October 23, 2000

RESPONSES TO SENATOR ALLARD'S QUESTIONS ABOUT THE 1999 ACTUARIAL REVIEW OF THE FEDERAL HOUSING ADMINISTRATION'S MUTUAL MORTGAGE INSURANCE FUND

1. Following the release of the 1999 Actuarial Review of the Mutual Mortgage Insurance Fund (MMIF), HUD stated that the MMIF was projected to have a $5-billion surplus. What does this $5 billion represent and how was it calculated?

The $5 billion amount referred to by the Department of Housing and Urban Development (HUD) is the difference between estimates of the MMIF's economic net worth at the end of fiscal year 1998 and at the end of fiscal year 1999. That difference reflects an additional year of loan guarantee activity, as well as the fact that the two estimates were done by different contractors, at different times, using different economic models and assumptions.

The Cranston-Gonzalez National Affordable Housing Act (NAHA) requires the Federal Housing Administration's (FHA's) MMIF to undergo an independent actuarial review annually. The independent reviewers use their own models to evaluate the financial soundness of the MMIF. The results of such a review are only preliminary because the data available at the time do not include actual results for the full fiscal year and because NAHA also requires that the FHA undergo a financial audit after the fiscal year is over.

The 1999 actuarial review, prepared by Deloitte & Touche, estimates that the MMIF had an economic net worth of $16.6 billion at the end of September 1999. The fund's economic net worth consists of the assets credited to the fund, mostly in the form of Treasury securities but also including the estimated discounted present value of future cash flows, less the fund's liabilities. Cash receipts to the MMIF come mostly from premiums charged to home buyers and receipts associated with the sale of foreclosed property. Outlays are primarily for claims payments. FHA provides mostly 30-year loan guarantees, so the estimated cash flows for a given group of loan guarantees are projected well into the future.

Compared to the estimated economic net worth of $11.4 billion at the end of September 1998 (as estimated by Price Waterhouse Coopers), this new amount represents a $5.3 billion increase in the fund's estimated value. This amount,

which some have referred to as a "surplus," thus represents the change in the preliminary, actuarial estimate of the MMIF's economic net worth from fiscal year 1998 to fiscal year 1999. About half of the increase represents the estimated net value of the fund's 1999 activity; the other half results from new assumptions and new methodologies used to project the value of future cash flows.

2. How much of the estimated "$5-billion surplus" is based on real cash balances in the MMIF and how much is based on future cash flows? Is the value of the estimated "surplus" sensitive to changes in future economic conditions?

The MMIF is an accounting mechanism for tracking the income and spending of the mutual mortgage insurance program. The balances attributed to the fund do not necessarily represent cash or other assets of the federal government. Rather, the existence of balances indicates that, over time and including the present value of projected future cash flows from commitments already made, the income of the program has exceeded its spending.

For the most part, the assets credited to the fund represent income already received, largely reflecting the up-front premiums charged for FHA guarantees. The estimates of future liabilities are more uncertain because they are based on projections, far into the future, of economic and other variables that influence the rate of default and prepayment rates for insured mortgages.

The estimates of future cash flows are quite sensitive to the various assumptions used to project them. For example, Deloitte & Touche attributes about half of the estimated $5-billion change in economic net worth to changes it made to previous projections of future cash flows. Those changes resulted mostly from revised assumptions about the economy and about default and prepayment rates for outstanding loan guarantees. Deloitte & Touche found that alternative economic outcomes, such as lower appreciation in house prices, lower growth of household income, higher unemployment, or higher interest rates, would eliminate most of the estimated $5-billion change in economic net worth.

Federal budget estimates also indicate the sensitivity of MMI projections to estimating assumptions. Under the Federal Credit Reform Act, agencies that provide loans and loan guarantees must record the estimated long-term cost (known as the credit subsidy cost) of such commitments when the loans are

disbursed. In subsequent years, agencies may record reestimates to subsidy costs so that the budget reflects the actual performance and changed expectations of such loans and loan guarantees. The Administration has frequently revised its estimates of subsidy costs for the MMI program during the past several years. From 1993 through 1997, those reestimates reflected improved expectations for the program, showing reductions totaling $1.7 billion in subsidy costs. But in 1998 and 1999, the Office of Management and Budget (OMB) recorded substantial positive reestimates, adding $4.5 billion to outlays for estimated subsidy costs.

3. How does the estimated "$5-billion surplus" relate to the budget?

By itself, Deloitte & Touche's estimate of a change in the MMIF's economic net worth has no effect on the federal budget surplus. The estimated change in economic net worth would only affect the federal budget surplus if OMB uses this information to change its estimate of credit subsidy costs for the MMIF program. But OMB does not rely solely on the actuarial review in developing its subsidy estimates. It is also possible that OMB's estimates already reflect some of the same factors that led Deloitte & Touche to reach its conclusions.

If OMB were to conclude that the long-term outlook for FHA guarantees has improved, relative to its previous estimates, and therefore were to reduce its estimate of past or future credit subsidies for the MMIF program, then the federal surplus could increase; but according to OMB staff, no change in the estimated cost of previous loan guarantees was made for fiscal year 2000. Such a reestimate, however, could be made in future years, and information from the actuarial review and the program's financial audit may be used by OMB and FHA to make changes in estimated subsidy rates for future loan guarantees. Even if a subsidy reestimate is made, it would not represent a new windfall of cash receipts in hand, but rather an estimate of the value of expected net receipts over 30 years.

4. What does the estimated "$5-billion surplus" mean to FHA's single-family program? Can the surplus be spent on other housing programs or on programs within the single-family program?

The balances attributed to the MMIF affect the authority of the HUD Secretary to make adjustments to the single-family program. The Secretary can make certain types of changes to the single-family program if the estimated economic

net worth of the MMIF exceeds the 2 percent capital ratio required by NAHA. (That ratio is defined as the economic net worth of the fund divided by the volume of outstanding guarantees.) For example, the Secretary can reduce premiums for first-time home buyers who agree to undergo housing counseling or return annual insurance premiums paid by home buyers who have prepaid their mortgages. (The former is currently being done.) To meet the 2 percent requirement, the 1999 economic net worth of the MMIF would have to be at least $9 billion. The Deloitte & Touche estimate of the fund's net worth is well in excess of that amount.

The Secretary can make other programmatic changes, such as reducing the price of certain foreclosed homes for certain types of buyers, regardless of the capital ratio. Changes to the program could either result in an increase or decrease in receipts to the MMIF over time, and would eventually be reflected in the cost of this program.

The accounting balances attributed to the MMIF do not create spending authority, and spending any of those amounts on other housing programs would require new legislative authority. Legislation that provided for any additional spending authority for FHA would add to federal outlays and reduce projected surpluses, just as any other additional spending would.