United States General Accounting Office

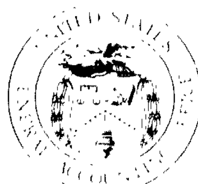
GAO

Report to the Chairman, Committee on Veterans' Affairs, U.S. Senate

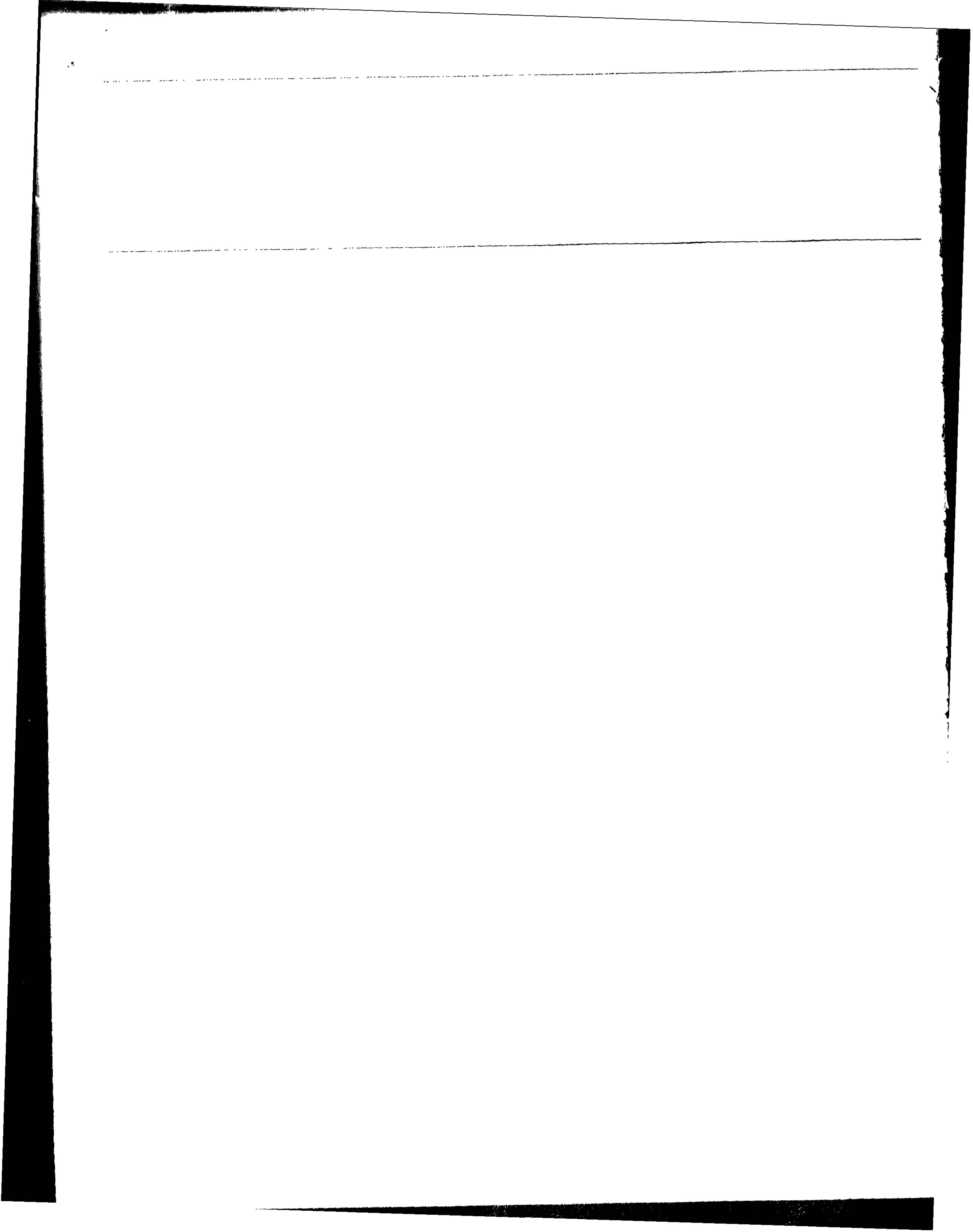
November 1991

FINANCIAL MANAGEMENT

Analysis of Selected VA and FHA Housing Program Accounting Methods



GAO/AFMD-92-8



GAO

United States
General Accounting Office
Washington, D.C. 20548

Accounting and Financial
Management Division

B-246102

November 25, 1991

The Honorable Alan Cranston
Chairman, Committee on Veterans' Affairs
United States Senate

Dear Mr. Chairman:

In response to your request, this report compares certain accounting methods used by the Department of Veterans Affairs (VA) for its housing credit assistance program with those used by the Department of Housing and Urban Development's Federal Housing Administration (FHA) for its Mutual Mortgage Insurance (MMI) Fund. Specifically, this report discusses the VA housing assistance program and the MMI Fund accounting treatments of (1) losses from guaranteed or insured loans, (2) revenue from loan guarantee fees and insurance premiums, (3) the value of outstanding direct mortgage loans and property acquired through settlement of mortgage insurance or guarantor claims, and (4) administrative costs.

The report does not address related accounting principles because the Federal Accounting Standards Advisory Board is currently studying federal accounting practices to recommend appropriate principles. Based on advice from the Board, the Comptroller General of the United States and the Director of the Office of Management and Budget are to promulgate generally accepted accounting principles for federal entities. In the interim, federal agencies are to follow the accounting principles prescribed by their own policies and procedures.

Results in Brief

The VA housing assistance program accrues guaranteed loan losses at the time of loan origination. The MMI Fund accrues such losses when an insured loan defaults; for those loans that default, this generally occurs from 1 to 10 years following loan origination. The timing differences in accruing loan losses are attributable to variations in the nature and purposes of the loan programs involved. Revenue from VA guaranteed loan fees and MMI Fund insurance premiums is recognized at the same time as the guaranteed or insured loan losses; thus, both revenue and related costs are recorded in the same accounting period.

Both entities value acquired property at the net amount of cash expected to be realized from the property's sale. In addition, in their financial statements, the entities offset the principal amount of direct

mortgage loans with an allowance for loan losses, thus valuing loan assets at their net realizable value. In fiscal year 1992, the VA housing assistance program will begin to include administrative costs as a program operation cost, as the MMI Fund currently does.

Background

Both the VA housing assistance program and the MMI Fund are federal government programs that guarantee or insure mortgage loans. VA's housing assistance program is a government benefit program which provides mortgage credit assistance to qualified veterans and their dependents. In contrast, the MMI Fund operates like private mortgage insurers, which insure lenders against losses on home loans to the general public.

Mortgage loan guarantees and insurance are agreements by which an entity, an agency acting for the federal government, or a private sector mortgage insurer agrees to pay a part or all of the principal and interest to lenders or loan holders if a third-party borrower defaults. Events in the cycle of insuring or guaranteeing loans can include (1) issuance of the guarantee or insurance when the mortgage loan is made (loan origination and endorsement), (2) the borrower's failure to make a loan payment (default), (3) foreclosure[1] of the mortgage and payment of a lender's or loan holder's claim, and (4) the sale of any property acquired in the claim settlement process. These events usually occur during different years and thus would normally occur in different accounting periods in the life cycle of a mortgage loan.

Accounting principles for the federal government are currently undergoing study. The Comptroller General, the Director of the Office of Management and Budget, and the Secretary of the Treasury established the Federal Accounting Standards Advisory Board to recommend federal accounting principles. The Board is studying a wide range of accounting issues, including accounting for guaranteed loans. Based on this work, the Board may recommend accounting principles for guaranteed and insured loans that could change VA's and FHA's accounting for their guaranteed/insured loan programs.

Also, the Federal Credit Reform Act of 1990 (Public Law 101-508, 104 Stat. 1388-609) is intended to more accurately measure the costs of federal credit programs by placing those costs on a budgetary basis

[1] When a borrower defaults on repaying a mortgage loan as agreed, the lender may acquire the property through a legal process known as foreclosure. VA also occasionally acquires property through other means, such as a borrower's voluntarily transferring title. In this report, foreclosure refers to both methods of acquiring properties after a borrower defaults.

equivalent to that of other federal spending. To meet the act's requirements, agencies may need to modify their accounting for guaranteed/insured loan programs.

VA's Housing Assistance Program

As of September 30, 1989, VA's housing assistance program was made up of the Direct Loan Revolving Fund, which provides veterans with direct home loans, and the Loan Guaranty Revolving Fund, which partially guarantees home loans private sector mortgage lenders make to veterans.[2] VA's direct home loan program was initially established to provide mortgage funds to veterans in certain geographic areas where private mortgage funds were unavailable. Since 1981, direct home loans under the Direct Loan Revolving Fund have been restricted to severely disabled veterans requiring special housing. As a result, few new direct home loans are approved each year. Thus, most of VA's housing assistance program involves guaranteed loans. VA guarantees lenders, such as banks or savings and loan institutions, against full financial loss not to exceed a maximum amount if the loan is foreclosed.

The VA housing assistance program may acquire properties through the guarantee loan claim settlement process. When such properties are acquired, the VA housing assistance program may sell the properties to the public on credit. These credit, or direct loan, transactions are referred to as "vendee loans." As with direct loans made under the Direct Loan Revolving Fund, VA must collect loan repayment and interest charges on them.

Instead of collecting insurance premiums as the MMI Fund does, the VA housing assistance program collects legislatively set fees from borrowers when loans are made and guaranteed. These fees, referred to as loan fees, have historically been insufficient to cover the total costs of the housing assistance program and have been supplemented through appropriations.

At September 30, 1989, the VA housing assistance program had outstanding guaranteed loans totaling about $152 billion. Of that amount, VA's maximum potential liability to lenders was about 40 percent of loan value, or about $60 billion. The program's recorded liability for estimated losses on these loans amounted to $2.7 billion. Also at that date,

[2]The VA housing assistance program was changed to a three-fund program by the Veterans Home Loan Indemnity and Restructuring Act of 1989 (Public Law 101-257, Title III), enacted December 18, 1989. This act established the Guaranty and Indemnity Fund, which began financing all new VA home loan guarantees, except those for manufactured homes, on January 1, 1990.

direct loans outstanding amounted to about $1.2 billion, including $1.1 billion in vendee loans of the Loan Guaranty Revolving Fund and $60 million in Direct Loan Revolving Fund loans. VA's estimated allowance for losses on these loans was about $100 million.

The MMI Fund's Program

The MMI Fund is the largest of FHA's four major mortgage insurance programs.[3] At September 30, 1989, the MMI Fund had $251 billion of insurance in force, or 76 percent of the total insurance outstanding for FHA's insurance programs, and a claim loan loss liability of $2.1 billion. The MMI Fund provides basic (principally 30-year) single family mortgage insurance to the public. As established, the MMI Fund must be operated in accord with sound actuarial and accounting practice, and, thus, borrowers should be charged a premium that will cover loan losses and administrative expenses and provide equity.

Objectives, Scope, and Methodology

In our report, Financial Management: Federal Housing Administration's Accounting Methods and Section 203(b) Program (GAO/AFMD-89-26BR, May 5, 1989), we identified four areas pertinent to MMI Fund accounting: (1) loan losses, (2) revenues, (3) acquired property and direct mortgage loan values, and (4) administrative costs. At the request of the Chairman, Senate Committee on Veterans' Affairs, we compared the VA housing assistance program's accounting methods in these areas with those reported for the MMI Fund. Our objectives in making this comparison were to identify the accounting methods followed by the VA housing assistance program and the MMI Fund in the areas selected and determine whether there are differences.

In making our comparison and determining whether differences in accounting methods were evident, we used information on the MMI Fund's accounting practices and methods that was documented in the previously cited FHA report and in our report entitled, Financial Audit: Federal Housing Administration Fund's 1988 Financial Statements (GAO/AFMD-90-36, February 9, 1990). We also used the VA housing assistance

[3] FHA's second largest mortgage insurance activity is its General Insurance Fund, which had $65 billion of insurance in force at September 30, 1989. The recorded claim loan loss liability on these loans was $5.5 billion, which was greater than that for the MMI fund.

program accounting practices and methods we identified and documented during our financial audits of VA's fiscal years 1988 and 1989 financial statements.[4]

Thus, our work drew heavily upon the extensive knowledge of VA's accounting operations that we gained in performing our financial audits. Also, we confirmed our understanding of the MMI Fund's accounting methods with the independent public accountant engaged to audit FHA's fiscal year 1989 financial statements.

Our review was performed in accordance with generally accepted government auditing standards. Responsible VA and FHA officials commented on the information in this report and concurred with it. We have incorporated their comments where appropriate.

VA Recognizes Loan Losses Earlier Than MMI Fund

Accounting for guaranteed or insured loan losses involves determining a date for simultaneously recognizing the losses and accruing the liability to pay for those losses in the future. The VA housing assistance program and the MMI Fund recognize guaranteed and insured loan losses at different points in the loan guarantee and insurance cycles, which are generally in different accounting periods.

The VA housing assistance program recognizes losses on its guaranteed loans in the accounting period during which loans originate. This is because the program is expected to result in losses to the government and this accounting treatment recognizes these losses during the accounting period in which the government is committed to provide a housing assistance benefit to veterans. To establish the amount to recognize for guaranteed loan losses, VA annually determines the present value of estimated guaranteed loan losses that will be paid on future foreclosures of loans guaranteed during the previous 12 months. The estimated loan losses and related liability to pay for them is determined by projecting the number of foreclosures based on historical foreclosure experience and applying VA's average loss on foreclosed loans.

The MMI Fund's recognition of insured loan losses coincides with loan default, which generally occurs in years after the year in which the

[4] Financial Audit: Department of Veterans Affairs Financial Statements for Fiscal Years 1989 and 1988 (GAO/AFMD-91-6, November 14, 1990) and Financial Audit: VA Housing Assistance Program Financial Statements for Fiscal Years 1989 and 1988 (GAO/AFMD-92-2, October 24, 1991).

insured loans are initiated. This is consistent with private sector mortgage insurers, which normally do not knowingly issue single premium insurance policies that will result in losses to the entity. Thus, the insurer does not accrue a liability and recognize claim losses until an event, such as default, takes place that indicates the probable foreclosure of an insured loan. To implement this concept, the MMI Fund's loss reserve is based on historical claim cost and loss experience, adjusted for judgments concerning current economic factors.

VA and MMI Fund Account for Fee and Premium Revenue Differently

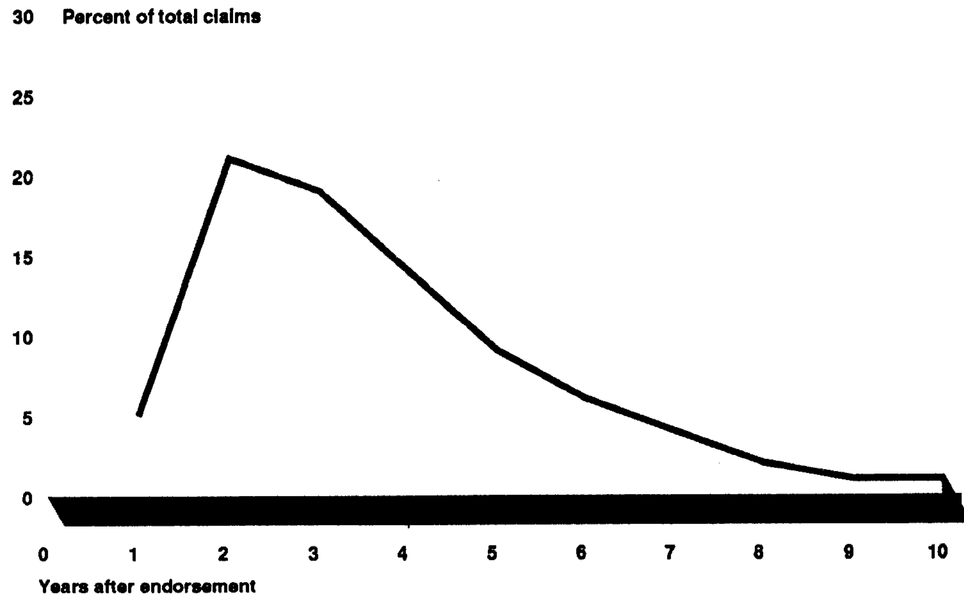
The VA housing assistance program accounts for revenue received from loan fees differently than the MMI Fund accounts for its insurance premiums, but both methods result in revenue and related costs being recorded in the same accounting period. This matching of costs and related revenue is a fundamental accounting concept.

As described in the preceding section, the VA housing assistance program records the present value of estimated guaranteed loan losses in the year the loans originate. In the same period, the VA housing assistance program records as revenue the loan fees related to loans guaranteed, thus matching this revenue and related cost.

The MMI Fund accounting process records estimated losses on loans insured each year over future periods as those loans default. To match loan loss costs with the revenue from premiums received for insuring the loans, the MMI Fund initially records the premiums in an unearned premium liability account and defers recognition of revenue from the premiums. Recognizing revenue in future periods over the life of the insured loans approximates the historical incidence of loss and records revenue proportionately as income over the loss exposure period. As a result, the matching of revenue and related costs is achieved.

For example, MMI Fund loan defaults and the resulting recognition of loan foreclosure losses, like those of any private sector mortgage insurer, occur in an uneven pattern. Figure 1 depicts the MMI Fund's loan loss recognition distribution curve, which is based on the loan default date. It shows that the loss rate is relatively high in the second and third years of the mortgage, but gradually declines thereafter. The accounting methodology used for the MMI Fund seeks to distribute revenue and cost proportionately to coincide with this curve. For instance, in the second year after insurance endorsement, about 20 percent of the insurance premium collected should be recognized as revenue in order to match loan loss costs recorded in that year.

Figure 1: MMI Fund's Loan Loss Recognition Distribution Curve Based on Loan Default Date



VA and MMI Fund Use Similar Accounting Methods to Value Direct Mortgage Loans and Acquired Property

In valuing direct mortgage loans and acquired property on their financial statements, VA and the MMI Fund use comparable accounting practices. The VA housing assistance program and the MMI Fund often acquire properties in settling claims through foreclosure. VA also makes direct mortgage loans either on an original loan basis or when acquired properties are sold on credit terms.

VA records allowances for losses on (1) acquired property held for sale and (2) vendee loans for acquired properties sold on credit. In VA's housing assistance program financial statements, these allowances reduce the property and loans receivable accounts. Accordingly, both property acquired in claims settlement and loans receivable are disclosed at the amounts expected to be realized from them in cash. The MMI Fund values its acquired property and loans receivable using similar accounting techniques.

Administrative Costs Recognized by MMI Fund but Not by VA's Housing Program

As of September 30, 1989, the MMI Fund recognized administrative costs associated with the fund's operations as a cost to the fund; VA's housing assistance program will begin to account for these as a program cost in fiscal year 1992. The administrative costs for mortgage insurance or guarantee operations include costs associated with personnel, office space, utilities, and computer services.

The MMI Fund's operations are conducted, along with other housing activities, by the Department of Housing and Urban Development, which bills FHA for providing administrative functions. FHA records these billed amounts in its accounts, including those of the MMI Fund, as administrative costs for operating its various mortgage insurance funds.

VA's housing assistance program does not presently account for administrative costs as part of the program's cost because these costs are financed through VA's administrative appropriations and accounted for as a cost to those appropriations. Also, administrative costs are not accounted for by VA's Loan Guaranty Revolving Fund because this fund is legislatively prohibited from financing administrative costs.

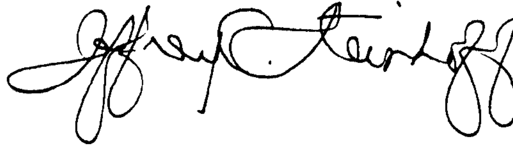
Under the Federal Credit Reform Act of 1990, VA will, in fiscal year 1992, begin to determine and allocate to the housing assistance program those costs attributable to the program's administrative activities. This will more accurately disclose the actual cost of providing housing benefits to veterans.[5]

We are sending copies of this report to the Secretaries of Veterans Affairs and Housing and Urban Development and to other interested parties. Copies will be made available to others upon request.

[5]The Federal Credit Reform Act of 1990 also requires that agencies determine loan programs' subsidy costs and that funds equal to the present value of the subsidy, less the present value of other anticipated cash flows, be appropriated in the year that the related loans originate.

Please call me on (202) 275-9454 if you or your staff have any questions. Major contributors to this report are listed in appendix I.

Sincerely yours,

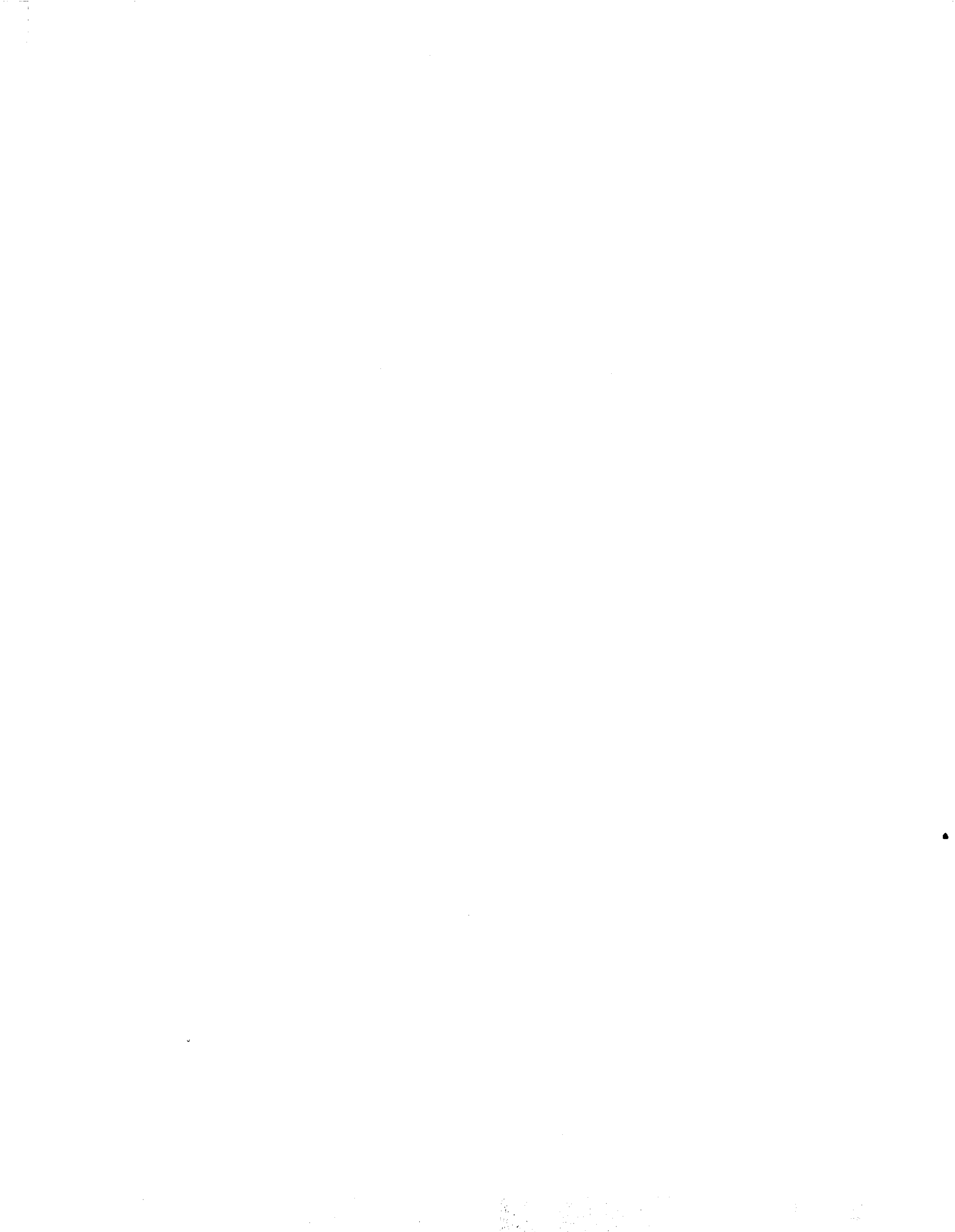


Jeffrey C. Steinhoff
Director, Civil Audits

Major Contributors to This Report

Accounting and Financial Management Division, Washington, D.C.

Arley R. Whitsell, Assistant Director
Gregory J. Ziombra, Assignment Manager
Donato Alvarez, Accountant



United States
General Accounting Office
Washington, D.C. 20548

Official Business
Penalty for Private Use $300

First-Class Mail
Postage & Fees Paid
GAO
Permit No. G100

Ordering Information

The first copy of each GAO report is free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20877

Orders may also be placed by calling (202) 275-6241.