the meaning of "established target subsidy rate" was not clear—indicating it could refer to a credit subsidy rate—but have interpreted it to mean the capital ratio.
HERA also requires FHA to provide quarterly reports to Congress that include "updated projections of [the Fund's] annual subsidy rates to ensure that increases in risk to the Fund are identified and mitigated."	In the quarterly reports, FHA has provided the credit subsidy rate for only the current loan cohort and in a given fiscal year has reported the same rate each quarter because credit subsidy rates generally are only reestimated annually.[a]

[a]Credit subsidy rates may be updated more than annually to reflect midyear policy changes. According to FHA officials, the credit subsidy rate included in their report for the third quarter of 2010 will be higher than the rate shown in prior reports because it will reflect FHA's April 2010 increase to its upfront insurance premium from 1.75 percent to 2.25 percent.

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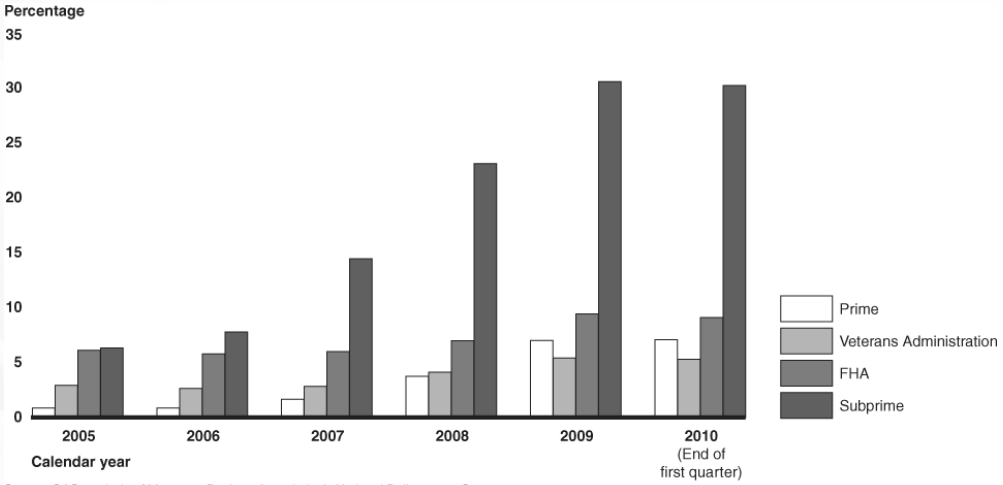
Changes in the Characteristics of FHA-insured Mortgages

Serious Delinquency Rates by Market Segment

- As in other segments of the mortgage market, FHA experienced increases in serious delinquency rates (percentage of active loans 90 or more days delinquent or in the foreclosure process) beginning in 2008 and continuing through 2009. As of the last quarter of calendar year 2009, FHA's serious delinquency rate reached a historical high of 9.4% before declining to 9.1% in the first quarter of 2010.



Source: GAO analysis of Mortgage Bankers Association's National Delinquency Survey.

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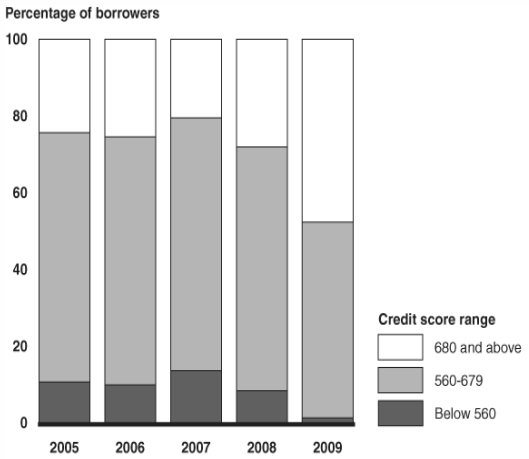
Changes in the Characteristics of FHA-insured Mortgages
Borrower Credit Score

- From 2005 through 2009, some risk attributes of FHA-insured mortgages improved, but the performance of FHA's portfolio worsened as the housing recession set in.
  - The proportion of FHA borrowers with stronger credit scores (680 and above) at loan origination increased from 24% in 2005 to 44% in 2009. This trend is associated with the contraction of the conventional mortgage market, which reduced mortgage options even for borrowers with strong credit histories.



Source: GAO analysis of FHA data.

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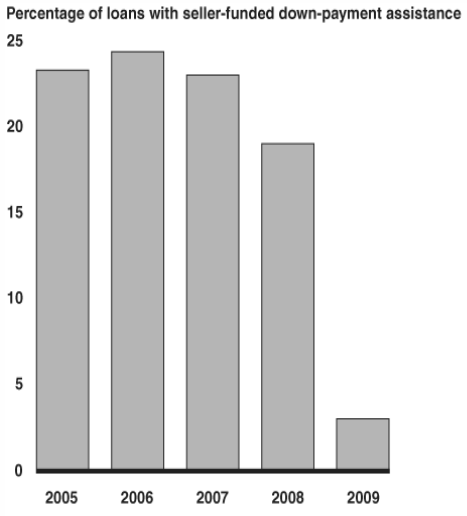
Changes in the Characteristics of FHA-insured Mortgages
Down-payment Assistance

- The percentage of loans with down-payment assistance funded by home sellers fell from 23 percent in 2005 to 19 percent in 2008, then dropped to 0 percent as a legislative ban on this assistance took effect in 2009. Loans with seller-funded down-payment assistance have significantly higher-than-average claim rates.
  - FHA has indicated that without seller-funded down-payment assistance loans in its portfolio, the Fund's estimated capital ratio as of September 30, 2009, would have been greater than the 2 percent statutory minimum.



Source: GAO analysis of FHA data.

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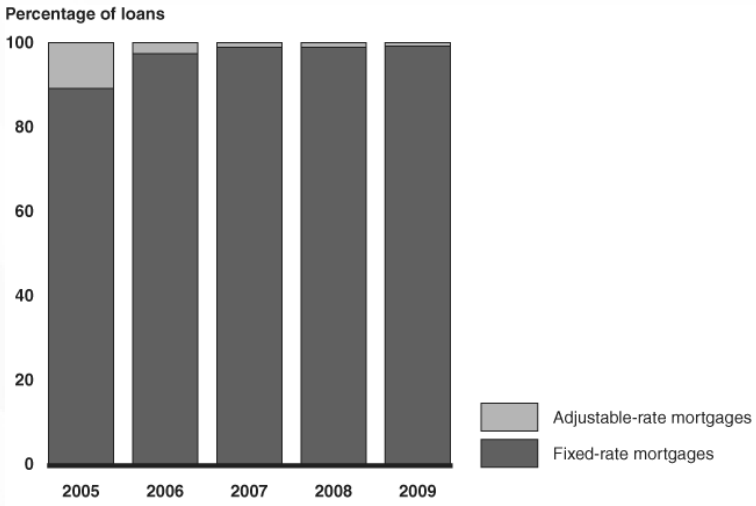
Changes in the Characteristics of FHA-insured Mortgages
Loan Type

- The percentage of FHA-insured mortgages with adjustable interest rates fell from 12% in 2005 to less than 1% in 2009.



Source: GAO analysis of FHA data.

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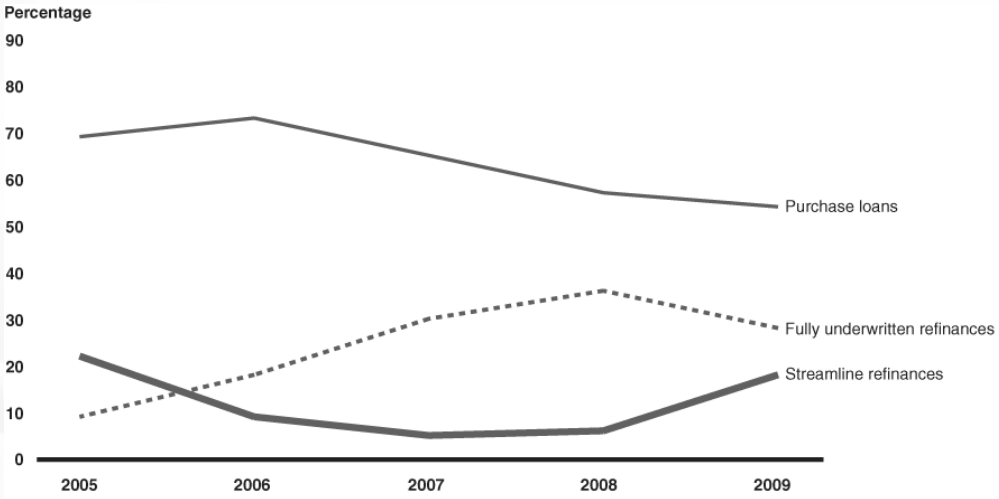
Changes in the Characteristics of FHA-insured Mortgages
Loan Purpose

- As a proportion of FHA's annual business, purchase loans declined during 2005-2009, while fully underwritten refinances grew. The proportion of streamline refinances fell from a high of more than 20% in 2005 to about 5% in 2008, then rebounded to about 20% in 2009.



Source: GAO analysis of FHA data.

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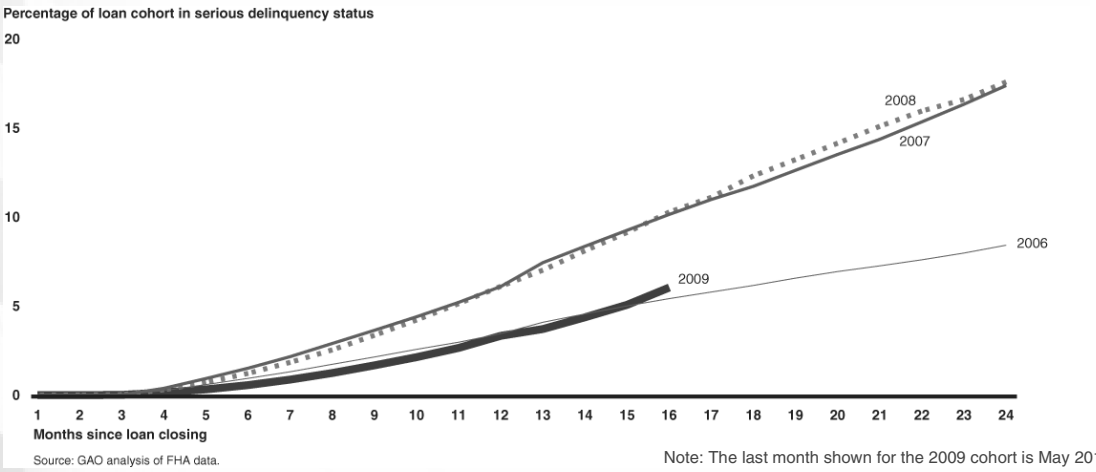
Changes in the Characteristics of FHA-insured Mortgages

Serious Delinquency Rate by Month after Loan Origination
All Loans

- FHA is closely monitoring the early performance of the 2009 loan cohort, which will have a major influence on the Fund's condition because of its large size (35% percent of the amortized insurance-in-force as of May 31, 2010). The 2009 cohort was projected to perform better than the 2006 cohort in the long run. However, it is unclear from the early performance of the 2009 cohort whether this projection will hold.



Source: GAO analysis of FHA data.

Note: The last month shown for the 2009 cohort is May 2010.

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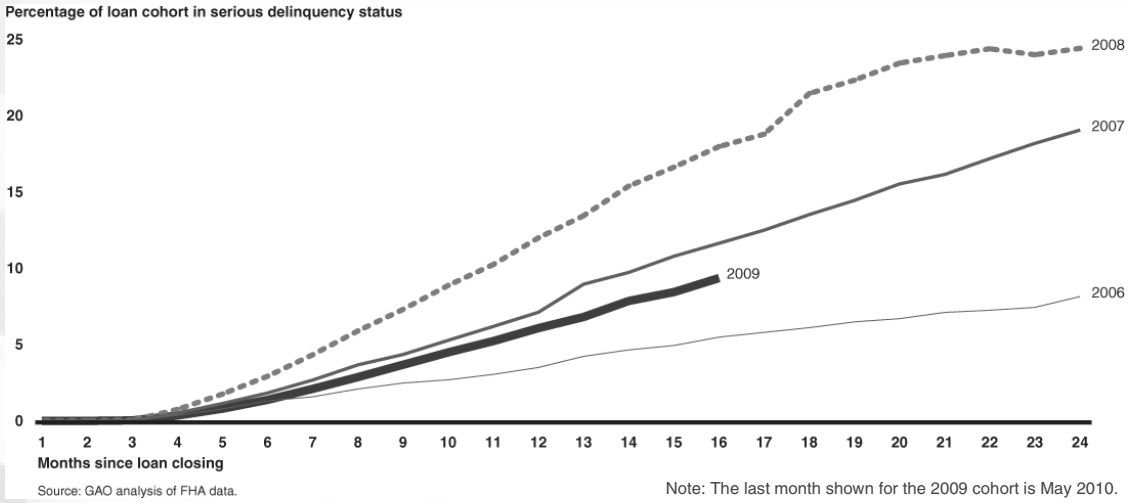
Changes in the Characteristics of FHA-insured Mortgages

Serious Delinquency Rate by Month after Loan Origination Streamline Refinances

- Looking at streamline refinance mortgages separately, the 2006 and 2009 cohorts were projected to perform about the same in the long run, but the early performance of the 2009 cohort is worse. As previously noted, streamline refinances became a larger part of FHA's overall portfolio in recent years.



Source: GAO analysis of FHA data.

Note: The last month shown for the 2009 cohort is May 2010.

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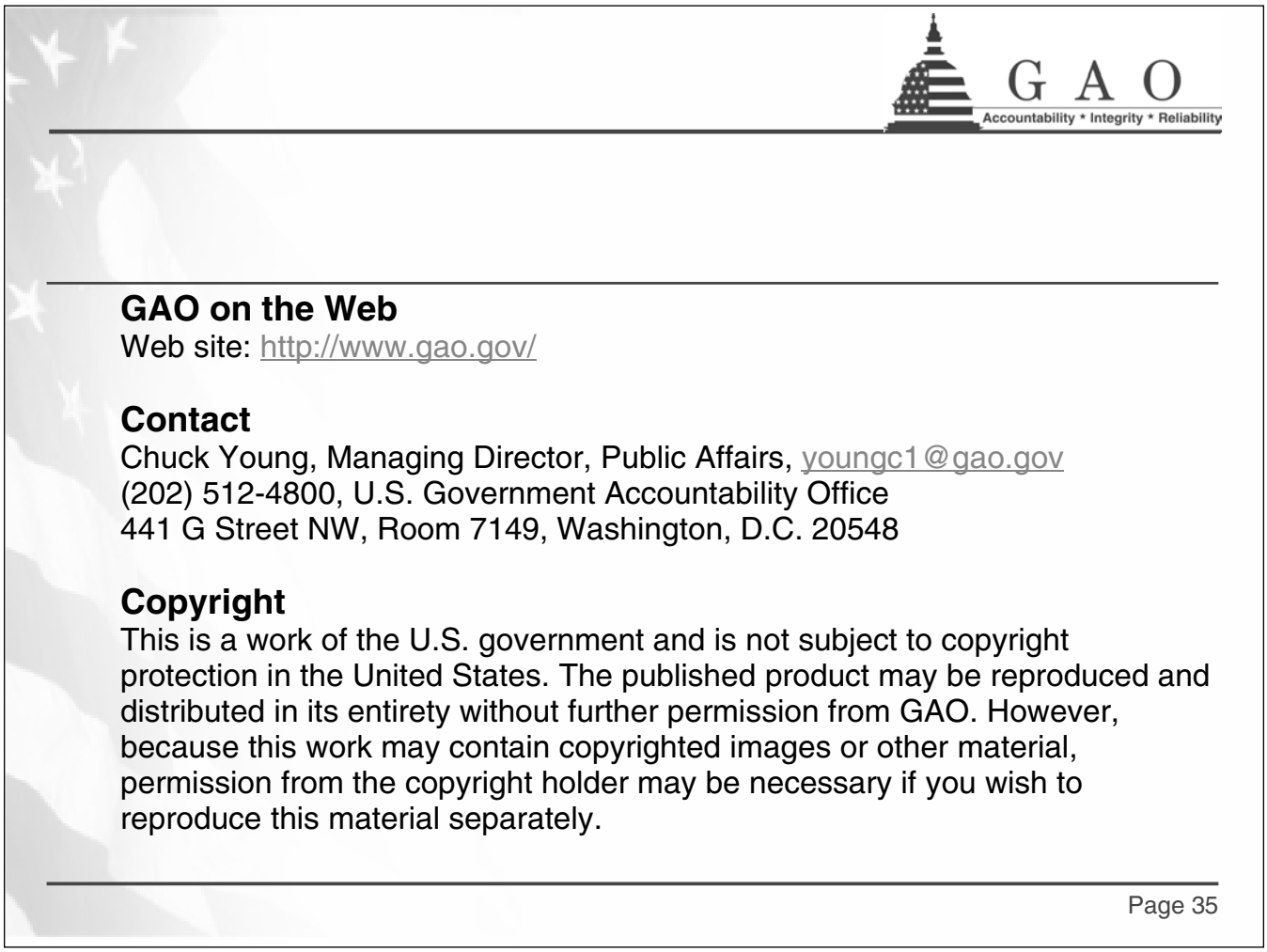
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Enclosure II: GAO Contact and Staff Acknowledgments

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Staff Acknowledgments

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