U.S. Department of Housing and Urban Development
Federal Housing Administration

FHA

Annual Management Report
Fiscal Year 2007

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

A MESSAGE FROM THE COMMISSIONER

TO THE CONGRESS OF THE UNITED STATES, MEMBERS OF THE HOUSING INDUSTRY, AMERICA'S HOMEOWNERS AND TENANTS, AND THE PUBLIC:

FHA has given millions of families the opportunity to pursue the dream of homeownership. FHA's goal is to continue our education and outreach efforts while also retooling and refining FHA to insure safer mortgages that will keep the dream alive for the next generation of homebuyers. FHA remains financially sound with a capital ratio in the Mutual Mortgage Insurance Fund substantially exceeding the statutory requirement of at least 2 percent. This financial capacity, as well as significant management initiatives and improvements has given FHA the ability to continue its primary mission.

Emerging Issues in the Housing Market

This past year has seen an increase in interest rates and a decrease in house price appreciation, leading to the current mortgage credit crunch. Accordingly, FHA will expand its refinance program, *FHASecure*, to include those individuals and families who are in default as a result of an interest rate reset. With the inclusion of delinquent borrowers under the *FHASecure* umbrella, the government's largest mortgage insurance provider will now be able to assist even more troubled homeowners. In addition, FHA will implement risk-based premiums that match the borrower's credit profile with the insurance premium they pay. This administrative risk-based pricing structure will begin in early 2008.

FHA Modernization

The 109th Congress introduced the Expanding American Homeownership Act in June 2006. This legislation proposes to modernize FHA and enable it to offer more underserved low- and moderate-income American families improved home financing options so they can achieve the American Dream of homeownership. Once enacted, the reform legislation would create an expanded risk-based insurance premium structure, eliminate the current three percent minimum downpayment, and increase FHA's loan limits.

Expanded Access for Seniors to Reverse Mortgages

The popularity of FHA's Reverse Mortgage program has grown significantly in the past year. *The Expanding American Homeownership Act of 2007* is proposed legislation that would allow more older Americans to access the equity they have built up in their homes by obtaining reverse mortgages. If this legislation is enacted, more seniors will be able to use equity withdrawn from their homes for health care needs, home repairs and other emergencies.

Reverse mortgages offer seniors the financial options they need and deserve, and this legislation would provide a greater number of older Americans the opportunity to convert the equity in their home into usable cash income.

Annual Management Report

FHA is committed to providing Americans access to homeownership opportunities, providing services to help families retain their FHA insured homes during economic hardships, increase the supply of affordable rental housing units, and help make possible the financing of healthcare facilities. Through these efforts, FHA has given millions of families the opportunity to pursue the dream of homeownership.

The following is the Fiscal Year 2007 Annual Management Report which presents FHA's accomplishments and financial condition.

Brian D. Montgomery
Assistant Secretary for Housing-
Federal Housing Commissioner

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MANAGEMENT’S DISCUSSION AND ANALYSIS

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Certain information contained in this discussion is considered "forward-looking information" as defined by the Federal Accounting Standards Advisory Board's (FASAB) Statement of Federal Financial Accounting Standards (SFFAS) No. 15, "Management's Discussion and Analysis," and Statement of Federal Financial Accounting Concepts (SFFAC) No. 3, "Management's Discussion and Analysis Concepts." Such forward-looking information includes estimates and is subject to risks and uncertainties that could cause actual results to differ materially from the estimates used in the discussion.

Performance information contained in this Management's Discussion & Analysis (MD&A) was obtained from operational and management sources and schedules prepared by management. The appropriate levels of Federal Housing Administration (FHA) management reviewed the information and data to provide reasonable assurance that reported performance information is relevant and reliable.

MISSION AND ORGANIZATIONAL STRUCTURE

In 1934, Congress created the FHA in the National Housing Act to expand opportunities for homeownership. The instability in the housing market and the breakdown of the banking system during the Great Depression heightened the need for FHA programs. Congress looked to FHA to boost the depressed economy and solve the nation's housing shortage.

FHA has expanded its mission since its inception and now provides mortgage insurance to private lenders that finance single family homes, multifamily projects, healthcare facilities, property improvements, and manufactured homes. Availability of FHA mortgage insurance stabilizes the provision of mortgage credit in the marketplace and encourages the provision of credit to households not served or underserved by the private sector, most notably first time and minority homebuyers. FHA has also expanded its mission to include establishing housing quality standards and demonstrating the financial viability of new mortgage instruments.

FHA and several other agencies were consolidated into the Department of Housing and Urban Development (HUD) in 1965. FHA's headquarters are located in Washington, D.C. FHA has field offices located throughout the country, consisting primarily of 4 Single Family Homeownership Centers (HOCs), 18 Multifamily Hubs, and 33 Multifamily Program Centers.

In many ways, FHA can be seen as a specialized insurance company that guarantees the payment of mortgages made by private lenders (banks and other mortgage lenders) who provide loans to developers and homebuyers. This guarantee of payment enables lenders to provide market rate loans to all eligible purchasers. Since its inception 73 years ago, FHA has provided mortgage insurance to 34.6 million single family households and 50,150 multifamily projects containing 5.7 million units of housing. FHA currently has 3.7 million insured single family mortgages and 12,156 insured multifamily projects in its portfolio. FHA collects mortgage insurance premiums and other fees for insuring these loans. With these insurance premiums, fees collected, and a small appropriation for the general insurance fund, FHA has been financially self-sustaining, operating in a financially sound manner, pursuing its objectives and responding to the needs of its constituency.

FHA Insurance Funds

FHA operates its programs through four insurance funds supported by premium and fee income, interest income, Congressional appropriations, borrowing from the U.S. Treasury, and other miscellaneous sources. The four insurance funds are:

- *The Mutual Mortgage Insurance (MMI) Fund*. This fund supports FHA's basic single family homeownership program. This fund is self-sustaining.

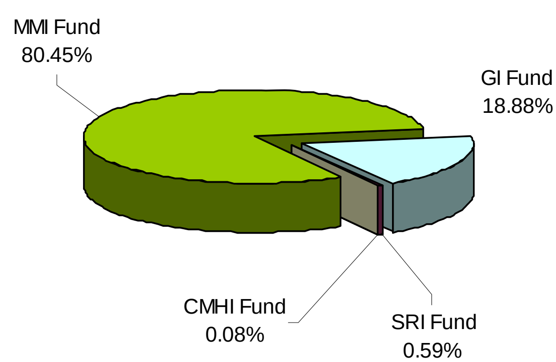
- *The General Insurance (GI) Fund*. This fund supports a wide variety of housing programs including rental apartments, cooperatives, condominiums, nursing homes, hospitals, property improvements, manufactured housing (Title I), home equity conversion mortgages, and disaster assistance.

- *The Special Risk Insurance (SRI) Fund*. This fund supports higher-risk single family and multifamily insured mortgages.

- *The Cooperative Management Housing Insurance (CMHI) Fund*. This fund supports insured loans on market-rate cooperatives. Historically this fund has been self-sustaining.

At the end of fiscal year 2007, the MMI Fund comprised 80.45 percent of the FHA Insurance Funds; the GI Fund 18.88 percent; the SRI Fund 0.59 percent; and the CMHI Fund 0.08 percent. The total mortgage insurance-in-force (IIF) in the FHA Insurance Funds was $399.9 billion, an increase of $4.2 billion or 1.07 percent, compared to fiscal year 2006. Specifically, the MMI Fund increased by $4.86 billion, the GI Fund decreased by $217 million, the SRI Fund decreased by $450 million, and the CMHI Fund, the smallest of the four, increased by $24 million.

FHA Insurance Funds
As of September 30, 2007



FHA's IIF increases with the increase in interest rates and the reduction of FHA mortgage refinancing. Additionally, higher FHA loan limits, escalated housing prices, and tightening of available credit has encouraged low and moderate income buyers to seek out traditional financing available through FHA Insurance Programs that offer flexible down payment options.

FHA's single family mortgage insurance business is 85.67 percent of its total IIF. The multifamily and healthcare insurance is 14.16 percent of IIF. Title I property improvement and manufactured home insurance is 0.17 percent of IIF.

Office of Single Family Housing

FHA's Office of Single Family Housing administers programs that promote affordable housing. FHA encourages homeownership by making loans more readily available to lower and moderate-income families through its FHA mortgage insurance program. HUD-approved mortgage lenders handle all of the HUD/FHA-insured mortgage loan programs.

Single Family Housing Programs

Single Family Housing programs are the most visible evidence of FHA's success in providing expanded homeownership opportunities for all Americans. Through these programs, FHA targets households that otherwise would have difficulty obtaining mortgages. During fiscal year 2007, its programs insured 532,494 loans, of which 281,883 were initial purchase endorsements. Of these purchase endorsements, 224,084 were loans to first-time homebuyers and 69,061 were loans to minority first-time homebuyers. The three largest FHA single family programs are Section 203(b), Section 234(c), and Home Equity Conversion Mortgages (HECM)/Reverse Mortgages.

The national homeownership rate as of third quarter 2007 is 68.2 percent, down 0.5 percent from 68.7 percent as of the same period in 2006. Despite the decrease in the homeownership rate, FHA saw an increase in market share primarily due to the collapse of the sub-prime mortgage market. Prospective borrowers who had opted for sub-prime loans in recent years are now choosing the dependability and safety of FHA products. Since inception, FHA's single family housing programs have made substantial contributions to the increase in the national homeownership rate over the past years (from 64.7 percent in 1995 to 68.2 percent today).

As part of the President's fiscal year 2007 budget submission, FHA submitted a modernization proposal requesting legislative flexibility from Congress to offer mortgage insurance to first-time homebuyers regardless of how much cash they choose to invest in the transaction. This will enhance FHA's capability to provide borrowers in the prime and sub-prime conventional mortgage markets with a lower cost alternative. FHA is currently seeking approval by Congress on its modernization proposal. Key FHA policy objectives include:

- Increase in the FHA loan limits
- Create a new, risk-based insurance premium structure for FHA
- Enhance downpayment flexibility requirements
- Simplify requirements for condominium loans
- Expand use of Home Equity Conversion Mortgages ("reverse mortgages")
- Increase access to pre-purchase and post-purchase counseling for low and moderate income homeowners

Additionally, FHA continues to greatly improve its business processes and is working with the Administration and Congress to develop new mortgage products and market the benefits of its mortgage insurance to lenders and the general public. Three of Single Family Housing's more popular programs, Section 203(b), Section 234(c), and HECM/Reverse Mortgages are described below.

Section 203(b)

Section 203(b) is the largest of FHA's single family programs covering 93.95 percent of total single family insurance-in-force. FHA established this program to create a stable mortgage finance market and to serve otherwise underserved borrowers by providing low down payment mortgages. Section 203(b) insures private lenders against loss in the event the borrower defaults on the mortgage. This insurance makes lenders more willing to originate loans to borrowers who do not meet conventional mortgage underwriting requirements. Additionally, lenders are more willing to make loans to underserved borrowers because FHA-insured mortgages can be packaged into mortgage-backed securities. These types of securities are attractive because they are guaranteed by the Governmental National Mortgage Association, a secondary market entity backed by the full faith and credit of the U.S. Government. FHA insured 403,114 Section 203(b) mortgages in fiscal year 2007, of which 207,150 were first-time homebuyers and 64,404 were minority first-time homebuyers.

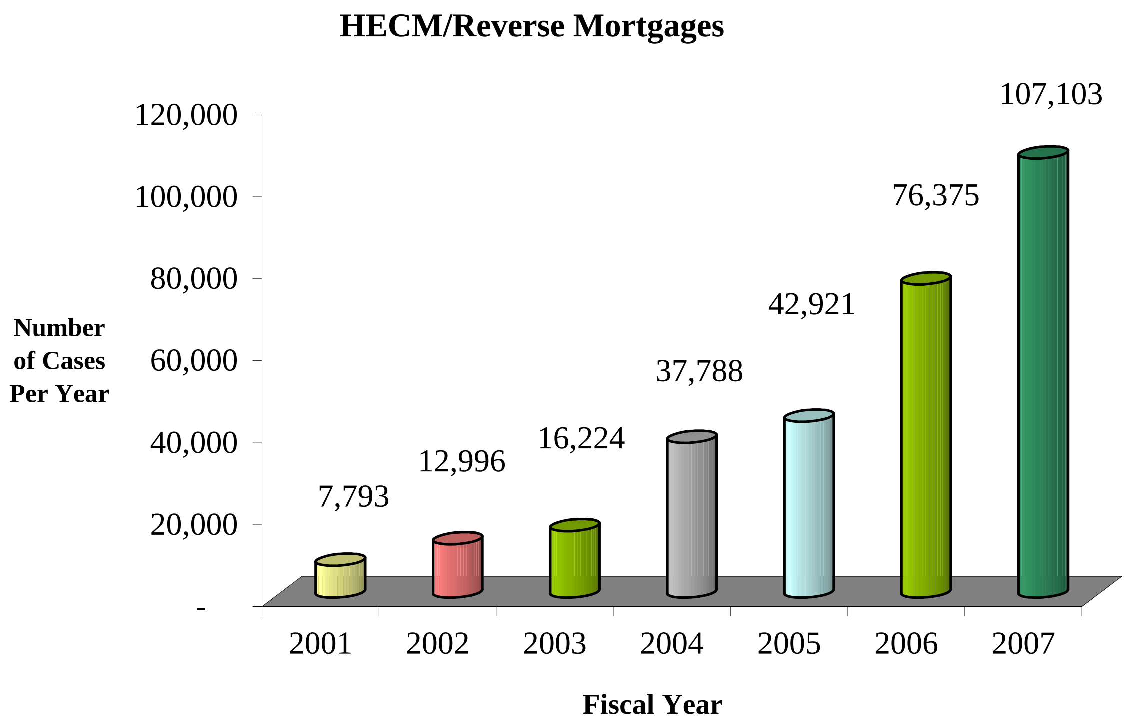
Section 234(c)

Section 234(c) covers 5.2 percent of FHA's total single family insurance-in-force. This program provides mortgage insurance for individual condominium units. A condominium is a single unit owned by an individual or family in a multi-unit project with a shared interest in common areas and facilities. This form of ownership is usually more affordable than other single family housing and often attracts first-time homebuyers who lack the capital for single family homeownership. FHA insured mortgages for 18,233 condominium units in fiscal year 2007. FHA's modernization proposal contains a provision that would move Section 234(c) loans from the General Insurance and Special Risk Insurance Funds to the Mutual Mortgage Insurance Fund simplifying the origination and underwriting process. Once the proposal is adopted, section 234(c) loans would no longer be subject to the more complex requirements of multifamily housing loans.

Home Equity Conversion Mortgages (HECM) - Reverse Mortgages

FHA was the first entity to promote and insure reverse mortgages on a national scale. The HECM program provides eligible homeowners access to the equity in their property with very flexible terms. The loan may provide a lump sum payment, monthly payments, a line of credit or a combination of the above. The financing allows homeowners to stay in their homes with no repayment requirement until the property is vacated or sold. The program is limited to homeowners 62 years of age and older and is designed for those with limited income.

The HECM program continues to be increasingly popular as more homeowners choose to remain in their homes and tap into their home equity to pay living expenses. The program provides a valuable resource to persons traditionally underserved by the mortgage market. HECM loans continue to be FHA's fastest growing product. Since its inception, FHA has endorsed 343,383 HECM loans. The number of reverse mortgages per year insured by FHA has increased over the past seven years, from 7,793 cases in fiscal year 2001 to 107,103 in fiscal year 2007. During fiscal year 2007, FHA was granted a waiver permitting the Department to exceed the 250,000 cap on HECM endorsements. The modernization proposal contains a provision that would move HECMs from the General Insurance Fund to the Mutual Mortgage Insurance Fund simplifying the origination and underwriting process.



Fiscal Year 2007 Accomplishments

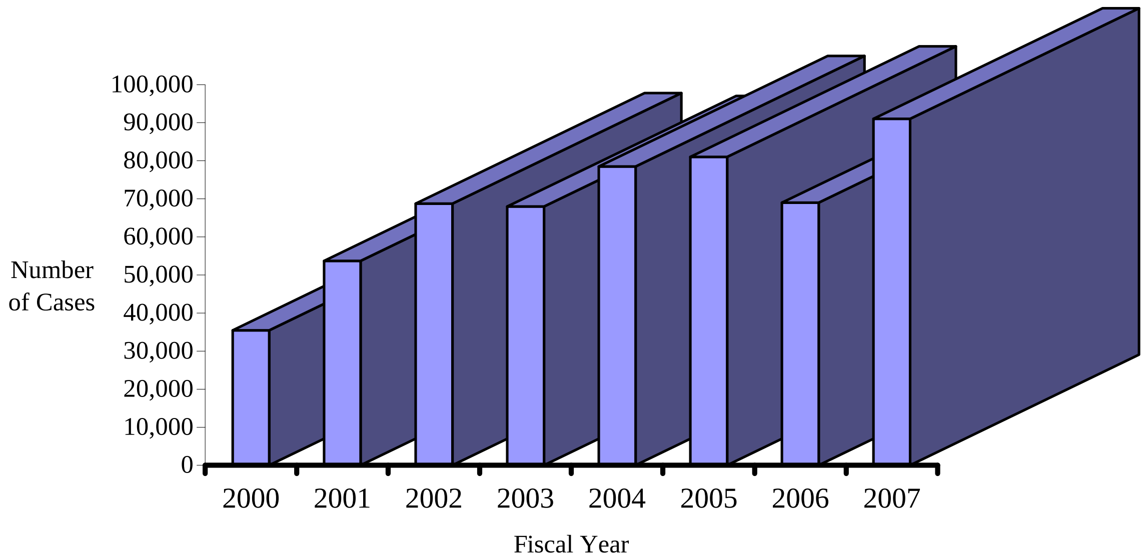
During fiscal year 2007, FHA was highly successful in assisting many Americans to achieve or sustain the goal of homeownership. FHA assisted:

- *First-Time Homebuyers.* In fiscal year 2007, 79.5 percent of FHA-insured purchase loans involved first-time homebuyers. FHA provided 224,084 families with the ability to purchase their first home during the fiscal year.

- *Minority First-Time Homebuyers.* In fiscal year 2007, 33 percent of first-time homebuyers who obtained FHA-insured mortgages were minorities.

- *Borrowers Experiencing Financial Difficulties.* One of FHA's most important goals is to assist homeowners facing financial difficulties to remain in their homes through increased use of loss mitigation tools. The use of these tools increased over the past eight years, from 35,426 cases in fiscal year 2000 to 91,051 in fiscal year 2007.

Use of Loss Mitigation Tools



Management Initiatives

FHA continues to enhance several initiatives and policies to ensure that its programs continue to serve target constituencies, while maintaining strong financial viability. These initiatives include:

- *FHASecure Program.* This temporary FHA program will provide refinancing opportunities to homeowners for various types of adjustable rate mortgages (ARMs). FHASecure is designed to increase liquidity in the mortgage market and help people who have good credit, but who have not made all of their payments on time because of rising mortgage payments due to ARMs that have "reset". This program will provide homeowners an option to help make their payments and keep their homes. FHA will also charge mortgage insurance premiums based on the individual risk of each loan, using traditional underwriting standards.

- *Predatory Lending Prevention.* FHA continues to help prevent millions of families from becoming victims of predatory lending practices. These efforts include denying FHA insurance for mortgages on homes that have been "flipped" at inflated prices and deploying special monitors to pursue unscrupulous appraisers and lenders. Additional efforts to combat predatory lending focus on print media advertising, publication of informational brochures, and other consumer outreach.

- *Good Neighbor.* HUD's Good Neighbor initiative allows police officers, firefighters, emergency first responders and schoolteachers to purchase HUD homes at significant discounts. The purpose of the Good Neighbor initiative is to strengthen distressed urban communities and to provide homeownership opportunities for public service professionals. This program is a catalyst in promoting the sale and rehabilitation of vacant HUD properties in targeted neighborhoods.

- *Credit Watch Termination.* FHA's Credit Watch Termination program identifies poorly performing mortgage lenders. FHA may temporarily suspend the authority to originate mortgage loans to the poorest performing mortgage lenders' branch office(s). The program also warns marginally performing lenders to improve their performance if they wish to maintain their status as approved FHA lenders and continue to participate in FHA insurance programs.

- *TOTAL Scorecard.* FHA's Technology Open to Approved Lenders (TOTAL) Scorecard evaluates mortgage applications and credit information in an objective, consistent manner to assess the creditworthiness of FHA borrowers. The scorecard uses a methodology statistically proven to predict the likelihood of borrower default and FHA claims. FHA developed the automated tool to identify potential homebuyers not currently served by the conventional market due to real or perceived risk. When TOTAL returns an "Accept" decision, underwriting requirements are reduced and borrowers can save hundreds of dollars in mortgage origination fees. When TOTAL returns a "Refer" decision, the lender must manually underwrite the loan to ensure that it meets minimum credit-quality requirements. From its inception in May 2004, through September 2007, lenders scored 1.24 million loans in TOTAL for which FHA case numbers had been assigned. Case number assignment means that the borrower and lender intend to pursue FHA-insured financing. Of the 1.24 million case numbers assigned loan applications scored by TOTAL, 1.1 million resulted in mortgage loans insured by FHA. In fiscal year 2007 alone, TOTAL processed 425,282 scoring requests for loan applications with FHA case numbers.

- *Lender Insurance (LI).* "Lender Insurance", an initiative started in fiscal year 2006, allows high-performing mortgagees to endorse FHA loans without a pre-endorsement review conducted by FHA. Instead, a mortgagee performs its own pre-endorsement review and submits loan level data to FHA via FHA Connection. Upon transmitting sufficient data to satisfy FHA of the legitimacy of the mortgage insurance request, the FHA Connection system performs an automated verification process to check the data for accuracy and completeness and electronically generates a mortgage insurance certificate to serve as evidence that the loan was endorsed. LI eliminates the need for mortgagees to submit case binders as a pre-condition for obtaining FHA's mortgage insurance endorsement and therefore eliminates the need for binder re-submissions to satisfy Notices of Return (NOR). FHA will continue to select a sample of loans for Post-Endorsement Technical Review (PETR). A minimum five percent of all insured loans originated by HUD-approved lenders are selected for PETR. The selection process is based on a defined risk-based algorithm. If the five percent benchmark is not met using the risk-based algorithm, then a random sampling of additional files is selected to meet the benchmark. A loan insured under LI authority is not selected for post endorsement review at a higher percentage than other loans.

  LI provides the Department and its program participants enormous benefits by saving time, money and resources for all of the parties. Customer service dramatically improves under this program by providing lenders with prompt acceptance or denial of the endorsement package. Previously, mortgagees had to spend several days assembling a case binder and mailing it to the appropriate Home Ownership Center (HOC) and await notification. Under LI processing NOR procedures are eliminated because endorsement occurs first and case binder review occurs later. Only those few mortgage insurance applications, on a selected sampling of mortgages that fail risk mitigation tests will be reviewed before endorsement.

To qualify for participation in the LI program, lenders must be unconditionally approved for FHA's Direct Endorsement program for at least the past two years and have an acceptable default/claim record at the time the application for participation in the LI program is processed. Since inception, 413 lenders have participated in the program. After the first full year of implementation, the LI program covers approximately 69% of FHA insured mortgages providing tremendous savings in cost and time.

- *Accelerated Claims and Asset Disposition (ACD) Demonstration Program.* In 2002, FHA introduced the ACD Demonstration program under Section 601 of the VA, HUD, and Independent Agencies Appropriations Act for fiscal year 1999. The program was implemented by FHA conducting the first of four sealed bid auctions in which qualified bidders participated to acquire an equity interest in a forward pipeline of single family defaulted mortgage loans.

  The initial goals of the ACD Demonstration were to accelerate the claim submission time frame, align private interests with the Department's, increase the recovery to FHA, support homeownership retention and provide an alternate acquisition and disposition tool. The Demonstration to date has assisted over 58 percent of homeowners in retaining their homes. By refining the current approach, FHA can potentially reduce losses from defaulted mortgages by accepting assignment of mortgage notes to HUD through the ACD Demonstration rather than paying conveyance claims and acquiring foreclosed properties. The Asset Sales Office has sold previously insured FHA notes through four competitive sealed-bid auctions of majority interests in public/private joint ventures. These joint ventures, in which HUD maintains minority ownership interest, service, manage, and dispose of the defaulted single family mortgage loans. A total of 22,482 loans with balances of approximately $2.27 billion have been settled and sold into the four joint ventures. The number of loans has decreased by 13 since fiscal 2006 as there have been 13 loan repurchases or charge-offs in fiscal year 2007, in keeping with the Agreements between HUD and the Joint Venture partners. The sale of these loans and their final dispositions resulted in receipts of approximately $1.1 billion to HUD from the sale of the majority interest in the joint ventures plus approximately $651 million in distributions of income paid at the monthly settlements by the private sector investors to the Department.

  Continuing refinements and uses of the ACD legislative authority will be made as a result of comments on the Advanced Notice of Public Rulemaking received in October 2006 and from recommendations of the evaluation of the demonstration. The Advanced Notice of Public Rulemaking will ensure that the program benefits from feedback during the policy making phase. During fiscal year 2007, two of the joint ventures were closed and the remaining two joint ventures are scheduled to close in fiscal year 2008.

- *Post Endorsement Technical Review Process (PETR).* Based on continued evaluation of previous PETR findings and results, FHA has further refined the specific ratings and codes being used. The new system has four rating categories: Conforming, Deficient, Unacceptable, or Mitigated. The new improved ratings and codes clearly identify which loans pose too great a risk to FHA and which loans contain errors or other deficiencies. The revised system more accurately reflects the risk level associated with recently insured mortgages, while at the same time significantly reduces the number of unacceptable ratings.

- *Future of the Office of Single Family Housing.* FHA modernization efforts, which include completed administrative changes and proposed legislative changes, have streamlined the insurance process and received praise and acceptance by mortgage professionals. Furthermore, proposed legislation may make FHA products more attractive to mortgagees and could lead to an increase in demand for FHA insured loans. Changes in the legislation include introduction of risk-based premium pricing, more favorable loan terms with higher loan limits, extended repayment time, and flexible down payment options.

- *Other Single Family Improvements.* FHA continues to focus its efforts to improve all stages of the single family mortgage insurance process. These efforts include improved data collection and reporting, improved controls over the post-endorsement technical review process, systems re-engineering, and increased use of foreclosure alternatives to help homeowners retain possession of their homes.

  During fiscal year 2007, Single Family Housing continued its comprehensive systems re-engineering and integration effort that started in fiscal year 2004. There are over 40 systems currently in operation using different database platforms with varying capabilities, which cannot easily share or provide critical information. This initiative will modernize all Single Family Housing systems, consolidate existing systems, and enhance systems and business processes. Such efforts assist FHA to comply with federal legislation, address audit weaknesses, improve overall monitoring and oversight, and adhere to HUD's Enterprise Architecture Framework. The modernization and integration of Single Family's systems will simplify systems administration, reduce total cost of ownership and maintenance, provide flexible and adaptable business processes and functionality to continually meet and comply with industry standards. In addition, it will improve consumer and business stakeholder support and program oversight.

  FHA intensified actions during fiscal year 2007 to improve its overall risk management. These actions include improving oversight of Management & Marketing (M&M) contractors, revising protocols for monitoring appraisers listed on the FHA Rosters, revising delinquency rate reporting standards, and taking corrective actions against problem lenders, underwriters and appraisers. These measures helped fulfill the requirements of the President's Management Agenda and resulted in the removal of Single Family programs from GAO's high-risk designation.

FHA adopted industry standard 30-day delinquency rate tracking, publishing a final rule which established the new protocol in the Federal Register on March 31, 2006. A mortgagee letter (ML106-15) was issued June 8, 2006 that specified the exact data elements to be used under the new tracking protocol and FHA loan servicers were allowed time to make the appropriate adjustments to their systems to utilize the 30-day delinquency rate information. Loan servicers completed these adjustments and started to use the new reporting on November 1, 2006.

To better monitor program performance and fraud, FHA implemented Appraiser Watch during fiscal year 2004. This system relies on statistical analyses to identify appraisers who may contribute to poor loan performance based on certain risk factors, including association with high mortgage default rates compared to other appraisers. Appraiser Watch reduces the number of physical property reviews that are required to identify and verify inadequate appraiser performance. Using this method, FHA removed 60 appraisers from the FHA roster during fiscal year 2007, compared to 64 appraisers during fiscal year 2006. FHA augmented the benefits provided by its Appraiser Watch system by implementing system changes to its Computerized Homes Underwriting Management System (CHUMS) that automate the appraiser review selection process. FHA is now able to automatically select appraisers for review on the basis of certain risk factors, such as unusually high mortgage default rates compared to other appraisers, high volumes of excessive gifts, or fees exceeding six percent of a property's sales price.

Other system changes to FHA Connection were designed to combat fraud and identity theft by expanding its capability to validate Social Security Numbers (SSN) through other government agencies. FHA Connection is a web based tool through which approved lenders conduct business with FHA. A lender can verify data immediately upon entry of name, SSN and Date of Birth (DOB) into FHA Connection. However, if the first level of verification suggests a need for further direct verification with the Social Security Administration, the lender gets a response the following day.

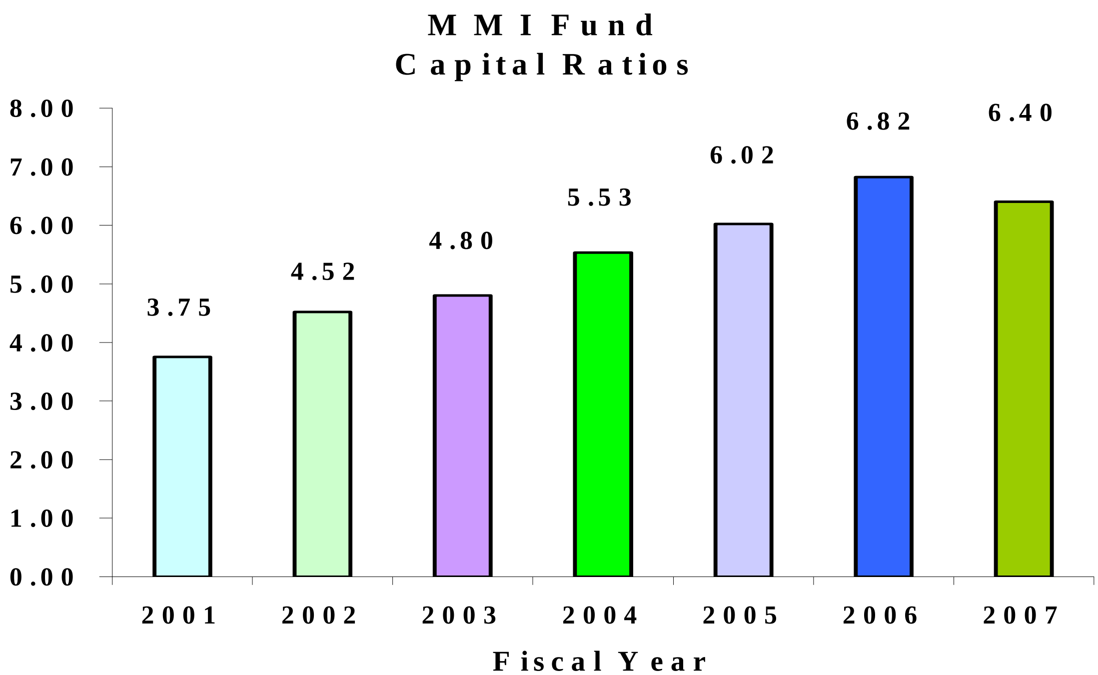
FHA uses a risk-based targeting model for Real Estate Owned (REO) properties. The Risk-Based Targeting Model (RBTM) was developed to assist in assessing the single family asset portfolio and the contractors' performance. RBTM establishes benchmarking at both the macro and micro levels to determine which HOC, contractor, area or property demonstrates anomalous behavior and needs to receive specific and detailed attention. RBTM prioritizes which risk conditions need immediate follow-up and increases the effectiveness of ongoing monitoring and forecasting functions. The model also captures property file review findings, tracks the success of corrective actions that have been implemented, and provides consistent, statistically-based review results.

Finally, FHA expanded its Asset Control Area program (ACA) during fiscal year 2007 through the inclusion of Columbus Housing Partnership as a new ACA participant. The ACA Program is designed to help stabilize distressed communities and overcome blight through expanded homeownership for low-income families. Foreclosed single-family homes in designated revitalization areas are sold by FHA to local governments and experienced nonprofits at a discount under the program. Participating entities are required to rehabilitate the homes and resell them to low-income home buyers. During fiscal year

2007, HUD renewed its ACA agreement with Community Development Corporation of Utah and currently has 10 active ACA participants. HUD is also working with one other entity to obtain applications and other documentation needed to qualify it for the ACA program. During fiscal year 2007 ACA participants rehabilitated and resold 324 former HUD properties to income eligible homeowners and acquired 274 new HUD properties that are currently being rehabilitated.

MMI Capital Ratio

The MMI Fund constitutes the majority of FHA single family business, with 94 percent of the total single family IIF dollars. One measure of the fund's financial soundness is the MMI capital ratio. The National Affordable Housing Act of 1990 requires an independent actuarial analysis of the economic net worth of the MMI Fund. The Act also mandates that the MMI Fund achieve a capital ratio, a measure of the Fund's economic net worth, of at least 2 percent by the year 2000, which was achieved in 1995 and maintained ever since as illustrated below.



The MMI Fund's capital ratio is estimated at 6.40 percent at the end of fiscal year 2007, compared to 6.82 percent in fiscal year 2006. The capital ratio is expected to be sufficient to withstand unexpected losses without exposing the taxpayers to financial risk.

Office of Multifamily Housing

FHA provides financing support for the development of rental housing and healthcare facilities through its Multifamily Mortgage Insurance programs. In fiscal year 2007, FHA initially endorsed 881 multifamily loans totaling $4.19 billion. There are 12,156 mortgages in the FHA portfolio with an outstanding principal balance of approximately $56.6 billion.

Multifamily Housing Programs

FHA's largest multifamily programs in terms of insurance-in-force dollars are Sections 221(d)(4), 207/223(f), Section 223(a)(7) and 232 which are discussed below.

Section 221(d)(4)

Section 221(d)(4) has historically been FHA's most popular multifamily program. It provides mortgage insurance for the construction or substantial rehabilitation of multifamily rental properties consisting of five or more units. FHA may insure mortgages for up to 90 percent of a project's estimated replacement cost under this program. During fiscal year 2007, FHA endorsed 92 mortgages, covering 14,924 units, with a mortgage amount of $0.98 billion. At the end of fiscal year 2007, there were 2,076 active mortgages in place, covering 304,404 units, with an outstanding mortgage balance of $16.3 billion. The program makes up 28.92 percent of total multifamily IIF.

Section 207/223(f)

The Section 207/223(f) program provides mortgage insurance for the refinancing or acquisition of existing multifamily rental properties consisting of five or more units. Under this program, FHA may insure mortgages for up to 85 percent of a project's appraised value, or up to 90 percent of a project's appraised value in cases of refinancing or acquisition of properties formerly financed with Section 202/8 Direct Loans. The program applies to both formerly FHA-insured and conventionally financed properties. In fiscal year 2007, FHA insured 355 mortgages valued at $1.2 billion, covering 29,284 units. At the end of the fiscal year 2007, the active portfolio consisted of 1,638 mortgages, covering 192,391 units, with a total outstanding balance of $6.79 billion. The program makes up 12 percent of total Multifamily IIF.

Section 223(a)(7)

The Section 223(a)(7) program provides mortgage insurance for the refinancing of existing multifamily rental properties with FHA-insured mortgages. In fiscal year 2007, FHA insured 167 mortgages. These mortgages, valued at $431.6 million, covered 17,541 units. At the end of the fiscal year 2007, the active portfolio consisted of 2,628 mortgages, covering 282,835 units, with a total outstanding balance of $6.69 billion. The program makes up 11.8 percent of total Multifamily IIF.

Section 232

The Section 232 Mortgage Insurance for Residential Care Facilities program insures loans to finance the construction, substantial rehabilitation, acquisition or refinancing of healthcare facilities. Eligible facilities include nursing homes, intermediate care facilities, board and care homes and assisted living facilities. FHA insured 174 mortgages for $1.1 billion under this program in fiscal year 2007, providing 18,910 units/beds. At the end of fiscal year 2007, the active portfolio consisted of 2,089 mortgages, covering 251,773 units/beds, with a total outstanding balance of $12.58 billion. This program makes up 22.2 percent of total Multifamily IIF.

The administration of Multifamily FHA programs is primarily the responsibility of two offices: Multifamily Development and Asset Management.

Multifamily Housing Development

The Office of Multifamily Housing Development provides direction and oversight for FHA mortgage insurance loan origination. During fiscal year 2007, Multifamily initially endorsed 881 loans totaling $4.19 billion and providing 90,614 units/beds in the District of Columbia, Puerto Rico and all states except Alaska and South Dakota. Of these 881 loans, 805 were processed by FHA's production offices under Basic FHA programs and 76 loans were processed by state housing finance agencies and Fannie Mae or Freddie Mac under risk sharing arrangements with HUD. The 805 Basic FHA loans were made by 58 lenders and provided a variety of shelter options, including 623 apartment projects, 7 cooperatives, 67 assisted living/board and care facilities, and 108 nursing homes. Risk Sharing programs created additional shelters, whereby 16 states made 57 FHA risk sharing loans covering 5,683 units. Fannie Mae and Freddie Mac made 19 loans covering 1,948 units.

With the general downturn in the U.S. housing market, Multifamily still endorsed 881 loans comprising IIF of $4.19 billion during fiscal year 2007. This represented 87 percent and 82 percent, respectively, of the FY 2006 levels of 1,017 loans endorsed comprising $5.13 billion IIF. Total production is decreased because nursing home new construction activity fell and refinancing activity declined significantly for both health care and 223(a)(7) programs. Refinancing activity declined because interest rates increased and most projects that could refinance had already done so. While total production declined, three FHA programs remained strong and showed an upward trend. FHA endorsed 104 loans for new construction/substantial rehabilitation of apartments in both fiscal years 2007 and 2006. Construction of assisted living facilities more than tripled to 16 in fiscal year 2007 from 5 loans in fiscal year 2006. Loans for purchase/refinancing of apartments under 223(f) remained fairly strong as FHA endorsed 355 loans in fiscal year 2007 only slightly less than the 365 loans in fiscal year 2006.

Management Tools for Multifamily Housing Development

The Office of Multifamily Housing Development has a number of tools in place to expedite and manage the development process.

- *DAP Tracking Module***.** Multifamily's Development Application Processing (DAP) system tracks and reports on applications, commitments and endorsements for all of FHA's basic, risk sharing and hospital programs. DAP assigns the project case numbers, captures all actions HUD takes on each case, and stores basic data for each application. DAP tracks a loan from receipt of the lender's application through processing of commitments, endorsements and completion of construction and repairs. DAP provides reports on lenders, field offices, program mix, endorsements, commitment activity, and pending pipeline. DAP feeds data to Real Estate Management System (REMS), the Multifamily Insurance System (F47) and to the Comptroller's funds control systems which tracks loan obligations and credit subsidy thus ensuring that all parts of HUD use the same commitment, endorsement and pipeline data.

- *Multifamily Accelerated Processing (MAP).* Lenders may choose to use accelerated processing (MAP) procedures rather than the traditional processing procedures. HUD staff performs many of the underwriting activities (e.g. appraisals, cost estimates, etc) under traditional processing; whereas under MAP, lenders perform most underwriting activities, collect data, make necessary analysis and submit an underwriting summary and recommendation to HUD. The HUD staff then reviews the submission from MAP lenders and decides whether to insure the loan thus providing better service by reducing processing time and cost to lenders. To become a HUD approved MAP Lender the lender's organizational structure and underwriting procedures must meet Multifamily Development's rigorous standards. Currently, 87 lenders are approved to process loans under MAP.

- *Annual Internal Control Reviews.* As a condition of using accelerated processing, all MAP lenders must perform yearly internal control reviews of at least 10% of the MAP loans HUD endorses and submit review findings to Multifamily Development's Lender Quality and Monitoring Division (LQMD). If the reviews disclose weaknesses in processing procedures, LQMD works with the lender to improve internal control procedures and ensures that lender staff receives training on the new procedures.

- *Lender Quality and Monitoring Division (LQMD).* This Division performs annual in-depth reviews of loans processed by MAP lenders. The review team includes HUD staff from all technical disciplines involved in underwriting a loan. In fiscal year 2007 LQMD completed reviews of 31 MAP cases. LQMD focuses on high volume lenders, large loans, and troubled loans in selecting cases for audit.

Multifamily Asset Management

FHA's Multifamily portfolio has 12,156 insured mortgages. At the end of September 2007, this portfolio covered 1.46 million units, with a total outstanding balance of over $56.6 billion. FHA held 2,990 notes in inventory, with a total outstanding principal balance of $3.2 billion.

Management Initiatives for Multifamily Asset Management

FHA's Multifamily Asset Management has significantly improved the accuracy and timeliness of its information in recent years through automation and workload streamlining. Better management information and updated systems have allowed FHA to make improvements in the physical condition of the FHA Multifamily portfolio.

- *Note Sales.* To dispose of multifamily assets, HUD can either sell a property through foreclosure or sell the mortgage note. Note sales have historically demonstrated a greater return to the FHA Insurance Fund as compared to foreclosures. FHA conducted two Multifamily and Healthcare Loan Sales in fiscal year 2007 that sold 52 mortgage notes to successful bidders. The assets included in the December 2006 sale had an estimated value to HUD, if retained, of roughly $60 million, or over 44 percent of unpaid principal balance (UPB) ($136 million). The net proceeds from the sale of these notes were approximately $92 million, over 67 percent of UPB, producing approximately $32 million in budget savings.

The second sale conducted in September 2007 increased the budget savings to HUD for fiscal year 2007 by approximately $6 million dollars, bringing the total savings to the Government to approximately $38 million.

The total sale proceeds for the two sales combined exceeded $231 million dollars. In the 2006-2 sale, there were three loans paid in full, producing $9.2 million in proceeds. The 2007-1 auction motivated one borrower to pay the loan in full which produced another $7.7 million in proceeds.

Multifamily Asset Management is currently negotiating a potential sale of HUD-held New York City subsidized multifamily mortgages with New York City Department of Housing Preservation and Development (NYC HPD). The Department has developed due diligence loan materials on the 23 assets including valuations and portfolio stratifications. According to the Deficit Reduction Act of 2005, assets in a negotiated sale are to be sold at market value.

The portfolio for the potential negotiated sale includes 23 multifamily loans for 21 collateral properties with a total UPB of $128.8 million. The mortgage loans in the sale portfolio are secured by liens on subsidized properties in which over 50% of the units receive Project Based Section 8 or some other form of assistance, which includes subsidized interest rate under Section 236 or below market interest rate under Section 221(d).

- *Lead-based paint.* Multifamily Asset Management continued to assess lead-based paint hazards in HUD assisted multifamily projects in fiscal year 2007. In addition to assessments, Multifamily monitors owner's actions to mitigate or correct the problems. Multifamily has developed a monitoring and tracking report that allows quarterly review of the owners' compliance with the regulations. Multifamily refers owners who fail to comply with the regulations to HUD's Departmental Enforcement Center and the Office of Healthy Homes and Lead Hazard Control for enforcement action.

- *Survey of Units for the Elderly and Persons with Disabilities*. In 2002, HUD conducted its first nationwide survey of HUD-insured and/or HUD-assisted multifamily housing properties. The purpose of the survey was to identify units that were designated in whole or in part for occupancy by elderly persons and persons with disabilities. The survey was also used to identify those units with special features designed to accommodate persons with disabilities. HUD posted the results of the survey on its website for public access, which was used to assist prospective applicants with locating units for which they are eligible. Under a new initiative, HUD has modified its on-site management and occupancy review and process using HUD's Real Estate Management System (REMS) to determine owner compliance with Title VI, Subtitle D of the Housing and Community Development Act of 1992. The REMS data will be used on an on-going basis to periodically update the Inventory of Units for the Elderly and Persons with Disabilities on HUD's web site.

Management Tools for Multifamily Asset Management

The Office of Multifamily Asset Management uses a number of tools in its oversight of insured and subsidized properties, mortgage notes, and HUD-owned properties.

- *Physical Assessment Subsystem (PASS).* PASS facilitates the completion of physical inspections according to HUD's Uniform Physical Condition Standards (UPCS) protocol. The subsystem schedules the inspections and notifies the property owner and the inspector of the inspection date. Inspectors are assigned a random selection of units using an electronic data collection device. The inspector records any deficiencies in the interior, exterior, common areas and building systems of a property with the device. The inspection results are scored by the collection device and uploaded to PASS. PASS technicians review the uploaded inspections for completeness and accuracy and post them on-line for the owners and HUD staff to review. In addition to the overall evaluation of the project's physical condition, HUD tracks the correction or mitigation of Exigent Health and Safety conditions identified in the physical inspection. Owners must certify that they have corrected these conditions within 3 business days of the inspection or they may be subject to administrative action.

  Properties scoring below 31 out of a possible scale of 100 are automatically referred to the Departmental Enforcement Center (DEC) for action. Additionally, HUD may make elective referral of properties with scores less than 60 to the DEC who then advises the owners that they have 60 days to bring the properties up to standard condition. HUD re-inspects the properties sometime after the 60-day period expires. If they remain below standard, HUD initiates steps to protect the tenants', community and the government's interests by taking action to permanently correct the problem. Possible options include, but are not limited to, abating or terminating subsidy contracts, recommending the sale or the physical transfer of the property to acceptable ownership, and foreclosure. As of the end of fiscal year 2007, 28,294 of 30,173 (about 94 percent) properties insured and under management in the PASS system had scores greater than 60.

- *Multifamily Default and Delinquency Reporting System (MDDR).* MDDR is a Web-enabled system for the collection, tracking, and reporting of FHA-insured mortgage delinquencies, defaults, and elections to assign. MDDR provides the basis for HUD's quarterly report to Congress on multifamily defaults.

- *Integrated Real Estate Management System (iREMS). i*REMS is the primary system for HUD staff to review and manage multifamily properties. *i*REMS draws its data from multiple multifamily data systems, including the Financial Assessment Subsystem (FASS), the Physical Assessment Subsystem (PASS), and the Online Property Integrated Information Suite (OPIIS).

- *Financial Assessment Subsystem (FASS*). The FASS subsystem collects annual project financial statement information, assesses a project's financial performance and compliance, and identifies financial risks and compliance deficiencies in need of loss mitigation or enforcement actions by the Office of Housing or the Departmental Enforcement Center (DEC). As part of an overall asset management strategy, FASS addresses open recommendations from the Office of Inspector General to improve the processing and use of annual project financial statement information. FHA continues to refine its financial evaluation indicators to better predict which properties may be facing financial difficulties that, if left unaddressed by the owner or HUD, would create a claim against the FHA insurance fund. An enhanced FASS, integrated under the Online Property Integrated Information Suite (OPIIS) with other data, creates better servicing and management priorities for staff in the local field offices.

- *Online Property Integrated Information Suite (OPIIS).* OPIIS integrates HUD's multifamily data systems including PASS, FASS, MDDR with REMS and external data for property and portfolio analysis. HUD staff use OPIIS to access multiple years of financial statement data and physical inspection results to determine trends in property performance. OPIIS calculates an Integrated Risk Assessment score (IRA) based upon statistical analysis of defaults and delinquencies to predict the likelihood of claims against the insurance fund. The IRA is dynamically updated every time the applicable data changes. Portfolio IRAs are used to establish workload priorities. A popular feature enables users to compare a given property with its peers based on location, size, and program characteristics selected by the user.

Other Housing Programs

Office of Insured Healthcare Facilities

Section 242

The Section 242 Mortgage Insurance for Hospitals program provides hospitals access to affordable financing for capital projects, including new construction or modernization. Since the program's inception in 1968, FHA has insured 352 hospital mortgages for $13.1 billion. Clients range from small rural hospitals to major medical centers. Hospitals with FHA-insured loans serve as community anchors, providing jobs as well as healthcare services. FHA currently has 76 active hospital loans with an unpaid principal balances (UPB) totaling over $5.8 billion. FHA issued insurance commitments totaling $647 million for nine hospitals in six states in fiscal year 2007.

Office of Affordable Housing Preservation

Mark-to-Market Program

FHA's Mark-to-Market (M2M) program seeks to preserve affordable housing inventory by maintaining the long-term physical and financial integrity of such housing and to reduce the Section 8 rental assistance costs and the cost of FHA insurance claims. Under the M2M program, the Office of Affordable Housing Preservation (OAHP) analyzes FHA-insured multifamily properties for which Section 8 rents exceed comparable market rents, and reduces the rents to bring them in line with comparable market rents or levels that preserve financial viability. Sometimes rent reductions can be accomplished and financial viability assured without affecting project debt. More frequently, however, M2M restructures FHA-insured mortgages on eligible multifamily projects. HUD/FHA analyzes properties under M2M and makes appropriate reductions to the mortgages to allow the project debt to be serviced with reduced subsidy payments while remaining financially viable with market rate rent schedules. The M2M process involves either a full or partial payment of claim by FHA on the original mortgage, followed by FHA's commitment of a new mortgage that can be supported at market rents.

During fiscal year 2007, OAHP completed mortgage restructuring on 220 (16,713 units) properties under the M2M program, with 64 percent resulting in reduced rents and Section 8 savings. Of the 220 properties with mortgage restructuring completed during fiscal year 2007, 107 properties resulted in full debt restructurings, contributing to the long-term preservation of 8,421 units. The restructurings represent an annual Section 8 savings (non-incurrence of cost) of $30 million. In addition, 34 properties (2,352 units) charged reduced rents only, representing an annual Section 8 savings (non-incurrence of cost) of over $38 million. In total, 141 properties representing over 10,773 units received reduced rents, resulting in annual savings (non-incurrence of cost) of over $68 million.

Hurricane Relief Efforts

HUD continues to focus efforts on providing relief to residents in the Gulf Coast and Southeast that were displaced as a result of damages incurred by Hurricane Katrina. The Federal Emergency Management Agency (FEMA) has designated disaster areas that were directly affected by the hurricane in the states of Alabama, Florida, Louisiana, Mississippi, and Texas. Furthermore, HUD continues to work with FEMA to help enhance FEMA's housing recovery program and has developed general disaster recovery policy and guidance that will apply to any Presidential Declared Disaster.

For the Multifamily portfolio, the Department's goal was to work with the owners to repair, rehabilitate or rebuild affordable housing units as quickly as possible and to maintain the rental subsidies when possible. In FY 2007, the Department has continued those efforts. There were a total of 1,054 HUD-assisted projects with 82,404 units in the areas that were impacted by Katrina. Of the 1,054 projects, 1,012 with 76,346 units have been repaired or rehabilitated and are fully operational. In Alabama, all 225 properties are fully operational and in Mississippi 98.8% of the 422 properties are fully operational. In Louisiana, approximately 37 of the 407 properties are still being repaired, rebuilt or are in the process of obtaining funds to complete the necessary work. The Department continues to monitor the status of the repairs, rehabilitation or rebuilding efforts for each property until the work is complete and the project is fully operational.

For the Single Family portfolio, borrowers with FHA-insured mortgages were protected from untimely foreclosure by a series of moratoriums that continued until August 31, 2006 for the most severely impacted borrowers in Mississippi and Louisiana. Lenders effectively used HUD's loss mitigation program to cure hurricane related defaults. From the date of the Katrina disaster through the end of fiscal year 2007, more than 51,617 FHA insured borrowers in the five Gulf States were able to retain home ownership through these long-term solutions. Of that total, 46,207 were in the FEMA designated counties and 17,979 of those borrowers are in areas determined to be most directly impacted. The Mortgage Assistance Initiative is a loss mitigation option that was crafted specifically for hurricane victims who were committed to rebuilding but needed help with mortgage payments during construction. To date 786 families have received mortgage payment assistance of up to 12 months PITI (Principal, Interest, Taxes, and Insurance).

Additional assistance to victims continued to be made available through Single Family Housing's Section 203(h) program (Mortgage Insurance for Disaster Victims), in which families and individuals whose homes were either destroyed or severely damaged may obtain 100% mortgage financing for the purchase of a new home anywhere in the country. Since Hurricane Katrina struck, FHA has helped 1053 individuals and families purchase new homes, with over 80% of the mortgages insured under this program located in the Gulf States of Louisiana, Mississippi and Texas.

FHA issued an extension of its special authority for the use of partial claims and loan modifications to assist the victims of Hurricanes Katrina, Rita and Wilma in Presidential Declared disaster areas of the five Gulf States. The original Mortgage Assistance Initiative (MAI) announced in December 2005 scheduled to expire June 1, 2007 was extended through August 31, 2007. This extension was due to the fact that special loss mitigation tools were still needed to assist homeowners with FHA-insured loans who were unable to maintain mortgage obligations due to hurricane related home damage, curtailment of income, or increased living expenses in areas declared eligible for disaster assistance.

Typically, disaster victims have a one-year period to apply with a lender for a 203(h) loan. However, due to the unprecedented extent of destruction caused by the 2005 hurricane season, FHA determined that the one-year period was insufficient to meet the housing needs of the hurricanes' victims and extended the application period. As of September 30, 2007 disaster victims of Hurricanes Katrina, Rita and Wilma were still able to file applications with lenders under the 203(h) Mortgage Insurance Program for Disaster Victims. Lenders have been advised accordingly. Under an interagency agreement with FEMA, more than 2,000 families were provided emergency rental housing in HUD REO properties. HUD made minor repairs to homes in its inventory in the Gulf Region and leased the properties to hurricane evacuees for up to 18 months.

Additionally, HUD is making permanent replacement housing available by selling properties in its nationwide REO inventory to hurricane evacuees at very special terms including a discount off the sales price. To date, 371 properties have been sold to evacuees and 23 transactions are pending. Many of these purchasers are also taking advantage of the 203(h) financing option.

For Healthcare Facilities, FHA has also kept close contact with the HUD-insured hospitals that have been affected by hurricanes. For example, FHA issued a commitment to Baptist Hospitals of Southeast Texas (BHSET) for repairs and additional improvements as a result of hurricane Rita. Baton Rouge General Medical Center (BRGMC), also insured by HUD, operated as a triage center following hurricane Katrina while the community absorbed former displaced residents of New Orleans. FHA is also actively disseminating information to other affected hospitals about rebuilding, using Section 242, such as those affected by Hurricane Humberto.

PERFORMANCE GOALS, OBJECTIVES, AND RESULTS

The Government Performance and Results Act (GPRA) and the Government Management Reform Act (GMRA) mandate that Federal agencies improve their financial and program accountability. GPRA requires Federal agencies to develop multiyear strategic plans, set program goals, measure performance against the goals, and publicly report the findings. GMRA mandates improvements and reforms to promote better accountability and financial management of the Federal government. FHA has outlined a series of reforms designed to improve efficiency, responsiveness to clients, and accountability to the public.

Office of Single Family Housing Programs

The following sections summarize the Office of Single Family Housing's success in meeting its fiscal year 2007 performance goals.

A. Strategic Goal: Increase Homeownership Opportunities

- *Resolve 55 percent of total claims on FHA-insured single family mortgages through loss mitigation.*

  FHA established a national goal of resolving 55 percent of single family mortgage defaults via loss mitigation techniques. Single Family Housing surpassed this goal resolving 65 percent of defaults through loss mitigation techniques in fiscal year 2007. The fiscal year 2007 rate exceeds the 61 percent of mortgage defaults resolved using loss mitigation techniques in fiscal year 2006.

- *Endorse 71 percent of FHA-insured single family home purchase mortgages to first-time homebuyers (HOC).*

  To help increase the number of families able to secure financing for their first home FHA established a target of 71 percent for its Homeownership Centers for single family home purchase mortgage endorsements to first-time homebuyers. In fiscal year 2007, 79.5 percent of FHA-insured single family home purchase mortgages were to first-time homebuyers, compared with the target of 71 percent and the 79.3 percent achieved in fiscal year 2006. The consistency in the share of home purchase mortgages endorsed to first-time homebuyers for fiscal year 2007 may be attributable to FHA's continued commitment to reaching first-time homebuyers. FHA will continue its efforts to reach potential first-time homebuyers through participation in conferences, seminars and other outreach events.

- *Endorse at least 395,000 FHA single family mortgages nationwide.*

  Although FHA did not establish an output goal in the Annual Performance Plan for the number of single family endorsements nationwide, the agency established an internal field-planning target of 395,000 endorsements. Homeownership Centers can use this target to allocate processing and underwriting workload across the nation to help increase single family homeownership rates. During fiscal year 2007, FHA endorsed 532,494 single family mortgages for insurance, exceeding the internal field-planning target of 395,000 endorsements. The increase in the total volume of single family mortgage insurance endorsements from 502,049 in fiscal year 2006 is largely attributable to the collapse of the sub-prime mortgage market. Prospective borrowers who had opted for sub-prime loans in recent years are now choosing the dependability and safety of FHA products. Proposed FHA modernization will reduce statutory barriers and increase FHA's flexibility to respond to changes in the marketplace. As a result, FHA will be able to reach more prospective homebuyers to provide an alternative to sub-prime loans that have high interest rates and closing costs, as well as expensive repayment penalties.

- *Endorse 35 percent of FHA-insured first-time single family home purchase mortgages to minorities.*

  To help increase the number of minority families able to secure financing for their first home, FHA established a target of 35 percent for its Homeownership Centers for single family home purchase mortgage endorsements to minority first-time homebuyers. In fiscal year 2007, FHA-insured 33 percent of single family home purchase mortgages to first-time homebuyers who were minority, compared with the target of 35 percent and the 31.7 percent achieved in fiscal year 2006. Though FHA did not meet the target, there was a 1.3 percent increase from fiscal year 2006 in the share of home purchase mortgages endorsed to minority first-time homebuyers. This may be attributable to FHA's continued outreach to prospective first time and minority homebuyers. The collapse of the sub-prime market during fiscal year 2007 also likely attributed to the increase in minority first time endorsements. Many homebuyers realize the uncertainty of several sub-prime products and have opted to finance their home via safer alternatives such as an FHA insured loans.

  The approval and passage of the modernization legislation will enhance FHA's market flexibility and enable it to reach more first-time single family homebuyers. FHA will continue to pursue the President's commitment to reaching minorities and increasing the minority homeownership rate through housing counseling program outreach and print and radio advertising.

B. Strategic Goal: Strengthen Communities

- *Endorse at least 35 percent of FHA-insured single family mortgages in underserved communities.*

  FHA established a national goal to ensure that at least 35 percent of single family mortgages endorsed for insurance are in underserved communities, thereby enhancing homeownership opportunities in these neighborhoods. During fiscal year 2007, 42 percent (218,640 out of 519,350) of single family mortgages endorsed for insurance by FHA were in underserved communities.

- *Inspect 100% of Real Estate Owned (REO) property acquired by HUD subject to a Lead Based Paint.*

Implemented in fiscal year 2007, the goal requires all acquired properties that are subject to a lead based paint inspection per the Lead Safe Housing Rule (24 CFR Part 35) to have undergone an inspection. No numerical target was set because it is not possible to accurately determine the number of properties HUD may acquire throughout the year and which of those are subject to a LBP inspection. HUD will inspect 100% of the required properties prior to them being sold. In fiscal year 2007, HUD completed 100% of the LBP inspections on acquired properties.

C. Strategic Goal: Embrace High Standards of Ethics, Management and Accountability

- *Meet congressionally mandated capital reserve targets on the FHA Mutual Mortgage Insurance Fund.*

  FHA's Mutual Mortgage Insurance (MMI) Fund is responsible for all expenses, excluding administrative expenses but including insurance claims incurred under FHA's basic single family mortgage insurance program. The program is expected to be entirely self-financing through up-front earnings and annual insurance premiums paid by borrowers obtaining FHA mortgage loans, as well as from asset sales, earnings on fund assets and other income. The fund is subject to an annual actuarial review. The review assesses the fund's current economic value, its capital ratio, and its ability to provide homeownership opportunities while remaining self-sustaining based on current and expected future cash flows. The capital ratio is an indicator of the MMI Fund's financial soundness. The Cranston-Gonzalez National Affordable Housing Act required that FHA achieve a capital ratio of 2.0 percent by fiscal year 2000. FHA has met this requirement every year since fiscal year 1995. In fiscal year 2007, FHA achieved a 6.40 percent MMI fund ratio compared to 6.82 percent for fiscal year 2006. In the future, this ratio is expected to remain above the 2.0 percent goal.

- *Average at least 63 percent net recovery rate per property sale.*

  FHA established a net recovery rate goal of 63 percent per HUD Real Estate Owned (REO) property sale to reduce insurance claim losses associated with foreclosures. During fiscal year 2007, the average net recovery rate per sale was 60.5 percent. This result falls short of meeting the goal set for this performance indicator in fiscal year 2007. This shortfall may be attributed to three factors: larger loss rates attributable to loans originated with seller provided down payment assistance, longer holding times and greater rehabilitation expenses on properties held off the market to house those displaced by the Hurricanes Katrina and Rita and large concentrations of inventory in severely depressed real estate markets including Ohio, Michigan, and Indiana.

- *Conduct 360 lender-monitoring reviews of FHA-approved lenders.*

  HUD set a national goal to conduct 360 lender-monitoring reviews of FHA-approved lenders in fiscal year 2007. HUD exceeded that goal by conducting 368 reviews in fiscal year 2007.

- *Sell 90 percent of FHA-insurable Real Estate Owned (REO) properties to owner-occupants.*

  During fiscal year 2007, FHA met its goal, selling 93 percent (2,883 out of 3,102 of FHA-insurable REO single family properties to owner-occupants, compared with the 90 percent (2,378 out of 2,648) of FHA-insurable properties sold to owner-occupants during fiscal year 2006.

Office of Multifamily Housing Programs

The following sections summarize the Office of Multifamily Housing's success in meeting its fiscal year 2007 performance goals.

D. Strategic Goal: Increase the Availability of Affordable Rental Housing

- *Endorse 1000 Multifamily Initial Loans.*

  Multifamily initial endorsements for fiscal year 2007 totaled 881. The goal of 1000 endorsements was not met because refinancing declined as interest rates increased and because heavy refinancing activity in fiscal year 2005 and 2006 reduced the number of loans available for refinancing.

E. Strategic Goal: Improve Management Accountability for Assisted Housing

- *Ensure 98 percent of the active inventory of Multifamily properties has no compliance flags or have their findings closed.*

  Multifamily Housing continues to improve the financial condition of properties by assuring that all property owners submit Annual Financial Statements (AFS) to the Real Estate Assessment Center and HUD field offices for review. Multifamily Housing met the goal that at least 98 percent of the properties in the multifamily inventory have no compliance flags or have their findings closed in fiscal year 2007.

- *Bring at least 75 percent HUD-held loans that are 90 or more days delinquent under control.*

  HUD-held loans are placed under a workout plan when delinquent. Delinquent loans that do not have a workout plan are recommended for foreclosure, put in the mortgage sale, or referred to the Departmental Enforcement Center for further action. In fiscal year 2007, Multifamily Housing exceeded its goal attaining an 83 percent rate.

E. Strategic Goal: Help Communities More Readily Access Revitalization Resources to Become More Livable

- *Maintain the share of multifamily properties in underserved areas insured by FHA at 33 percent of initial endorsements.*

FHA set a goal of endorsing at least 33 percent of initial endorsements of multifamily properties in underserved areas in fiscal year 2007. FHA exceeded the goal as of the end of the year and endorsed 404 multifamily properties serving underserved communities, equaling 46 percent of its initial endorsements.

2007 Schedule of Performance Goals and Actual Results

Strategic Goals and Performance Objectives	*Goals*	*Actual Results*	*Variance*
Office of Single Family Housing Programs			
A. Increase Homeownership Opportunities			
Claims resolved on FHA-insured mortgages through loss mitigation	55%	65%	10%
Mortgage endorsed to first-time homebuyers	71%	80%	9%
FHA single family mortgages endorsements nationwide	395,000	532,494	137,494
FHA-insured first-time home purchase mortgages endorsed to minorities	35%	33%	-2%
B. Strengthen Communities			
FHA-insured mortgages endorsed in underserved communities	35%	42%	7%
Inspect All Real Estate Owned (REO) property for Lead Based Paint	100%	100%	0
C. Embrace High Standards of Ethics, Management and Accountability			
Meet congressional reserve target of 2%	2.0%	6.40%	4.40%
Net recovery rate per property sale	63%	60%	-3%
Number of lender-monitoring reviews of FHA-approved lenders	360	368	8
REO properties sold to owner-occupants	90%	93%	3%
Office of Multifamily Housing Programs			
D. Increase the Availability of Affordable Rental Housing			
Multifamily Initial Endorsements	1,000	881	-129
E. Improve Management Accountability for Assisted Housing			
Inventory properties with no compliance flags	98%	98.6%	0.6%
HUD-held loans delinquent 90 days or more brought "under control"	75%	83%	8%
F. Help Communities More Readily Access Revitalization Resources to Become More Livable			
Initial endorsements in underserved areas	33%	46%	13%

FINANCIAL STATEMENTS

Credit Reform Accounting

The financial statements have been prepared in accordance with the Federal Accounting Standards Advisory Board's (FASAB) Statement of Federal Financial Accounting Standards (SFFAS). The authoritative guidance for the statements are contained primarily in: SFFAS No. 2, *Accounting for Direct Loans and Loan Guarantees*, as amended; by SFFAS No. 18, *Amendments to Accounting Standards for Direct Loans and Loan Guarantees;* SFFAS No. 19, *Technical Amendments to Accounting Standards for Direct Loans and Loan Guarantees;* the Federal Credit Reform Act (FCRA) of 1990.

Before the enactment of the FCRA, credit program costs were recorded in the budget of the U.S. federal government on the cash basis. While this accurately reflected the actual cash flows, it did not reflect the ultimate costs of credit programs, and thus hindered the comparison between the costs of these programs with those of other federal programs. Beginning in fiscal year 1992, the FCRA requires that the ultimate costs of a credit program be calculated, and the budgetary resources obtained, before new direct loan obligations are incurred and new loan guarantee commitments are made. The cost of loan guarantee programs is the net present value of the estimated future cash flows from payments (for claims, interest rate subsidies, and other payments) and collections (for loan origination and other fees, penalties and recoveries) by credit agencies.

SFFAS No. 2, which generally mirrors the requirements of the FCRA, established guidance for estimating the cost of direct and guaranteed loan programs, as well as for recording direct loans and the liability for loan guarantees for financial reporting purposes. SFFAS No. 2 states that the actual and expected costs of federal credit programs should be fully recognized in both budgetary and financial reporting. To accomplish this, agencies first predict or estimate the future performance of direct and guaranteed loans when preparing their annual budgets. The data used for these budgetary estimates are re-estimated after the fiscal year-end to reflect changes in actual loan performance and the actual interest rate in effect when the loans were insured. This re-estimated data is then used to report the cost of the loans disbursed under the direct or guaranteed loan program as a "Program Cost" on the agencies' Statement of Net Costs.

The FCRA establishes budgetary and financing control for each credit program through the use of the program, financing, and negative subsidy receipt accounts for loan guarantee commitments and direct loans obligated after September 30, 1991. It also establishes the liquidating account for any loan guarantee commitments and direct loans obligated before October 1, 1991. For further information regarding the FCRA and credit reform accounting, refer to Notes 1 and 6 of the Notes to Principal Financial Statements.

Budgetary Resources

FHA finances its operations primarily through appropriations, borrowings from the U.S. Treasury, spending authority from offsetting collections, and prior year unobligated balances. During fiscal year 2007, FHA received appropriations of $1,254 million, borrowings of $617 million, spending authority from offsetting collections of $11,255 million, and recoveries of prior year obligations of

$213 million. Additionally, FHA's budgetary resources were increased by $29,422 million of unobligated balances carried forward from fiscal year 2006 and reduced by $3,215 million for repayment of borrowings, the return of the unobligated GI/SRI liquidating account balances to Treasury, the return of cancelled program funds, and non expenditure transfers for salaries, administrative and working capital fund expenses.

For fiscal year 2007, $413 million in appropriations were received for MMI/CMHI contract and administrative expenses. FHA transferred $370 million to HUD for administrative expenses and obligated $39 million for contract expenses in fiscal year 2007. The GI/SRI program appropriations for subsidy, administrative and contract expenses totaled $317 million in fiscal year 2007. FHA transferred $240 million to HUD for administrative expenses and obligated $61 million for contract expenses and $5 million for subsidy expenses in fiscal year 2007.

During the year, FHA used its borrowing authority to obtain approximately $617 million from the U.S. Treasury and the public. These funds were used to pay for loan guarantee claims and for negative credit subsidy.

Spending authority of $9,067 million and $2,188 million was received from offsetting collections in the MMI and GI/SRI funds, respectively. These offsetting collections include collections of premiums, fees, sales proceeds of credit program assets and credit subsidy transferred between different FHA accounts.

These funds provided FHA the resources to cover the fiscal year 2007 obligations totaling $12,626 million. These obligations included: payments on defaulted guaranteed loans; the cost of acquiring, maintaining and disposing of foreclosed properties; the transfers of credit subsidy re-estimates; and maintaining MMI reserves (capital ratios) as required by the National Affordable Housing Act of 1990.

Assets and Liabilities

FHA maintains a highly liquid balance sheet with the majority of its assets consisting of fund balances with the U.S. Treasury and investments in non-marketable, market-based securities issued by the U.S. Treasury. The nature of FHA's business requires it to carry, or acquire through borrowing, the assets necessary for claim payments on defaulted guaranteed loans. Additionally, FHA must meet credit reform requirements of transferring out negative subsidy and downward credit subsidy re-estimates from the financing accounts. The negative subsidy and downward re-estimate calculations are based on various assumptions about premium and fee collections, prepayments, claims, and recoveries on credit program assets. Accordingly, FHA's total assets and financial leverage can fluctuate significantly depending largely on economic and market conditions, volume of activity, and customer demand.

As of September 30, 2007 FHA had total assets of $37,165 million, a slight decrease from the September 30, 2006 total asset balance of $37,293 million. Total liabilities as of September 30, 2007 were $16,590 million as compared to $13,294 million as of September 30, 2006. The decrease in assets is mainly attributable to a decrease in accounts receivable. The increase in liabilities is primarily attributable to an increase in loan guarantee liability.

Schedule of Balance Sheet
As of September 30th
(Dollars in millions)

	2004	2005	2006	2007
Assets	$ 35,815	$ 37,161	$ 37,293	$ 37,165
Liabilities	14,646	14,006	13,294	16,590
Net Position	$ 21,169	$ 23,155	$ 23,999	$ 20,575

As of September 30, 2007, FHA assets consisted of: investments in U.S. Treasury securities totaling $22,481 million; a fund balance with U.S. Treasury of $9,559 million; loan receivables and related foreclosed properties, net totaling $4,738 million; other receivables and assets totaling $387 million. FHA liabilities as of September 30, 2007 consisted of: loan guarantee liability totaling $7,431 million; borrowings from the U.S. Treasury of $4,573 million; payables to the public totaling $385 million; debentures issued to claimants totaling $70 million; other liabilities to federal agencies and to the public totaling $4,131 million.

<u>Secretary-Held Mortgage Notes</u>

A note is assigned to the Secretary when FHA pays a claim prior to foreclosure and takes possession of the mortgage note for servicing. Between fiscal years 2006 and 2007, the overall unpaid principal balance of Secretary-held mortgage notes had a slight decrease from $3,896 million to $3,863 million and the overall number of notes decreased by 7 percent. The number of Title I notes decreased by 64 percent in fiscal year 2007 from 9,350 notes in fiscal year 2006 to 3,346 notes in fiscal year 2007. The number of multifamily notes in inventory decreased from 2,995 notes in fiscal year 2006 to 2,990 notes in fiscal year 2007. The number of single-family notes increased by 3 percent from 53,779 notes in fiscal year 2006 to 55,622 notes in fiscal year 2007.

For the single family programs, mortgage notes in default were assigned to FHA for servicing until 1996 when the program was terminated due to the high cost of servicing assigned notes. However, eligible borrowers in older cohorts who applied for the program before April 26, 1996 may still receive such benefits.

Legislation passed in 1999 allows FHA to accept mortgage note assignments for single family properties again. FHA can either service the notes directly or transfer them to a third party for servicing.

Schedule of Secretary-Held Mortgage Notes
As of September 30th
(Dollars in Millions)

	2004	2005	2006	2007
Single Family	$ 474	$ 506	$ 550	$ 667
Title I	147	102	81	31
Multifamily	3,184	3,363	3,265	3,165
Total	$ 3,805	$ 3,971	$ 3,896	$ 3,863

Secretary - Held Property

FHA acquires single family and multifamily properties through conveyance claims. Secretary-held property increased 4 percent in fiscal year 2007 to $3,061 million from $2,940 million in fiscal year 2006.

Schedule of Secretary-Held Property
As of September 30th
(Dollars in Millions)

	2004	2005	2006	2007
Single Family	$ 2,566	$ 2,830	$ 2,939	$ 3,060
Multifamily	106	5	1	1
Total	$ 2,672	$ 2,835	$ 2,940	$ 3,061

Loan Guarantee Liability

The loan guarantee liability (LGL) is comprised of two components, the liability for loan guarantee (LLG) for post-1991 loan guarantees and the loan loss reserves (LLR) for pre-1992 loan guarantees.

Post-1991 LLG

The LLG related to Credit Reform loans (made after September 30, 1991) is comprised of the present value of anticipated cash outflows, such as claim payments, premiums refunds, property expense for on-hand properties and sales expense for sold properties, less anticipated cash inflows such as premium receipts, proceeds from property sales and principal and interest on Secretary-held notes.

In fiscal year 2007, the LLG increased by $ 4,076 million from $2,984 million to $7,060 million. The single family LLG increased from a balance of $3,027 million in fiscal year 2006 to a balance of

$7,485 million in fiscal year 2007. The $4,458 million single family LLG increase can be mostly attributed to increased claim rates due to two factors: (1) increased insurance of loans with down payment assistance, and (2) the nationwide decrease in house price appreciation, which results in increased claims and lower proceeds from the sale of foreclosed properties.

The Title I LLG decreased to $(2) million in fiscal year 2007. The decrease can be attributed to the updated loss rates for Manufactured Housing and Property Improvement. The loss rate assumption was changed from a management assumption to actual performance. The multifamily LLG decreased from a balance of $(44) million in fiscal year 2006 to a balance of $(423) million in fiscal year 2007. The majority of the $379 million decrease can be attributed to a decrease in the number of loans eligible for Mark to Market restructuring.

Schedule of FHA Liability for Loan Guarantees
As of September 30th
(Dollars in Millions)

	2004	2005	2006	2007
Single Family	$ 1,444	$ 1,886	$ 3,027	$ 7,485
Title I	2	1	1	(2)
Multifamily	1,279	1,480	(44)	(423)
Total	$ 2,725	$ 3,367	$ 2,984	$ 7,060

Pre-1992 Loan Loss Reserve (LLR)

The liability associated with pre-Credit Reform endorsements is computed by estimating the LLR. FHA maintains loss reserves for the estimated costs of future mortgage insurance claims resulting from defaults that have occurred or are likely to occur among insured single family and multifamily mortgages and Title I loans. FHA records a loss reserve for its pre-Credit Reform insured mortgages to provide for anticipated losses which may occur on claims for defaults that have taken place but have not yet been filed. The LLR is computed using the present value of anticipated cash outflows, such as claim payments, premiums refunds, property expense for on-hand properties and sales expense for sold properties, less present value of anticipated cash inflows such as premium receipts, proceeds from property sales and principal and interest on Secretary-held notes. Overall, loss reserves decreased by $127 million from $498 million in fiscal year 2006 to $371 million in fiscal year 2007. The majority of the decrease can be attributed to a decrease in the Mark to Market program.

Schedule of FHA Loan Loss Reserves
As of September 30th
(Dollars in Millions)

	2004	2005	2006	2007
Single Family	$ 91	$ 56	$ 51	$ 96
Title I	2	1	1	1
Multifamily	2,256	1,160	446	274
Total	$ 2,349	$ 1,217	$ 498	$ 371

<u>Net Cost/ (Surplus)</u>

FHA's program costs exceeded revenues in fiscal year 2007, thus resulting in a net cost. The most important facet of FHA's cost and revenue activity is the treatment of loan guarantee subsidy cost. Loan guarantee subsidy cost is the estimated long-term cost to FHA of a loan guarantee calculated on a net present value basis, excluding administrative costs. The cost of a loan guarantee is the net present value; at the time the loan is disbursed by the lender, of the estimated cash flows paid by FHA to cover claims, interest subsidies, and other requirements. Payments made to FHA, including origination premiums, penalties, and recoveries are also included in the calculation.

For the first time in four years, there is a positive net program cost. This is due to a $4 billion upward re-estimate in the MMI fund. In past years, FHA's negative subsidies generated by loan guarantee endorsements throughout the year have resulted in a negative net program cost. This year, the upward re-estimate is greater than the negative subsidy creating a net program cost.

Schedule of FHA Net Cost (Surplus)
For the year ended September 30th
(Dollars in Millions)

	2004	2005	2006	2007
Program Cost	$ 52	$ 786	$ (380)	$ 3,890
Program Revenues	1,802	1,854	1,701	1,521
Net Cost (Surplus)	$ (1,750)	$ (1,068)	$ (2,081)	$ 2,369

The $4,450 million increase in the Net Cost between fiscal year 2006 and fiscal year 2007 is comprised primarily of the $3,560 million increase in the loan subsidy expense.

<u>Net Position</u>

FHA's Net Position decreased to $20,575 million in fiscal year 2007, a decrease of 14.3 percent, due to the $3,347 million decrease in Cumulative Results of Operations and the $50 million decrease in Unexpended Appropriations.

Schedule of Statement of Changes in Net Position
As of September 30th
(Dollars in Millions)

	2004	2005	2006	2007
Net Position, Beginning of Year	$ 18,235	$ 21,169	$ 23,155	$ 23,999
Net Change in Cumulative Results of Operations	2,811	2,076	859	(3,347)
Increase in Unexpended Appropriations	123	(90)	(15)	(50)
Net Position, End of Year	$ 21,169	$ 23,155	$ 23,999	$ 20,575

SYSTEMS, CONTROLS, AND COMPLIANCE

FHA continues to improve financial management through the phased implementation of an integrated financial system to better support FHA's business needs. The FHA Comptroller developed a Blueprint for Financial Management to implement an integrated core financial management system that addressed financial management and system deficiencies previously documented by HUD's Inspector General, FHA and HUD financial statement auditors, OMB examiners and GAO auditors.

The FHA Subsidiary Ledger serves as FHA's core financial system and produces FHA's audited financial statements. The Subsidiary Ledger provides funds controls for all FHA financial operations and supports the FHA Comptroller's cash management and contract accounting functions. The FHA Subsidiary Ledger integrates all of FHA's financial operations through interfaces with the systems that perform underwriting, servicing, and post insurance operations for FHA's insurance programs. Through this integration, FHA has achieved compliance with federal statutory and regulatory requirements for financial systems.

FY 2007 Systems Accomplishments

- The platform for the Subsidiary Ledger was moved to a new host that significantly improved system processing time.

- The Subsidiary Ledger database management software was upgraded to Oracle version 10(g) and the development software was upgraded to PeopleTools 8.4.8.08.

- The development of the transaction processing functions required for Multifamily premium billing and collection and Multifamily claims was completed and the modules will go live in FY 2008.

- The interface development for the FHASL to a HUD-wide procurement data warehouse has been completed.

On-going and Planned Initiatives

- Complete data conversion, testing, training, and operational implementation of Multifamily premium billing and collection and claims functions within the FHASL.

- Test new interfaces for the Single Family property management service provider for HUD's Single Family Acquisition Management.

- Test and support business process engineering and related development and configuration work to adapt the FHA Subsidiary Ledger in response to Treasury's Pay.Gov initiative.

Fiscal Year 2007 Material Weaknesses

The financial statement auditors have identified two material weaknesses in their audit report. FHA management strongly disagrees with this assessment and does not believe that FHA has any material weaknesses.

Fiscal Year 2007 Material Weakness No. 1: *A risk assessment and systems development plan are needed for FHA's Home Equity Conversion Mortgage systems and transactions. FHA maintains a number of different system platforms for processing HECM endorsements, premiums, claims and assigned notes. These systems are not automatically integrated and require significant compensating manual controls to ensure the accuracy and reliability of financial information being reported in the general ledger. They are neither compliant with federal loan financial management system requirements nor with federal information technology security requirements, including regulations for the safeguarding of personally identifiable information. Since the HECM program is growing rapidly, the auditors believe the growth in a manually intensive control environment greatly increases the risk of material errors in financial reporting.*

FHA has significant compensating controls to ensure the accuracy and reliability of HECM financial information. The effectiveness of these controls and the absence of errors relating to FHA's HECM financial records demonstrate that the risks associated with FHA's HECM systems and controls do not rise to a material level.

Fiscal Year 2007 Material Weakness No. 2: *HECM credit subsidy cash flow model needs enhancement. FHA has developed a cash flow model to estimate the net present value of future HECM cash flows, which is recorded as a Liability for Guaranteed Loans in the Principal Financial Statements. This model contains projected cash flows for premiums, pre-foreclosure sales claims, mortgage note assignments, terminations, post-assignment drawdowns and terminated loan note recoveries. FHA uses the limited historical experience available and management assumptions to calculate the conditional rates for most of these complex HECM loan events. The auditors noted significant discrepancies between projected and actual program events which may be caused by changes in interest rates and other external variables. The auditors found management has not effectively documented its assessment of statistical correlations between these various macroeconomic variables that appear to be having a significant impact on the program's experience, including house price appreciation, short term interest rates, and borrower* *characteristics including gender, age, and mobility patterns due to the limited historical experience for the program. FHA also had not effectively documented its sensitivity analysis of the model and did not have an effective process to document its conclusions regarding the results of its validation review and what changes to the models are needed to improve the model's predictability. FHA has indicated that they are currently assessing new pricing and termination models, the results of which will improve future cash flow estimates.*

The HECM cash flow model was developed to reflect the current and future cash flows of the HECM program. The cash flow model is regularly reviewed and has evolved in response to historical program experience, published research, and management's understanding of the program. The cash flow model takes advantage of all historical program experience available, makes use of proxy data if no historical experience exists, and uses management assumptions based on economic theory to estimate the liability for loans guaranteed.

Fiscal Year 2006 Material Weaknesses

FHA had no material weaknesses for fiscal year 2006.

FHA Compliance with OMB Circular A-123, Management's Responsibility for Internal Control

An internal control certification statement is provided by the Department's Assistant Secretaries in support of an overall statement from the Secretary. Housing complies with Sections 2 and 4 of the FMFIA. Housing provides reasonable assurance that FHA's system of internal controls meets Federal standards.

In addition, FHA conducted its assessment of the effectiveness of internal control over financial reporting in accordance with the requirements of Appendix A of OMB Circular A-123. Based on the results of this evaluation, FHA can provide reasonable assurance that its internal control over financial reporting as of June 30, 2007 was operating effectively and no material weaknesses were found in the design or operation of the internal control over financial reporting.

Fiscal Year 2007

Annual Assurance Statement on Internal Control over Financial Reporting

The Federal Housing Administration (FHA) management is responsible for establishing and maintaining effective internal control over financial reporting, which includes safeguarding of assets and compliance with applicable laws and regulations. FHA conducted its assessment of the effectiveness of the FHA internal control over financial reporting in accordance with OMB Circular A-123, Management's Responsibility for Internal Control. Based on the results of this evaluation, FHA can provide reasonable assurance that internal control over financial reporting as of June 30, 2007 was operating effectively and no material weaknesses were found in the design or operation of the internal controls over financial reporting

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Brian D.Montgomery

Assistant Secretary for Housing, Federal Housing Commissioner

Improper Payments Information Act of 2002

FHA Accomplishments

In accordance with the Improper Payments Information Act, enacted on November 26, 2002, and the OMB Memorandum M-03-13, dated May 21, 2003, (now subsumed into OMB Circular A-123 as Appendix C) FHA continued to comply with the requirements of the Act and determined which of its activity inventory required review this year. Following the procedures that were used in 2005 with fiscal year 2004 data, the dollar amount of each FHA disbursement system's total disbursements were compared to the $40 million threshold. In fiscal years 2007 and 2006 the disbursements from the other four systems listed below exceeded the threshold.

- Single Family Insurance Claims System (SFIC)
- Multifamily Claims
- Single Family Distributive Shares and Premium Refunds
- Single Family Acquired Asset Management System (SAMS)

In fiscal year 2007, limited risk assessments were made on all of the above systems to assure that there were no changes that might contribute to vulnerability to improper payments. In addition, FHA's internal control review triggered by OMB Circular A-123, Appendix A concluded that each of these systems has adequate internal controls that are fully documented and implemented to control fraud, waste and abuse.

Single Family Insurance Claims System (SFIC)

In July of fiscal year 2006, the Office of the Inspector General (OIG) issued an audit that challenged the payment of insurance claims when insufficient underwriting documentation existed in the case binder. FHA rebutted the arguments of the OIG, and rejected the findings in the Draft Audit. While the OIG accepted some of the FHA comments, including OGC's position that the claims had to be paid unless fraud was suspected, the HUD OIG chose to stand behind their audit. FHA will continue to find accommodation with the OIG during fiscal year 2008, while maintaining its position on the audit.

FHA continues to assert that the previous risk assessment is still valid, that neither volume of claims, total dollars disbursed or program essentials have changed since the previous assessment, which showed that Single Family Claims were deemed to be not susceptible to improper payments. Additionally, HUD has modified the systems that track loan origination by adding flags that will trigger a review and/or action. Instructions have been made clearer both for HUD field offices and approved lenders to improve the oversight of the process. With loans that are more carefully underwritten and monitored, there will be fewer high-risk loans and fewer claims against the insurance fund.

To provide management with the confidence that the Single Family Claims system, as well as the process employed for assuring that only the appropriate amounts were paid to lenders submitting claims, were not subject to significant risk of improper payments, FHA initiated a review of the Single Family Claims process. The review incorporated a sample of a review of financial transactions with the results of an in house examination of Post Claim reviews for the Fiscal Year 2006. The review found that the controls were excellent and that the Single Family Claims process should be categorized as low risk.

Multifamily Claims

In fiscal year 2007, as in fiscal year 2006, the dollar amounts of disbursements in the Multifamily Claims system exceeded the $40 million threshold and warranted a risk assessment. Our limited risk assessment revealed that there were no significant changes to the volumes of business or the processes in place to make disbursement, leading us to conclude that the system is still not susceptible to improper payments.

Single Family Premium Refunds and Distributive Shares

In fiscal year 2007, as in fiscal year 2006, the dollar amounts of disbursements in the Single Family Premium Refunds and Distributive Shares system exceeded the $40 million threshold and warranted a risk assessment. Our limited risk assessment revealed that there were no significant changes to the volume of business or the processes in place to make disbursements, leading us to conclude that the system is still not susceptible to improper payments and places this system in the low risk category.

Single Family Acquired Asset Management System (SAMS) Improper Payment Analysis

During the fiscal year 2005 improper payment review, the risk assessments showed that SAMS was deemed not susceptible to improper payments. A limited transaction review was conducted and corroborated the previous finding of no significant risk of improper payments for the fiscal year 2006. In fiscal year 2007, a more sophisticated review was conducted, and again showed that the improper payments continue to fall well below the OMB threshold.

LIMITATIONS OF FINANCIAL STATEMENTS

The following limitations apply to the preparation of the fiscal year 2007 financial statements:

- The financial statements have been prepared to report the financial position and results of operations of the entity, pursuant to the requirements of 31 U.S.C. 3515(b).
- While the statements have been prepared from the books and records of the entity in accordance with the formats prescribed by OMB, the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.
- The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity. One implication of this is that liabilities cannot be liquidated without legislation that provides resources to do so.

PRINCIPAL FINANCIAL STATEMENTS

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FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED BALANCE SHEETS
As of September 30, 2007 and 2006
(Dollars in Millions)

	2007	2006
ASSETS		
Intragovernmental		
Fund Balance with U.S. Treasury (Note 3)	$ 9,559	$ 10,568
Investments (Note 4)	22,481	22,012
Other Assets (Note 7)	4	24
Total Intragovernmental	32,044	32,604
Investments (Note 4)	121	98
Accounts Receivable, Net (Note 5)	119	168
Loans Receivable and Related Foreclosed Property, Net (Note 6)	4,738	4,283
Other Assets (Note 7)	143	140
TOTAL ASSETS	**$ 37,165**	**$ 37,293**
LIABILITIES		
Intragovernmental		
Borrowings from U.S. Treasury (Note 9)	4,573	6,258
Other Liabilities (Note 10)	3,657	2,486
Total Intragovernmental	8,230	8,744
Accounts Payable (Note 8)	385	396
Loan Guarantee Liability (Note 6)	7,431	3,482
Debentures Issued to Claimants (Note 9)	70	95
Other Liabilities (Note 10)	474	577
TOTAL LIABILITIES	**16,590**	**13,294**
NET POSITION		
Unexpended Appropriations (Note 16)	544	594
Cumulative Results of Operations	20,031	23,405
TOTAL NET POSITION	**20,575**	**23,999**
TOTAL LIABILITIES AND NET POSITION	**$ 37,165**	**$ 37,293**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION

(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)

CONSOLIDATED STATEMENTS OF NET COST

For the periods ended September 30, 2007 and 2006

(Dollars in Millions)

	2007	2006
MMI/CMHI PROGRAM COSTS		
Intragovernmental Gross Costs (Note 12)	$ 284	$ 387
Less: Intragovernmental Earned Revenue (Note 13)	1,299	1,334
Intragovernmental Net Costs	(1,015)	(947)
Gross Costs with the Public (Note 12)	4,700	1,135
Less: Earned Revenue from the Public (Note 13)	24	94
Net Costs with the Public	4,676	1,041
NET MMI/CMHI PROGRAM COST (SURPLUS)	**$ 3,661**	**$ 94**
GI/SRI PROGRAM COSTS		
Intragovernmental Gross Costs (Note 12)	$ 141	$ 147
Less: Intragovernmental Earned Revenue (Note 13)	107	188
Intragovernmental Net Costs	34	(41)
Gross Costs with the Public (Note 12)	(1,235)	(2,049)
Less: Earned Revenue from the Public (Note 13)	91	85
Net Costs with the Public	(1,326)	(2,134)
NET GI/SRI PROGRAM COST (SURPLUS)	**(1,292)**	**(2,175)**
NET COST (SURPLUS) OF OPERATIONS	**$ 2,369**	**$ (2,081)**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENTS OF CHANGES IN NET POSITION
For the periods ended September 30, 2007 and 2006
(Dollars in Millions)

	2007 Cumulative Results of Operations	2007 Unexpended Appropriations	2006 Cumulative Results of Operations	2006 Unexpended Appropriations
BEGINNING BALANCES	**$ 23,405**	**$ 594**	**$ 22,546**	**$ 609**
BUDGETARY FINANCING SOURCES				
Appropriations Received (Note 16)	-	1,252	-	1,281
Other Adjustments (Note 16)	2	(119)	-	(83)
Appropriations Used (Note 16)	415	(415)	1,178	(1,178)
Transfers-Out (Note 15 and Note 16)	(1,014)	(768)	(731)	(35)
OTHER FINANCING SOURCES				
Transfers-Out (Note 15)	(445)	-	(1,692)	-
Imputed Financing (Note 12)	37	-	23	-
TOTAL FINANCING SOURCES	**(1,005)**	**(50)**	**(1,222)**	**(15)**
NET (COST) SURPLUS OF OPERATIONS	**(2,369)**	**-**	**2,081**	**-**
ENDING BALANCES	**$ 20,031**	**$ 544**	**$ 23,405**	**$ 594**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
COMBINED STATEMENT OF BUDGETARY RESOURCES
For the period ended September 30, 2007
(Dollars in Millions)

	2007 Budgetary	2007 Non-Budgetary	2007 Total
BUDGETARY RESOURCES			
Unobligated Balance, brought forward, October 1	$ 22,390	$ 7,032	$ 29,422
Recoveries of prior year unpaid obligations	89	124	213
Budget Authority:			
Appropriations	1,252	2	1,254
Borrowing authority	15	602	617
Spending authority from offsetting collections (gross):			
Earned			
Collected (Note 18)	2,057	9,104	11,161
Change in receivables from Federal sources	56	42	98
Change in unfilled customer order w/o advance	-	(4)	(4)
Nonexpenditure transfers net (Note 19)	(609)	-	(609)
Permanently not available	(291)	(2,315)	(2,606)
TOTAL BUDGETARY RESOURCES	$ 24,959	$ 14,587	$ 39,546
STATUS OF BUDGETARY RESOURCES			
Obligations incurred, Direct (Note 20)	$ 2,116	$ 10,510	$ 12,626
Unobligated balance-Apportioned	187	993	1,180
Unobligated balance-Not available	22,656	3,084	25,740
TOTAL STATUS OF BUDGETARY RESOURCES	$ 24,959	$ 14,587	$ 39,546
Change in Obligated Balances			
Obligated balance, net:			
Unpaid obligations, brought forward, October 1	$ 980	$ 1,377	$ 2,357
Uncollected customer payments from Federal sources, brought forward, October 1	(207)	(7)	(214)
Total, unpaid obligated balance, brought forward, net	773	1,370	2,143
Obligations incurred (Note 20)	2,116	10,510	12,626
Gross outlays	(2,053)	(10,420)	(12,473)
Recoveries of prior-year unpaid obligations, actual	(89)	(124)	(213)
Change in uncollected customer payments-Federal sources	(56)	(38)	(94)
Total, unpaid obligated balance, net, end of period	691	1,298	1,989
Obligated balance, net, end of period:			
Unpaid obligations	954	1,342	2,296
Uncollected customer payments from Federal sources	(263)	(44)	(307)
Total, unpaid obligated balance, net, end of period	691	1,298	1, 989
Net outlays:			
Gross outlays	2,053	10,420	12,473
Offsetting collections (Note 18)	(2,057)	(9,104)	(11,161)
Less: Distributed offsetting receipts	2,759	-	2,759
NET OUTLAYS	$ (2,763)	$ 1,316	$ (1,447)

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
COMBINED STATEMENT OF BUDGETARY RESOURCES
For the period ended September 30, 2006
(Dollars in Millions)

	2006 Budgetary	2006 Non-Budgetary	2006 Total
BUDGETARY RESOURCES			
Unobligated Balance, brought forward, October 1	$ 23,602	$ 5,891	$ 29,493
Recoveries of prior year unpaid obligations	97	6	103
Budget Authority:			
Appropriations	1,281	-	1,281
Borrowing authority	9	888	897
Spending authority from offsetting collections (gross):			
Earned	-	-	-
Collected (Note 18)	2,636	11,470	14,106
Change in receivables from Federal sources	(55)	(46)	(101)
Change in unfilled customer order w/o advance	-	-	-
Nonexpenditure transfers net (Note 19)	-	-	-
Permanently not available	(152)	(2,186)	(2,338)
TOTAL BUDGETARY RESOURCES	$ 27,418	$ 16,023	$ 43,441
STATUS OF BUDGETARY RESOURCES			
Obligations incurred, Direct (Note 20)	$ 5,028	$ 8,990	$ 14,018
Unobligated balance-Apportioned	161	2,132	2,293
Unobligated balance-Not available	22,229	4,901	27,130
TOTAL STATUS OF BUDGETARY RESOURCES	$ 27,418	$ 16,023	$ 43,441
Change in Obligated Balances			
Obligated balance, net:			
Unpaid obligations, brought forward, October 1	$ 1,067	$ 1,263	$ 2,330
Uncollected customer payments from Federal sources, brought forward, October 1	(262)	(52)	(314)
Total, unpaid obligated balance, brought forward, net	805	1,211	2,016
Obligations incurred (Note 20)	5,028	8,990	14,018
Gross outlays	(5,018)	(8,871)	(13,889)
Recoveries of prior-year unpaid obligations, actual	(97)	(6)	(103)
Change in uncollected customer payments-Federal sources	55	46	101
Total, unpaid obligated balance, net, end of period	773	1,370	2,143
Obligated balance, net, end of period:			
Unpaid obligations	980	1,377	2,357
Uncollected customer payments from Federal sources	(207)	(7)	(214)
Total, unpaid obligated balance, net, end of period	773	1,370	2,143
Net outlays:			
Gross outlays	5,018	8,871	13,889
Offsetting collections (Note 18)	(2,636)	(11,470)	(14,106)
Less: Distributed offsetting receipts	677	-	677
NET OUTLAYS	$ 1,705	(2,599)	$ (894)

The accompanying notes are an integral part of these statements.

NOTES TO FINANCIAL STATEMENTS
September 30, 2007

Note 1. Significant Accounting Policies

Entity and Mission

The Federal Housing Administration (FHA) was established under the National Housing Act of 1934 and became a wholly owned government corporation in 1948 subject to the Government Corporation Control Act, as amended. While FHA was established as a separate Federal entity, it was subsequently merged into the Department of Housing and Urban Development (HUD) when that department was created in 1965. FHA does not maintain a separate staff or facilities; its operations are conducted, along with other Housing activities, by HUD organizations. FHA is headed by HUD's Assistant Secretary for Housing/Federal Housing Commissioner, who reports to the Secretary of HUD. FHA's activities are included in the Housing section of the HUD budget.

FHA administers a wide range of activities to make mortgage financing more accessible to the home-buying public and to increase the availability of affordable housing to families and individuals, particularly to the nation's poor and disadvantaged. FHA insures private lenders against loss on mortgages, which finance Single Family homes, Multifamily projects, health care facilities, property improvements, manufactured homes, and reverse mortgages (also referred to as HECM). The objectives of the activities carried out by FHA relate directly to developing affordable housing.

FHA categorizes its activities as Single Family, Multifamily, or Title I. Single Family activities support initial or continued home ownership; Multifamily activities support high-density housing and medical facilities; Title I activities support manufactured housing and property improvement.

FHA organizes its operations into two overall program types – MMI/CMHI and GI/SRI. These program types are composed of four major funds. The Mutual Mortgage Insurance fund (MMI), FHA's largest fund, provides basic Single Family mortgage insurance and is a mutual insurance fund, whereby mortgagors, upon non-claim termination of their mortgages, share surplus premiums paid into the MMI fund that are not required for operating expenses and losses or to build equity. The Cooperative Management Housing Insurance fund (CMHI), another mutual fund, provides mortgage insurance for management-type cooperatives. The General Insurance fund (GI), provides a large number of specialized mortgage insurance activities, including insurance of loans for property improvements, cooperatives, condominiums, housing for the elderly, land development, group practice medical facilities, nonprofit hospitals, and reverse mortgages. The Special Risk Insurance fund (SRI) provides mortgage insurance on behalf of mortgagors eligible for interest reduction payments who otherwise would not be eligible for mortgage insurance.

Basis of Accounting

The principal financial statements are presented in conformity with accounting principles generally accepted in the United States of America (GAAP) applicable to Federal agencies as promulgated by the Federal Accounting Standards Advisory Board (FASAB). The recognition and measurement of budgetary resources and their status for purposes of preparing the Combined Statements of Budgetary Resources, is based on concepts and guidance provided by Office of Management and Budget (OMB) Circular A-11, *Preparation, Submission, and Execution of the Budget*. The format of the SBR is based on the SF 133, *Report on Budget Execution and Budgetary Resources*.

Basis of Consolidation

The accompanying principal financial statements include all Treasury Account Fund Symbols (TAFSs) designated to FHA, which consist of two principal program funds, six revolving funds, two general funds and a deposit fund. All inter-fund accounts receivable, accounts payable, transfers in and transfers out within these TAFSs have been eliminated to prepare the consolidated balance sheets, statements of net cost, and statements of changes in net position. The statement of budgetary resources is prepared on a combined basis as allowed by OMB Circular A-136, *Financial Reporting Requirements*.

Fund Balance with U.S. Treasury

Fund balance with U.S. Treasury consists of amounts collected and available to fund payments for expenses and of amounts collected but unavailable until authorizing legislation is enacted (see Notes 2 and 3).

Investments

FHA investments include investments in U.S. Treasury securities, Multifamily risk sharing debentures and investments in private-sector entities where FHA is a member with other parties under the Accelerated Claims Disposition Demonstration program (see Note 4).

Under current legislation, FHA invests available MMI/CMHI capital reserve fund resources in excess of its current needs in non-marketable market-based U.S. Treasury securities. These U.S. Treasury securities may not be sold on public securities exchanges, but do reflect prices and interest rates of similar marketable U.S. Treasury securities. Investments are presented at acquisition cost net of unamortized premium or discount. Amortization of the premium or discount is recognized monthly in interest income on investments in U.S. Treasury securities on the effective interest rate basis.

The Departments of Veterans Affairs and Housing and Urban Development Appropriations Act of 1999 and Section 601 of the Independent Agencies Act of 1999 provide FHA with new flexibility in reforming its Single Family claims and property disposition activities. In accordance with these Acts, FHA implemented the Accelerated Claims Disposition Demonstration program (the 601 program) to shorten the claim filing process, obtain higher recoveries from its defaulted guaranteed loans, and support the Office of Housing's mission of keeping homeowners in their home. To achieve these objectives, FHA transfers assigned mortgage notes to private sector entities in exchange for cash and equity interest. The servicing and disposition of the mortgage notes are performed by the private-sector entities whose primary mission is dedicated to these types of activity. With the transfer of assigned mortgage notes under the 601 program, FHA obtains ownership interest in the private-sector entities. This level of ownership interest enables FHA to exercise significant influence over the operating and financial policies of the entities. Accordingly, to comply with the requirement of Opinion No. 18 issued by the Accounting Principles Board (APB 18), FHA uses the equity method of accounting to measure the value of its investments in these entities. The equity method of accounting requires FHA to record its investments in the entities at cost initially. Periodically, the carrying amount of the investments is adjusted for cash distributions to FHA and for FHA's share of the entities' earnings or losses.

Multifamily Risk Sharing Debentures [Section 542(c)] is a program available to lenders. The lender shares the risk in a property by issuing debentures for claim amount paid by FHA on defaulted insured loans. HUD must approve FHA's participation in the risk sharing program and determines the portion of risk FHA assumes. If FHA's risk is over 50%, HUD must review and approve the underwriting standards, terms, and conditions of the loan. If the loan defaults, the lender has 75 days to file a claim with FHA. FHA then pays the lender the initial settlement. The initial settlement is the Unpaid Principal Balance (UPB) and interest at the note rate from the date of the default to the date of the initial settlement. On the settlement date the lender issues FHA a debenture for the amount of the settlement at the note rate (determined by the U.S. Treasury) thus sharing the risk in the property. The percentage of risk for each party is stated in the debenture. Interest is accrued monthly and is paid on the anniversary date of the initial settlement. Only interest payments are required. The term of the debenture is 5 years. The debenture can be redeemed early if the property is sold. The lender will be paid their percentage of risk sharing from the net proceeds of the sale of the property after adjustments for escrows, reserve for placement, and interest on debenture, hazard insurance and property repairs. The net amount is considered to be the final claim profit or loss.

Credit Reform Accounting

The FCRA established the use of program, financing, general fund receipt and capital reserve accounts to separately account for transactions that are not controlled by the Congressional budget process. It also established the liquidating account for activity relating to any loan guarantees committed and direct loans obligated before October 1, 1991 (pre-Credit Reform). These accounts are classified as either budgetary or non-budgetary in the Combined Statements of Budgetary Resources. The budgetary accounts include the program, capital reserve and liquidating accounts. The non-budgetary accounts consist of the credit reform financing accounts.

The program account receives and obligates appropriations to cover the subsidy cost of a direct loan or loan guarantee and disburses the subsidy cost to the financing account. The program account also receives appropriations for administrative expenses. The financing account is a non-budgetary account that is used to record all of the cash flows resulting from Credit Reform direct loans or loan guarantees. It includes loan disbursements, loan repayments and fees, claim payments, borrowing from the U.S. Treasury, interest, negative subsidy and the subsidy cost received from the program account.

The general fund receipt account is used for the receipt of amounts paid from the financing account when there is a negative subsidy from the original estimate or a downward reestimate. In most cases, the receipt account is a general fund receipt account and amounts are not earmarked for the FHA's credit programs. They are available for appropriations only in the sense that all general fund receipts are available for appropriations. Any assets in this account are non-entity assets and are offset by intragovernmental liabilities. At the beginning of the following fiscal year, the fund balance in the general fund receipt account is transferred to the U.S. Treasury general fund. The FHA general fund receipt account of the GI and SRI funds are in this category.

The liquidating account is a budget account that is used to record all cash flows to and from FHA resulting from pre-Credit Reform direct loans or loan guarantees. Liquidating account collections in any year are available only for obligations incurred during that year or to repay debt. Unobligated balances remaining in the GI and SRI liquidating funds at year-end are transferred to the U.S. Treasury's general fund. Consequently, in the event that resources in the GI/SRI liquidating account are otherwise insufficient to cover the payments for obligations or commitments, the FCRA provides that the GI/SRI liquidating account can receive permanent indefinite authority to cover any resource shortages.

Loans Receivable and Related Foreclosed Property, Net

FHA's loans receivable include mortgage notes assigned (MNA), also described as Secretary-held notes, and purchase money mortgages (PMM). Under the requirements of the FCRA, PMM notes are considered to be direct loans while MNA notes are considered to be defaulted guaranteed loans. The PMM loans are generated from the sales on credit of FHA's foreclosed properties to qualified non-profit organizations. The MNA notes are created when FHA pays the lenders for claims on defaulted guaranteed loans and takes assignment of the defaulted loans for direct collections. In addition, Multifamily and Single Family performing notes insured pursuant to Section 221(g)(4) of the National Housing Act may be assigned automatically to FHA at a pre-determined point.

In accordance with the FCRA and Statement of Federal Financial Accounting Standards (SFFAS) No. 2, *Accounting for Direct Loans and Loan Guarantees*, Credit Reform direct loans, defaulted guaranteed loans and foreclosed property are reported at the net present value of expected cash flows associated with these assets, primarily estimated proceeds less selling and maintenance costs. The difference between the cost of these loans and property and the net present value is called the allowance for subsidy cost. Pre-Credit Reform loans receivable and foreclosed property in inventory are recorded at net realizable value, which is based on historical recovery rates net of any selling expenses (see Note 6).

Loan Guarantee Liability

The net potential future losses related to FHA's central business of providing mortgage insurance are reflected in the Loan Guarantee Liability in the consolidated balance sheets. As required by SFFAS No. 2, the Loan Guarantee Liability includes the Credit Reform related Liabilities for Loan Guarantees (LLG) and the pre-Credit Reform Loan Loss Reserve (LLR) (see Note 6).

The LLG is calculated as the net present value of anticipated cash outflows and cash inflows. Anticipated cash outflows include lender claims arising from borrower defaults, (i.e., claim payments), premium refunds, property costs to maintain foreclosed properties arising from future defaults and selling costs for the properties. Anticipated cash inflows include premium receipts, proceeds from asset sales and principal and interest on Secretary-held notes.

FHA records loss estimates for its Single Family LLR (includes MMI and GI/SRI) to provide for anticipated losses incurred (e.g., claims on insured mortgages where defaults have taken place but claims have not yet been filed). Using the net cash flows (cash inflows less cash outflows), FHA computes an estimate based on conditional claim rates and loss experience data, and adjusts the estimate to incorporate management assumptions about current economic factors.

FHA records loss estimates for its Multifamily LLR (includes CMHI and GI/SRI) to provide for anticipated outflows less anticipated inflows. Using the net present value of claims less premiums, fees, and recoveries, FHA computes an estimate based on conditional claim rates, prepayment rates, and recovery assumptions based on historical experience.

Use of Estimates

The preparation of the principal financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

Amounts reported for net loans receivable and related foreclosed property and the Loan Guarantee Liability represent FHA's best estimates based on pertinent information available.

To estimate the allowance for subsidy (AFS) associated with loans receivable and related to foreclosed property and the liability for loan guarantees (LLG), FHA uses cash flow model assumptions associated with loan guarantee cases subject to the Federal Credit Reform Act of 1990 (FCRA), as described in Note 6, to estimate the cash flows associated with future loan performance. To make reasonable projections of future loan performance, FHA develops assumptions, as described in Note 6, based on historical data, current and forecasted program and economic assumptions.

Certain programs have higher risks due to increased chances of fraudulent activities perpetrated against FHA. FHA accounts for these risks through the assumptions used in the liabilities for loan guarantee estimates. FHA develops the assumptions based on historical performance and management's judgments about future loan performance.

General Property, Plant and Equipment

FHA does not maintain separate facilities. HUD purchases and maintains all property, plant and equipment used by FHA, along with other Office of Housing activities.

Current HUD policy concerning SFFAS No. 10 *Accounting for Internal Use Software* indicates that HUD will either own the software or the functionality provided by the software in the case of licensed or leased software. This includes "commercial off-the-shelf" (COTS) software, contractor-developed software, and internally developed software. FHA had several procurement actions in place and had incurred expenses for software development. FHA identified and transferred those expenses to HUD to comply with departmental policy.

Unearned Premiums

Unearned premiums are recognized for pre-Credit Reform loan guarantee premiums collected but not yet earned in the liquidating account. Premiums charged by FHA's MMI fund include up-front and annual risk-based premiums. Up-front risk-based premiums are recorded as unearned revenue upon collection and are recognized as revenue over the period in which losses and insurance costs are expected to occur. Annual risk-based premiums are recognized as revenue on a straight-line basis throughout the year. FHA's other funds charge periodic insurance premiums over the mortgage insurance term. Premiums on annual installment policies are recognized for the liquidating account on a straight-line basis throughout the year. Premiums associated with Credit Reform loan guarantees are included in the calculation of the LLG and are not included in the unearned premium amounts reported in the consolidated balance sheets.

Appropriations and Monies Received from Other HUD Programs

The National Housing Act of 1990, as amended, provides for appropriations from Congress to finance the operations of GI and SRI funds. For Credit Reform loan guarantees, appropriations to the GI and SRI funds are provided at the beginning of each fiscal year to cover estimated losses on insured loans during the year. For pre-Credit Reform loan guarantees, FHA has permanent indefinite appropriation authority to finance any shortages of resources needed for operations.

Monies received from other HUD programs, such as interest subsidies and rent supplements are recorded as revenue for the liquidating accounts when services are rendered. Monies received for the financing accounts are recorded as additions to the LLG or the Allowance for Subsidy (AFS) when collected.

Full Cost Reporting

SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards*, requires that Federal agencies report the full cost of program outputs in the financial statements. Full cost reporting includes all direct, indirect, and inter-entity costs. For purposes of HUD's consolidated financial statements, HUD identifies each responsibility segment's share of the program costs or resources provided by other Federal agencies. As a responsibility segment of HUD, FHA's portion of these costs was $19 million for fiscal year 2007 and $23 million for fiscal year 2006, and was included in FHA's financial statements as an imputed cost in the Consolidated Statements of Net Cost, and an imputed financing in the Consolidated Statements of Changes in Net Position. An additional $18 million was included in fiscal year 2007 for a legal judgment paid by judgment fund on FHA's behalf.

In a separate effort, FHA conducts time allocation surveys of all Office of Housing operational managers. These surveys determine FHA's direct personnel costs associated with the Housing Salaries and Expenses (S&E) transfer to HUD and where to allocate these costs between the MMI/CMHI and GI/SRI programs. The HUD Chief Financial Officer (CFO) office also conducts surveys to determine how the department's fiscal year overhead, Office of Inspector General, and Working Capital Fund costs, which are paid for by S&E transfer, should be accounted for by responsibility segments. This data is an integral part of the FHA direct cost S&E allocation prepared for financial statement reporting.

Distributive Shares

As mutual funds, excess revenues in the MMI Fund and CMHI Fund may be distributed to mortgagors at the discretion of the Secretary of HUD. Such distributions are determined based on the funds' financial positions and their projected revenues and costs. As previously discussed, in November 1990, Congress passed the NAHA, which effectively suspended payment of distributive shares from the MMI fund, other than those already declared by the Secretary, until the fund meets certain Capital Ratio requirements. Although the Capital Ratio requirement has been met since September 30, 1995, no distributive shares have been declared from the MMI fund because legislation is not yet enacted.

Liabilities Covered by Budgetary Resources

Liabilities of federal agencies are required to be classified as those covered and not covered by budgetary resources, as defined by OMB Circular A-136, and in accordance with SFFAS No. 1, *Selected Assets and Liabilities*. In the event that available resources are insufficient to cover liabilities due at a point in time, FHA has authority to borrow monies from the U.S. Treasury (for post-1991 loan guarantees) or to draw on permanent indefinite appropriations (for pre-1992 loan guarantees) to satisfy the liabilities. Thus, all of FHA’s liabilities are considered covered by budgetary resources.

Statement of Budgetary Resources

The Statement of Budgetary Resources has been prepared as a combined statement and as such, intra-entity transactions have not been eliminated. Budget authority is the authorization provided by law to enter into obligations to carry out the guaranteed and direct loan programs and their associated administrative costs, which would result in immediate or future outlays of federal funds. FHA's budgetary resources include current budgetary authority (i.e., appropriations and borrowing authority) and unobligated balances brought forward from multi-year and no-year budget authority received in prior years, and recoveries of prior year obligations. Budgetary resources also include spending authority from offsetting collections credited to an appropriation or fund account.

Unobligated balances associated with appropriations that expire at the end of the fiscal year remain available for obligation adjustments, but not for new obligations, until that account is canceled. When accounts are canceled, five years after they expire, amounts are not available for obligations or expenditure for any purpose.

FHA funds its programs through borrowings from the U.S. Treasury and debentures issued to the public. These borrowings and debentures are authorized through a permanent indefinite authority at interest rates set each year by the U.S. Treasury and the prevailing market rates.

Note 2. Non-entity Assets

Non-entity assets consist of assets that belong to other entities but are included in FHA's consolidated balance sheets. To reflect FHA's net position accurately, these non-entity assets are offset by various liabilities. FHA's non-entity assets as of September 30, 2007 and 2006 are as follows:

(Dollars in millions)

		2007		2006
Intragovernmental:				
Fund Balance with U.S. Treasury	$	2,828	$	731
Investments in U.S. Treasury Securities		5		5
Total Intragovernmental		2,833		736
Other Assets		110		111
Total Non-entity Assets		2,943		847
Total Entity Assets		34,222		36,446
Total Assets	$	**37,165**	$	**37,293**

FHA's non-entity assets consist of FHA's U.S. Treasury deposit of negative credit subsidy in the GI/SRI general fund receipt account and of escrow monies collected by FHA from the borrowers of its loans.

According to the FCRA, FHA transfers negative credit subsidy from new endorsements and downward credit subsidy reestimates from the GI/SRI financing account to the GI/SRI general fund receipt account. At the beginning of each fiscal year, fund balance in the GI/SRI general fund receipt account is transferred into the U.S. Treasury's general fund.

Other assets consisting of escrow monies collected from FHA borrowers are either deposited at the U.S. Treasury or Minority-owned banks or invested in U.S. Treasury securities. Subsequently, FHA disburses these escrow monies to pay for property taxes, property insurance or maintenance expenses on behalf of the borrowers.

Note 3. Fund Balance with U.S. Treasury

FHA's fund balance with U.S. Treasury was composed of the following as of September 30, 2007 and 2006:

(Dollars in millions)

		2007		2006
Fund Balances:				
Revolving Funds	$	6,450	$	9,393
Appropriated Funds		321		408
Other Funds		2,788		767
Total	$	**9,559**	$	**10,568**
Status of Fund Balance with U.S. Treasury:				
Unobligated Balance:				
Available		1,180		2,292
Unavailable		6,083		5,919
Obligated Balance not yet Disbursed		2,296		2,357
Total	$	**9,559**	$	**10,568**

Revolving Funds

FHA's revolving funds include the liquidating and financing accounts as required by the FCRA. These funds are created to finance a continuing cycle of business-like operations in which the fund charges for the sale of products or services. These funds also use the proceeds to finance spending, usually without requirement of annual appropriations.

Appropriated Funds

FHA's appropriated funds consist of the program accounts created by the FCRA. Annual or multi-year program accounts expire at the end of the time period specified in the authorizing legislation. For the subsequent five fiscal years after expiration, the resources are available only to liquidate valid obligations incurred during the unexpired period. Adjustments are allowed to increase or decrease valid obligations incurred during the unexpired period that were not previously reported. At the end of the fifth expired year, the annual and multi-year program accounts are cancelled and any remaining resources are returned to the U.S. Treasury.

Other Funds

FHA's other funds include the general fund receipt accounts established under the FCRA. Additionally, included with these funds is the capital reserve account that is used to retain the MMI/CMHI negative subsidy and downward credit subsidy reestimates transferred from the financing account. If subsequent upward credit subsidy reestimates are calculated in the financing account or there is shortage of budgetary resources in the liquidating account, the capital reserve account will return the retained negative subsidy to the financing account or transfer the needed funds to the liquidating account, respectively.

Status of Fund Balance with U.S. Treasury

Unobligated Fund Balance with U.S. Treasury represents Fund Balance with U.S. Treasury that has not been obligated to purchase goods or services either because FHA has not received apportionment authority from OMB to use the resources (unavailable unobligated balance) or because FHA has not obligated the apportioned resources (available unobligated balance). Fund Balance with U.S. Treasury that is obligated, but not yet disbursed, consists of resources that have been obligated for goods or services but not yet disbursed either because the ordered goods or services have not been delivered or because FHA has not yet paid for goods or services received by the end of the fiscal year.

Note 4. Investments

Investment in U.S. Treasury Securities

As discussed in Note 1, all FHA investments in Treasury securities are in non-marketable securities issued by the U.S. Treasury. These securities carry market-based interest rates. The market value of these securities is calculated using the bid amount of similar marketable U.S. Treasury securities as of September 30. The cost, par value, net unamortized discount, net investment, and market values of FHA's investments in U.S. Treasury securities as of September 30, 2007 were as follows:

(Dollars in millions)

	Cost	Par Value	Unamortized Premium (Discount), Net	Investment, Net	Market Value
MMI/CMHI Investments	$ 22,129	$ 22,405	$ (191)	$ 22,214	$ 22,667
GI/SRI Investments	5	5	-	5	5
Subtotal	22,134	22,410	(191)	22,219	22,672
MMI/CMHI Accrued Interest	-	-	-	262	-
Total	**$ 22,134**	**$ 22,410**	**$ (191)**	**$ 22,481**	**$ 22,672**

The cost, par value, net unamortized discount, net investment, and market values as of September 30, 2006 were as follows:

(Dollars in millions)

	Cost	Par Value	Unamortized Premium (Discount), Net	Investment, Net	Market Value
MMI/CMHI Investments	$ 21,715	$ 22,030	$ (223)	$ 21,807	$ 21,987
GI/SRI Investments	6	6	-	6	6
Subtotal	21,721	22,036	(223)	21,813	21,993
MMI/CMHI Accrued Interest	-	-	-	199	-
Total	**$ 21,721**	**$ 22,036**	**$ (223)**	**$ 22,012**	**$ 21,993**

Investments in Private-Sector Entities

The following table presents financial data on FHA's investments in private-sector entities as of September 30, 2007 and 2006:

(Dollars in millions)

	Beginning Balance	New Acquisitions	Share of Earnings or Losses	Return of Investment	Other Adjustments	Ending Balance
2007	$ 98	$ -	$ (1)	$ (56)	$ -	$ 41
2006	$ 201	$ 49	$ 15	$ (167)	$ -	$ 98

The fiscal year for these private-sector entities is from January 1 to December 31. Their condensed, audited financial information as of December 31, 2006 and 2005 are as follows:

(Dollars in millions)	**2007**	**2006**
Total assets, primarily mortgage loans	$ 258	$ 422
Liabilities	2	3
Partners' capital	256	419
Total liabilities and partners' capital	$ 258	$ 422
Revenues	78	184
Expenses	(23)	(20)
Net Income	$ 55	$ 164

This table of investments consists of the debentures issued to FHA by lenders participating in the Multifamily Risk-Sharing program under Section 542(c) as of September 30, 2007. The cost is the amount paid at settlement date.

(Dollars in millions)

	Beginning Balance	Debentures Acquired	Debentures Redeemed	Ending Balance
Debentures	$ -	$ 80	$ -	$ 80
Total	**$ -**	**$ 80**	**$ -**	**$ 80**

Note 5. Accounts Receivable, Net

Accounts receivable, net, as of September 30, 2007 and 2006 are as follows:

	Gross		Allowance		Net	
(Dollars in millions)	**2007**	**2006**	**2007**	**2006**	**2007**	**2006**
From the Public:						
Receivables related to credit program assets	$ 6	$ 73	$ (5)	$ (4)	$ 1	$ 69
Premiums receivable	97	50	-	-	97	50
Miscellaneous receivables	21	127	-	(78)	21	49
Total	**$ 124**	**$ 250**	**$ (5)**	**$ (82)**	**$ 119**	**$ 168**

Receivables Related to Credit Program Assets

These receivables include sale proceeds receivable and rents receivable from FHA's foreclosed properties. The sale proceeds receivable should be differentiated from the PMM notes receivables, which are created by the sales of FHA's foreclosed properties on credit to qualifying non-profit organizations.

Premiums Receivable

These amounts consist of the up-front and periodic premiums due to FHA from the mortgagors at the end of the reporting period. The details of FHA premium structure are discussed in Note 13 – Earned Revenue/Premium Revenue.

Miscellaneous Receivables

Miscellaneous receivables include late charges and penalties receivable on premiums receivable, generic debt receivables, refunds receivable from overpayments of claims and distributive shares and other immaterial receivables.

Allowance for Loss

The allowance for loss for these receivables is calculated based on FHA's historical loss experience and management's judgment concerning current economic factors.

Note 6. Direct Loans and Loan Guarantees, Non-Federal Borrowers

FHA Direct Loan and Loan Guarantee Programs and the related loans receivable, foreclosed property, and Loan Guarantee Liability as of September 30, 2007 and 2006 are as follows:

Direct Loan and Loan Guarantee Programs Administered by FHA Include:

MMI/CMHI Direct Loan Program
GI/SRI Direct Loan Program
MMI/CMHI Loan Guarantee Program
GI/SRI Loan Guarantee Program

Direct Loans Obligated Prior to Fiscal Year 1992 (Allowance for Loss Method):

(Dollars in millions)

Direct Loan Programs	Loans Receivable, Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	Value of Assets Related to Direct Loans
FY 2007:					
MMI/CMHI	$ 1	$ 1	$ (1)	$ -	$ 1
GI/SRI	15	4	(6)	-	13
Total	**$ 16**	**$ 5**	**$ (7)**	**$ -**	**$ 14**
FY 2006:					
MMI/CMHI	$ 3	$ -	$ (2)	$ -	$ 1
GI/SRI	14	3	(5)	-	12
Total	**$ 17**	**$ 3**	**$ (7)**	**$ -**	**$ 13**

Direct Loans Obligated After Fiscal Year 1991:

(Dollars in millions)

Direct Loan Programs	Loans Receivable, Gross	Interest Receivable	Foreclosed Property	Allowance for Subsidy Cost	Value of Assets Related to Direct Loans
FY 2007:					
MMI/CMHI	$ 1	$ -	$ -	$ (3)	$ (2)
GI/SRI	-	-	-	-	
Total	**$ 1**	**$ -**	**$ -**	**$ (3)**	**$ (2)**
FY 2006:					
MMI/CMHI	$ 1	$ -	$ -	$ (3)	$ (2)
GI/SRI	-	-	-	-	-
Total	**$ 1**	**$ -**	**$ -**	**$ (3)**	**$ (2)**

Total Amount of Direct Loans Disbursed (Post-1991):

(Dollars in millions)

Direct Loan Programs	FY 2007	FY 2006
MMI/CMHI	$ 3	$ 3
GI/SRI	-	-
Total	**$ 3**	**$ 3**

Defaulted Guaranteed Loans from Pre-1992 Guarantees (Allowance for Loss Method):

(Dollars in millions)

Loan Guarantee Programs	Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	Value of Assets Related to Defaulted Guaranteed Loans Receivable, Net
FY 2007:					
MMI/CMHI	$ 10	$ 4	$ (2)	$ 4	$ 16
GI/SRI	2,979	208	(802)	5	2,390
Total	**$ 2,989**	**$ 212**	**$ (804)**	**$ 9**	**$ 2,406**
FY 2006:					
MMI/CMHI	$ 4	$ -	$ (1)	$ 6	$ 9
GI/SRI	2,974	135	(818)	8	2,299
Total	**$ 2,978**	**$ 135**	**$ (819)**	**$ 14**	**$ 2,308**

Defaulted Guaranteed Loans from Post-1991 Guarantees:

(Dollars in millions)

Loan Guarantee Programs	Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Foreclosed Property	Allowance for Subsidy Cost	Value of Assets Related to Defaulted Guaranteed Loans
FY 2007:					
MMI/CMHI	$ 331	$ -	$ 2,710	$ (1,661)	$ 1,380
GI/SRI	542	186	330	(118)	940
Total	**$ 873**	**$ 186**	**$ 3,040**	**$ (1,779)**	**$ 2,320**
FY 2006:					
MMI/CMHI	$ 341	$ -	$ 2,539	$ (1,257)	$ 1,623
GI/SRI	576	48	350	(633)	341
Total	**$ 917**	**$ 48**	**$ 2,889**	**$ (1,890)**	**$ 1,964**

Guaranteed Loans Outstanding:

(Dollars in millions)

Loan Guarantee Programs	Outstanding Principal of Guaranteed Loans, Face Value	Amount of Outstanding Principal Guaranteed
FY 2007		
Guaranteed Loans Outstanding:		
MMI/CMHI	$ 352,200	$ 322,152
GI/SRI	86,673	77,808
Total	**$ 438,873**	**$ 399,960**
FY 2006		
Guaranteed Loans Outstanding:		
MMI/CMHI	$ 346,658	$ 317,249
GI/SRI	87,412	78,522
Total	**$ 434,070**	**$ 395,771**
FY 2007		
New Guaranteed Loans Disbursed:		
MMI/CMHI	$ 56,510	$ 56,167
GI/SRI	7,001	6,971
Total	**$ 63,511**	**$ 63,138**
FY 2006		
New Guaranteed Loans Disbursed:		
MMI/CMHI	$ 51,780	$ 50,585
GI/SRI	9,846	9,140
Total	**$ 61,626**	**$ 59,725**

HECM (reverse mortgages) are not included in the above table due to the unique nature of the program. Since the inception of the program, FHA has insured 335,798 HECM loans with a maximum claim amount of $67 billion. Of these 335,798 HECM loans insured by FHA, 259,365 loans with a maximum claim amount of $57 billion are still active. As of September 30, 2007 the insurance in force (the outstanding balance of active loans) was $30 billion. The insurance in force includes balances drawn by the mortgagee; interest accrued on the balances drawn, service charges, and mortgage insurance premiums. The maximum claim amount is the dollar ceiling to which the outstanding loan balance can grow before being assigned to FHA.

Home Equity Conversion Mortgage Loans Outstanding (not included in the balances above):

(Dollars in millions)

Loan Guarantee Programs		New Guaranteed Loans	Cumulative: Guaranteed Balance Outstanding	Cumulative: Maximum Potential Liability
FY 2007	GI/SRI	$ 24,567	$ 29,982	$ 56,676
FY 2006	GI/SRI	$ 17,994	$ 18,295	$ 35,878

Loan Guarantee Liability, Net:

(Dollars in millions)

Loan Guarantee Programs	Liabilities for Losses on Pre-1992 Guarantees, Estimated Future Default Claims (LLR)	Liabilities for Loan Guarantees for Post-1991 Guarantees (LLG)	Total Loan Guarantee Liability, Net
FY 2007:			
MMI/CMHI	$ 89	$ 6,902	$ 6,991
GI/SRI	282	158	440
Total	**$ 371**	**$ 7,060**	**$ 7,431**
FY 2006:			
MMI/CMHI	$ 51	$ 2,828	$ 2,879
GI/SRI	447	156	603
Total	**$ 498**	**$ 2,984**	**$ 3,482**

Subsidy Expense for Loan Guarantee by Program and Component:
(Dollars in millions)

Subsidy Expense for New Loan Guarantees	Defaults	Fees and Other Collections	Other	Total
FY 2007:				
MMI/CMHI	$ 1,249	$ (2,125)	$ 667	$ (209)
GI/SRI	754	(1,569)	-	(815)
Total	**$ 2,003**	**$ (3,694)**	**$ 667**	**$ (1,024)**
FY 2006:				
MMI/CMHI	$ 818	$ (2,076)	$ 378	$ (880)
GI/SRI	647	(1,138)	-	(491)
Total	**$ 1,465**	**$ (3,214)**	**$ 378**	**$ (1,371)**

Subsidy Expense for Modifications and Reestimates	Total Modifications	Technical Reestimates
FY 2007:		
MMI/CMHI	$ (5)	$ 3,940
GI/SRI	-	(310)
Total	**$ (5)**	**$ 3,630**
FY 2006:		
MMI/CMHI	$ (9)	$ 1,531
GI/SRI	-	(1,110)
Total	**$ (9)**	**$ 421**

Total Loan Guarantee Subsidy Expense	2007	2006
MMI/CMHI	$ 3,726	$ 642
GI/SRI	(1,125)	(1,601)
Total	**$ 2,601**	**$ (959)**

Subsidy Rates for Loan Guarantees by Program and Component:
(Percentage)

	Defaults	Fees and Other Collections	Other	Total
Budget Subsidy Rates for Loan Guarantees of FY 2007 Cohort:				
MMI/CMHI	2.21	(3.76)	1.18	(0.37)
GI/SRI	2.28	(4.75)	-	(2.47)
Budget Subsidy Rates for Loan Guarantees of FY 2006 Cohort:				
MMI/CMHI	1.58	(4.01)	0.73	(1.70)
GI/SRI	2.32	(4.09)	-	(1.77)

Schedule for Reconciling Loan Guarantee Liability Balances:

(Dollars in millions)	2007 LLR	2007 LLG	2006 LLR	2006 LLG
Beginning Balance of the Loan Guarantee Liability	**$ 498**	**$ 2,984**	**$ 1,217**	**$ 3,367**
Add: Subsidy Expense for guaranteed loans disbursed during the reporting fiscal years by component:				
Default Costs (Net of Recoveries)	-	2,003	-	1,465
Fees and Other Collections	-	(3,694)	-	(3,214)
Other Subsidy Costs	-	667	-	378
Total of the above subsidy expense components	**-**	**(1,024)**	**-**	**(1,371)**
Adjustments:				
Fees Received	-	3,234	-	2,819
Foreclosed Property and Loans Acquired	-	3,756	-	4,011
Claim Payments to Lenders	-	(5,869)	-	(6,296)
Interest Accumulation on the Liability Balance	-	(68)	-	35
Other	-	(6)	-	13
Ending Balance before Reestimates	**498**	**3,007**	**1,217**	**2,578**
Add or Subtract Subsidy Reestimates by Component:				
Technical/Default Reestimate:				
Subsidy Expense Component	(127)	3,571	(719)	(677)
Interest Expense Component	-	381	-	(269)
Adjustment to credit subsidy reestimates	**-**	101	**-**	**1,352**
Total Technical/Default Reestimate	**(127)**	**4,053**	**(719)**	**406**
Ending Balance of the Loan Guarantee Liability	**$ 371**	**$ 7,060**	**$ 498**	**$ 2,984**

Administrative Expense:

(Dollars in millions)	2007	2006
MMI/CMHI	$ 221	$ 227
GI/SRI	273	274
Total	**$ 494**	**$ 501**

Other Information on Foreclosed Property:

Additional information on FHA foreclosed property as of September 30, 2007 and 2006 is as follows:

	2007	2006
Number of properties in foreclosure process	84	120
Number of properties held	27,782	27,539
Average holding period for property held	6 Months	6 Months

Pre-Credit Reform Valuation Methodology

FHA values its Pre-Credit Reform related notes and properties in inventory at net realizable value, determined on the basis of net cash flows. To value these items, FHA uses historical claim data, revenues from premiums and recoveries, and expenses of selling and maintaining property.

The majority of FHA's Pre-Credit Reform liability relates to the Mark-to-Market program. A separate analysis was conducted to adjust the loan loss estimate for anticipated reductions for these project-based Section 8 rental assistance subsidies administered by the Office of Affordable Housing Preservation (OAHP). All projects that are required to submit financial statements and have submitted annual financial statements within the past two years, received Section 8 assistance, expected to expire in the next five years, and had contract rents exceeding 100 percent of fair market value were included. In the analysis, the gross rent for these projects was reduced to bring the contract rent for assisted units to fair market levels. The effects of this rent reduction on projects' financial health was assessed and a revised loan principal balance was computed based on a sustainable debt service level. A potential claim was calculated based on this reduction of loan principal.

Credit Reform Valuation Methodology

FHA values its Credit Reform LLG and related receivables on notes and properties in inventory at the net present value of their estimated future cash flows.

To apply the present value computations, FHA divides the loans into cohorts and risk categories. Multifamily cohorts are defined based on the year in which loan guarantee commitments are made. Single Family mortgages are grouped into cohorts based on loan endorsement dates for the GI/SRI fund and commitment dates for the MMI fund. Within each cohort year, loans are subdivided by risk categories. Each risk category has characteristics that distinguish it from others, including risk profile, premium structure, and the type and quality of collateral underlying the loan.

The cash flow estimates that underlie the present value calculations are determined using the significant assumptions detailed below.

Significant Assumptions – FHA developed financial models in order to estimate the present value of future program cash flows. The models incorporate information on the cash flows' expected magnitude and timing. The models rely heavily on the following loan performance assumptions:

- <u>Conditional Termination Rates:</u> The estimated probability of an insurance policy claim or non-claim termination in each year of the loan guarantee's term.
- <u>Recovery Rates:</u> The estimated percentage of a claim payment that is recovered through disposition of a mortgage note or underlying property.
- <u>Conditional Claim Amount:</u> The estimated amount of the claim payment relative to the unpaid principal balance at the time the claim occurs.

Additional information about loan performance assumptions is provided below:

<u>Sources of data</u>: FHA developed assumptions for claim rates, prepayment rates, claim amounts, and recoveries based on historical data obtained from its systems.

<u>Economic assumptions</u>: Forecasts of economic conditions used in conjunction with loan-level data to generate Single Family and Multifamily claim and prepayment rates were obtained from Global Insights (formerly DRI)

forecasts of U.S. annual economic figures. OMB provides other economic assumptions used, such as discount rates.

<u>Reliance on historical performance</u>: FHA relies on the average historical performance of its insured portfolio to forecast future performance of that portfolio. Changes in legislation, subsidy programs, tax treatment and economic factors all influence loan performance. FHA assumes that similar events may occur during the remaining life of existing mortgage guarantees, which can be as long as 40 years for Multifamily programs and affect loan performance accordingly.

<u>Current legislation and regulatory structure</u>: FHA's future plans allowed under current legislative authority have been taken into account in formulating assumptions when relevant. In contrast, future changes in legislative authority may affect the cash flows associated with FHA insurance programs. These changes cannot be reflected in LLG calculations because of uncertainty over their nature and outcome.

<u>Discount rates</u>: The disbursement weighted interest rate on U.S. Treasury securities of maturity comparable to the guaranteed loan term is the discount factor used in the present value calculation for cohorts 1992 to 2000. For the 2001 and future cohorts, the rate on U.S. Treasury securities of maturity comparable to the term of each cash flow for the loan guarantee is used in the present value calculation. This methodology is referred to as the basket of zeros discounting methodology. OMB provides these rates to all Federal agencies for use in preparing credit subsidy estimates and requires their use under OMB Circular A-11, Part 4, “Instructions on Budget Execution.” The basket of zeros discount factors are also disbursement weighted.

Analysis of Change in the Liability for Loan Guarantees

FHA has estimated and applied credit subsidy rates to each FHA loan guarantee program since fiscal year 1992. Over this time FHA’s credit subsidy rates have varied. The variance is caused by three factors: (1) additional loan performance data underlying the credit subsidy rate estimates, (2) revisions to the calculation methodology used to estimate the credit subsidy rates, and (3) revisions on expected claims and prepayments derived from the revised Actuarial Review of the MMI Fund. Loan performance data, which reflect mortgage market performance and FHA policy direction, are added as they become available. Revisions to the estimation methodology result from legislative direction and technical enhancements.

FHA estimated the credit subsidy rates for the 2007 cohort in fiscal year 2005. At the time of budget submission, the rates reflected prevailing policy and loan performance assumptions based on the most recent information available. These credit subsidy rates can be reconciled to the credit subsidy rates estimated at the end of 2007. Credit subsidy reestimates allow FHA to adjust the LLG and subsidy expense to reflect the most current and accurate credit subsidy rate.

Described below are the programs that comprise the majority of FHA’s fiscal year 2007 business. In addition, the Hospital Insurance program is also described. These descriptions highlight the factors that contributed to changing credit subsidy rates and the credit subsidy reestimate. Overall, FHA’s liability increased by $4 billion from the fiscal year 2006 estimates.

Mutual Mortgage Insurance (MMI) - During fiscal year 2007, FHA continued to experience increased claim rates due to two factors: (1) increased insurance of loans with down payment assistance, and (2) the nationwide decrease in house price appreciation, which results in increased claims and lower proceeds from the sale of foreclosed properties. The decline in proceeds is also attributable to loans where borrowers received down payment assistance from seller-financed nonprofits. A recent Internal Revenue Service ruling that had withdrawn nonprofit status from such entities has not reduced the incidence of these loans.

GI/SRI Home Equity Conversion Mortgage (HECM) - As the HECM volume increased significantly during fiscal year 2007, the HECM liability also increased from $123 million in fiscal year 2006 to $169 million in fiscal year 2007.

GI/SRI Section 221(d)(4) - The Section 221(d)(4) program was established to provide mortgage insurance for the construction or substantial rehabilitation of Multifamily rental properties with five or more units. Under this program, HUD may insure up to 90 percent of the total project cost and is prohibited from insuring loans with HUD-subsidized interest rates. The Section 221(d)(4) program is the largest Multifamily program in the GI/SRI fund. The Section 221(d)(4) liability decreased in FY 2007 and was impacted by the improved risk profile of cohorts 2002 through 2004.

Mark-to-Market – The Mark to Market (MTM) program was established by legislation to assess rents at the time of Section 8 Assistance contract renewal. If rents are above market levels, the project is referred to OAHP. OAHP then evaluates the project for potential financial restructuring to determine if the project could survive given the lower revenues from reduced rents. The MTM liability decreased in fiscal year 2007 as a result of a reduced pool of loans that are eligible for restructuring. This eligible pool is comprised of active loans with Section 8 assistance and FHA insurance. However, since Section 8 assistance is no longer offered to newly endorsed loans, the number of existing FHA-insured and assisted loans continues to shrink every year, thereby reducing the number of loans eligible for MTM restructuring.

GI/SRI Section 234(c) - The Section 234(c) program insures loans for condominium purchases. One of the many purposes of FHA's mortgage insurance programs is to encourage lenders to make affordable mortgage credit available for non-conventional forms of ownership. Condominium ownership, in which the separate owners of the individual units jointly own the development's common areas and facilities, is one particularly popular alternative. Historically, the program generates a reduction in credit subsidy expense ($95 million in fiscal year 2006). As in the MMI fund, the projected losses from future foreclosures were significantly increased to factor the decrease in proceeds and the additional losses from down payment assistance loans. These changes resulted in a liability of $107 million for fiscal year 2007.

Hurricane Cost Estimate

At the end of fiscal year 2005 the damage assessments for hurricane Katrina were not complete and there was not sufficient information for FHA to reasonably estimate the losses or predict the liability. This was subsequently addressed during the preparation of the fiscal year 2007 budget, at which time OMB included additional liability estimates for hurricane Katrina. These additional amounts were apportioned by OMB and recorded by FHA during fiscal year 2006. This adjustment resulted in an additional $250 million added to the GI/SRI reestimate and an additional $1.1 billion added to the MMI/CMHI reestimate, which was combined with current year cost estimates for the MMI and GI/SRI funds to provide for the total liability to the LLG and LLR of $3.5 billion for fiscal year 2006.

Single Family Hurricane Cost

FHA evaluated all open default cases from the hurricane-impacted areas as of August 31, 2007. The various status categories found for these default cases was used to estimate number of claims and cost for each category. Based on this evaluation, FHA estimated 2,548 total claims (including failed loss mitigation actions) with an unpaid principal balance of $203.1 million. FHA program offices estimated a 62% loss rate for these properties, which is higher than the normal loss rate of 36% in the national portfolio. The 62% loss rate was taken from the pool of not-for-profit sales in the MMI fund in fiscal year 2006. Based on this evaluation and assumptions the estimated net present value hurricane cost is $139.05 million.

Multifamily Hurricane Cost
Impacted properties included in the Multifamily hurricane cost estimate were determined from physical inspections conducted by FHA's Office of Multifamily Housing Programs. During fiscal year 2007, it was determined no additional Multifamily liabilities related to Hurricane Katrina were required.

Note 7. Other Assets

The following table presents the composition of other assets held by FHA as of September 30, 2007 and 2006:

(Dollars in millions)

		2007		2006
Intragovernmental:				
Advances to HUD for Working Capital Fund Expenses	$	4	$	24
Total	**$**	**4**	**$**	**24**
With the Public:				
Escrow Monies Deposited at Minority-Owned Banks	$	110	$	110
Undistributed Charges		33		30
Total	$	**143**	$	**140**

Advances to HUD for Working Capital Fund Expenses

The Working Capital Fund was established by HUD to consolidate, at the department level, the acquisition of certain property and equipment to be used by different organizations within HUD. Advances to HUD for Working Capital Fund expenses represent the amount of payments made by FHA to reimburse the HUD Working Capital Fund for its share of the fund's expenses prior to the receipt of goods or services from this fund.

Escrow Monies Deposited at Minority-Owned Banks

FHA holds in trust escrow monies received from the borrowers of its Multifamily mortgage notes to cover property repairs and renovations expenses. These escrow monies are deposited at the U.S. Treasury (see Note 2), invested in U.S. Treasury securities (see Note 4 - GI/SRI Investments) or deposited at minority-owned banks.

Undistributed Charges

Undistributed charges include FHA disbursements processed by the U.S. Treasury but the identification of the specific FHA operating area associated with the disbursement has not been determined by the end of the reporting period. When the FHA operating area that initiated the disbursement is identified, the undistributed charges are reclassified by recognizing new expenses or by liquidating previously established accounts payable.

Note 8. Accounts Payable

Accounts payable as of September 30, 2007 and 2006 are as follows:

(Dollars in millions)

		2007		2006
With the Public:				
Claims Payable	$	224	$	206
Premium Refunds and Distributive Shares Payable		81		84
Disbursements in Transit		61		46
Miscellaneous Payables		19		60
Total	$	**385**	$	**396**

Claims Payable

Claims payable represents the amount of claims that have been processed by FHA, but the disbursement of payment to lenders has not taken place at the end of the reporting period.

Premium Refunds and Distributive Shares Payable

Premium refunds payable are refunds of previously collected Single Family premiums that will be returned to the borrowers resulting from prepayment of the insured mortgages. Distributive shares payable represents the amount of excess revenues in the liquidating account of the CMHI fund that is to be distributed to the mortgagors at the discretion of the Secretary of HUD.

Disbursements in Transit

Disbursements in transit represent the payments recorded in FHA financial systems that have not been processed by the U.S. Treasury. The disbursements in transit will be reclassified into the reductions of the Fund Balance with U.S. Treasury once the disbursements are confirmed as paid by the U.S. Treasury.

Miscellaneous Payables

Miscellaneous payables include interest enhancement payables, interest penalty payables for late payment of claims, generic debt payables and other payables related to various operating areas within FHA.

Note 9. Debt

The following tables describe the composition of debt held by FHA as of September 30, 2007 and 2006:

(Dollars in millions)	2006			2007	
	Beginning Balance	**Net Borrowing**	**Ending Balance**	**Net Borrowing**	**Ending Balance**
Agency Debt:					
Debentures Issued to Claimants	$ 132	$ (37)	$ 95	$ (25)	$ 70
Other Debt:					
Borrowings from U.S. Treasury	7,548	(1,290)	6,258	(1,685)	4,573
Total	**$ 7,680**	**$ (1,327)**	**$ 6,353**	**$ (1,710)**	**$ 4,643**

	2007	**2006**
Classification of Debt:		
Intragovernmental Debt	$ 4,573	$ 6,258
Debt held by the Public	70	95
Total	**$ 4,643**	**$ 6,353**

Debentures Issued to Public

The National Housing Act authorizes FHA, in certain cases, to issue debentures in lieu of cash to settle claims. FHA-issued debentures bear interest at rates established by the U.S. Treasury. Interest rates related to the outstanding debentures ranged from 4.00 percent to 12.875 percent in both fiscal years 2007 and 2006. Lenders may redeem FHA debentures prior to maturity in order to pay mortgage insurance premiums to FHA, or they may be called with the approval of the Secretary of the U.S. Treasury.

The par value of debentures outstanding at September 30 was $70 million in fiscal year 2007 and $95 million in fiscal year 2006. The fair values for fiscal years 2007 and 2006 were $101 and $143 million, respectively.

Borrowings from U.S. Treasury

In accordance with Credit Reform accounting, FHA borrows from the U.S. Treasury when cash is needed in its financing accounts. Usually, the need for cash arises when FHA has to transfer the negative credit subsidy amounts related to new loan disbursements, and existing loan modifications from the financing accounts to the general fund receipt account (for cases in GI/SRI funds) or to the liquidating account (for cases in MMI/CMHI funds). In some instances, borrowings are also needed to transfer the credit subsidy related to downward reestimates from the GI/SRI financing account to the GI/SRI receipt account or when available cash is less than claim payments due.

During fiscal year 2007, FHA's U.S. Treasury borrowings carried interest rates ranging from 2.33 percent to 7.34 percent. In fiscal year 2006 the carried interest rates ranged from 2.41 percent to 7.36 percent. Fiscal year 2007 maturity dates occur from August 2010 – April 2027. Loans may be repaid in whole or in part without penalty at any time prior to maturity.

Note 10. Other Liabilities

The following table describes the composition of other liabilities as of September 30, 2007 and 2006:

(Dollars in millions)	Current		Non-Current		Total	
	2007	**2006**	**2007**	**2006**	**2007**	**2006**
Intragovernmental:						
Special Receipt Account Liability	$ 3,657	$ 2,486	$ -	$ -	$ 3,657	$ 2,486
Total	**$ 3,657**	**$ 2,486**	**$ -**	**$ -**	**$ 3,657**	**$ 2,486**
With the Public:						
Trust and Deposit Liabilities	$ 155	$ 170	$ -	$ -	$ 155	$ 170
Unearned Premiums	24	21	7	120	31	141
Undistributed Credits	48	50	-	-	48	50
Miscellaneous Liabilities	240	216	-	-	240	216
Total	**$ 467**	**$ 457**	**$ 7**	**$ 120**	**$ 474**	**$ 577**

Special Receipt Account Liability

The special receipt account liability is created from negative subsidy endorsements and downward credit subsidy in the GI/SRI special receipt account.

Trust and Deposit Liabilities

Trust and deposit liabilities include mainly escrow monies received by FHA for the borrowers of its mortgage notes and earnest money received from potential purchasers of the FHA foreclosed properties. The escrow monies are eventually disbursed to pay for insurance, property taxes, and maintenance expenses on behalf of the borrowers. The earnest money becomes part of the sale proceeds or is returned to any unsuccessful bidders.

Unearned Premiums

As discussed in Note 1, unearned premiums represent premiums collected for the pre-1992 loan guarantees, but not recognized as revenue because the earning process has not been completed.

Undistributed Credits

Undistributed credits represent FHA collections processed by U.S. Treasury, but the identification of the specific operating area associated with the collections has not been determined at the end of the reporting period. When the FHA operating area that is entitled to the collections is identified, the undistributed credits are reclassified by recognizing revenue or by liquidating previously established accounts receivable.

Miscellaneous Liabilities

Miscellaneous liabilities include mainly other unearned revenue from Single Family and Multifamily operations. It also includes loss contingencies that are recognized by FHA for past events that warrant a probable, or likely, future outflow of measurable economic resources.

Note 11. Commitments and Contingencies

Litigation

FHA is party in various legal actions and claims brought by or against it. In the opinion of management and general counsel, the ultimate resolution of two of these legal actions and claims will have a material affect FHA's consolidated financial statements as of September 30, 2007. FHA has recognized an estimated amount of $11 million as a contingent liability due to the probable, or likely, adverse judgment in these cases. Additionally, there are two cases where judgment against FHA is considered reasonably possible with an estimated potential loss of $3 million.

During FY 2007 two judgments against FHA were paid. One was paid by The Department of Justice judgment fund and the other judgment was paid from FHA's funds. The judgments totaled $30 million.

Pending or Threatened Litigation Against FHA

(Dollars in millions)

	2007		2006	
Expected Outcome	Estimated Loss	Number of Cases	Estimated Loss	Number of Cases
Probable	$11	2	$24	1
Reasonably Possible	$3	2	$18	1
Remote	-	8	-	5

Note 12. Gross Costs

Gross costs incurred by FHA for the fiscal years ended September 30, 2007 and 2006 are as follows:

(Dollars in millions)	2007 MMI/CMHI	2007 GI/SRI	2006 MMI/CMHI	2006 GI/SRI
Intragovernmental:				
Interest Expense	$ 263	$ 104	$ 342	$ 101
Imputed Costs	8	29	10	13
Other Expenses	13	8	35	33
Total	**$ 284**	**$ 141**	**$ 387**	**$ 147**
With the Public:				
Salary and Administrative Expenses	$ 208	$ 265	$ 192	$ 241
Subsidy Expense	3,726	(1,125)	642	(1,601)
Interest Expense	697	(338)	284	(248)
Bad Debt Expense	(20)	11	20	(24)
Loan Loss Reserve Expense	48	(143)	(3)	(734)
Other Expenses	41	95	-	317
Total	**$ 4,700**	**$ (1,235)**	**$ 1,135**	**$ (2,049)**

Interest Expense

Intragovernmental interest expense includes interest expense on borrowings from the U.S. Treasury in the financing account. Interest expense is calculated annually for each cohort using the interest rates provided by the U.S Treasury. Interest expense with the public consists of interest expense on debentures issued to claimants to settle claim payments and interest expense on the annual credit subsidy reestimates.

Imputed Costs/Imputed Financing

Imputed costs represent FHA's share of the departmental imputed cost calculated and allocated to FHA by the HUD CFO office. Federal agencies are required by SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards,* to account for costs assumed by other Federal organizations on their behalf. The HUD CFO receives its imputed cost data from the Office of Personnel Management (OPM) for pension costs, federal employee health benefits (FEHB) and life insurance costs. It also receives Federal Employees' Compensation Act (FECA) costs from the Department of Labor (DOL). Subsequently, using its internally developed allocation basis, HUD CFO allocates the imputed cost data to each of its reporting offices. An additional $18 million was included in fiscal year 2007 for a legal judgment paid by judgment fund on FHA's behalf. The imputed costs reported by FHA in its Statements of Net Cost are equal to the amounts of imputed financing in its Statements of Changes in Net Position.

Salary and Administrative Expenses

Salary and administrative expenses include FHA's reimbursement to HUD for FHA personnel costs and FHA's payments to third party contractors for administrative contract expenses.

Subsidy Expense

Subsidy expense, positive and negative, consists of credit subsidy expense from new endorsements, modifications, and annual credit subsidy reestimates and the subsidy expense incurred by the Church Arson program. Credit subsidy expense is the estimated long-term cost to the U.S. Government of a direct loan or loan guarantee, calculated on a net present value basis of the estimated future cash flows associated with the direct loan or loan guarantee. Subsidy expense incurred by the Church Arson program is the expense of a HUD program administered by the Office of Community Planning and Development (CPD) even though its cost is funded through a FHA program account.

Bad Debt Expense

Bad debt expense represents the provision for loss recorded for uncollectible amounts related to FHA's pre-1992 accounts receivable and credit program assets. FHA calculates its bad debt expense based on the estimated change of these assets' historical loss experience and FHA management's judgment concerning current economic factors.

Loan Loss Reserve Expense

Loan loss reserve expense is recorded to account for the change in the balance of the loan loss reserve liabilities associated with FHA's pre-1992 loan guarantees. The loan loss reserve is provided for the estimated losses incurred by FHA to pay claims on its pre-1992 insured mortgages when defaults have taken place but the claims have not yet been filed with FHA.

Other Expenses

Other expenses with the public include only those associated with the FHA pre-1992 loan guarantees. They consist of net losses or gains on sales of FHA credit program assets, insurance claim expenses, fee expenses, and other miscellaneous expenses incurred to carry out FHA operations. Other intragovernmental expenses include FHA's share of HUD expenses incurred in the Working Capital Fund and expenses from intra-agency agreements.

Note 13. Earned Revenue

Earned revenues generated by FHA for the fiscal years ended September 30, 2007 and 2006 are as follows:

(Dollars in millions)	2007		2006	
	MMI/CMHI	**GI/SRI**	**MMI/CMHI**	**GI/SRI**
Intragovernmental:				
Interest Revenue from Deposits at U.S. Treasury	$ 308	$ 107	$ 293	$ 188
Interest Revenue from MMI/CMHI Investments	991	-	1,041	-
Total	**$ 1,299**	**$ 107**	**$ 1,334**	**$ 188**
With the Public:				
Premium Revenue	$ 13	$ 38	$ 86	$ 36
Interest Revenue	2	53	-	49
Other Revenue	9	-	8	-
Total	**$ 24**	**$ 91**	**$ 94**	**$ 85**

Interest Revenue

Intragovernmental interest revenue includes interest revenue from deposits at the U.S. Treasury and investments in U.S. Treasury securities. FHA's U.S. Treasury deposits are generated from post-1991 loan guarantees and direct loans in the financing accounts. FHA's investments in U.S. Treasury securities consist of investments of surplus resources in the MMI/CMHI liquidating accounts and of escrow monies collected from borrowers in the GI/SRI liquidating accounts.

Interest revenue with the public is generated mainly from FHA's acquisition of pre-1992 performing MNA notes from payments to lenders for defaulted guaranteed loans. Interest revenue associated with the post-1991 MNA notes is included in the Allowance for Subsidy balance.

Premium Revenue

According to the FCRA accounting, FHA's premium revenue includes only premiums associated with the pre-1992 loan guarantee business. Premium revenue for post-1991 loan guarantee cases is included in the balance of the LLG. The FHA premium structure, set by the National Affordable Housing Act and published in the Code of Federal Regulations, which became effective July 1991, includes both up-front premiums and annual periodic premiums.

Up-front Premiums

The up-front premium rates, which are set by legislation, vary according to the mortgage type and the year of origination. The pre-1992 up-front premiums in the MMI fund were recorded as unearned revenue upon collection and are recognized as revenue over the period in which losses and insurance costs are expected to occur. Other FHA funds' unearned revenue is recognized monthly as revenue on a straight-line basis.

The FHA up-front premium rates in fiscal year 2007 were:

	Premium Rate
Single Family	1.50%
Multifamily	0.45 %, 0.50%, 0.57% or 0.80%

Periodic Premiums

The periodic premium rate is used to calculate monthly or annual premiums receivable. These rates, which are also legislated, vary by mortgage type and program. The FHA periodic premium rate in fiscal year 2007 for Single Family and Multifamily were:

	Mortgage Term 15 Years or Less	Mortgage Term More Than 15 Years
Single Family	0.25%	0.50%
Multifamily	0.45 %, 0.50%, 0.57% or 0.80%	0.45 %, 0.50%, 0.57% or 0.80%

For Title I, the maximum insurance premium paid for guaranteed cases endorsed in years 1992 through 2001 is equal to 0.50 percent of the loan amount multiplied by the number of years of the loan term. The annual insurance premium for a Title I Property Improvement loan is 0.50 percent of the loan amount until the maximum insurance charge is paid. The annual insurance premium of a Title I Manufactured Housing loan is calculated in tiers by loan term until the maximum insurance charge is paid. For guaranteed cases endorsed in fiscal years 2006 and 2007, the Title I annual insurance premium is 1.00 percent of the loan amount until maturity.

Other Revenue

Other revenue includes revenue associated with FHA pre-1992 loan guarantees. FHA's other revenue consists of late charges and penalty revenue, fee income, and miscellaneous income generated from FHA operations.

Note 14. Gross Cost and Earned Revenue by Budget Functional Classification

FHA cost and earned revenue reported on the Statements of Net Cost is categorized under the budget functional classification (BFC) for Mortgage Credit (371). All FHA U.S. Treasury account symbols found under the department code "86" for Department of Housing and Urban Development appear with the Mortgage Credit BFC.

Note 15. Transfers Out

Transfers out incurred by FHA for the fiscal years ended September 30, 2007 and 2006 are as follows:

(Dollars in millions)		U.S. Treasury		HUD		Total
Budgetary Financing Sources	$	1,173	$	609	$	1,782
Other Financing Sources		834		(389)		445
FY 2007 Total	**$**	**2,007**	**$**	**220**	**$**	**2,227**
Budgetary Financing Sources	$	532	$	234	$	766
Other Financing Sources		1,692		-		1,692
FY 2006 Total	**$**	**2,224**	**$**	**234**	**$**	**2,458**

Transfers Out to U.S. Treasury

Transfers out to U.S. Treasury consists of negative subsidy from new endorsements, modifications and downward credit subsidy reestimates in the GI/SRI general fund receipt account, and the prior year unobligated balance of budgetary resources in the GI/SRI liquidating account.

Transfers Out to HUD

Transfers out to HUD include a certain portion of FHA's payments to HUD for salaries and expenses as well as amounts related to FHA's share in the departmental Working Capital Fund capitalized expense.

Note 16. Unexpended Appropriations

Unexpended appropriation balances at September 30, 2007 and 2006 are as follows:

(Dollars in millions)		Beginning Balance		Appropriations Received		Other Adjustments		Appropriations Used		Transfers-Out		Ending Balance
Positive Subsidy	$	64	$	9	$	(40)	$	(5)	$	-	$	28
Administrative Expenses		365		721		(79)		(105)		(609)		293
Reestimates		-		109		-		(109)		-		-
GI/SRI Liquidating		165		413		-		(196)		(159)		223
FY 2007 Total	**$**	**594**	**$**	**1,252**	**$**	**(119)**	**$**	**(415)**	**$**	**(768)**	**$**	**544**
Positive Subsidy	$	58	$	9	$	-	$	(3)	$	-	$	64
Administrative Expenses		450		728		(83)		(730)		-		365
Reestimates		-		361		-		(361)		-		-
GI/SRI Liquidating		101		183		-		(84)		(35)		165
FY 2006 Total	**$**	**609**	**$**	**1,281**	**$**	**(83)**	**$**	**(1,178)**	**$**	**(35)**	**$**	**594**

As required under FCRA, FHA receives appropriations to cover expenses or fund shortages related to its loan guarantee and direct loan operations.

FHA receives appropriations in the annual program accounts for administrative and contract expenses. The GI/SRI no-year program account also receives appropriations for positive credit subsidy and upward reestimates.

Additionally, FHA obtains permanent indefinite appropriations to cover any shortfalls for its GI/SRI pre-1992 loan guarantee operations.

When appropriations are first received, they are reported as unexpended appropriations. As these appropriations are expended, appropriations used are increased and unexpended appropriations are decreased. Additionally, unexpended appropriations are decreased when: salaries, administrative expenses, and working capital funds are transferred out to HUD; the year-end unobligated balance in the GI/SRI liquidating account is returned to the U.S. Treasury; appropriations are rescinded; or other miscellaneous adjustments are required.

Note 17. Budgetary Resources

The SF-133 and the Statement of Budgetary Resources for fiscal year 2006 have been reconciled to the fiscal year 2006 actual amounts included in the P&F Schedules presented in the Budget of the United States Government. There were no significant reconciling items. Information from the fiscal year 2007 Statement of Budgetary Resources will be presented in the fiscal year 2009 Budget of the U.S. Government. The Budget will be transmitted to Congress on the first Monday in February 2009 and will be available from the Government Printing Office at that time.

Obligated balances at the end of the fiscal year 2007 consist of accounts payable of $1,046 million, and undelivered orders of $1,250 million.

Undelivered Orders
(Dollars in millions)

	2007	2006
MMI/CMHI	$ 662	$ 687
GI/SRI	$ 588	$ 634
Total	**$ 1,250**	**$ 1,321**

In fiscal year 2006, the Salaries and Expense cost was obligated in FHA's accounts each month and a cash payment was made to HUD. FHA showed an obligation on its Statement of Budgetary Resources (SBR) and HUD showed an offsetting collection. In fiscal year 2007, FHA made a non-expenditure transfer to HUD for Salaries, Administrative, and Working Capital Fund Expenses. As a result, both FHA and HUD show a non-expenditure transfer on the SBR. The change does not affect the Statement of Net Cost.

NOTE 18. Budgetary Resources - Collections

The following table presents the composition of FHA's collections for fiscal year 2007:

(Dollars in millions)

	MMI/CMHI		GI/SRI		Total	
Collections:						
Premiums	$	2,148	$	904	$	3,052
Notes	$	39	$	542	$	581
Property	$	3,334	$	142	$	3,476
Interest Earned from U.S Treasury	$	1,264	$	107	$	1,371
Subsidy	$	214	$	124	$	338
Reestimates	$	1,904	$	109	$	2,013
Other	$	101	$	229	$	330
Total	**$**	**9,004**	**$**	**2,157**	**$**	**11,161**

The following table presents the composition of FHA's collections for fiscal year 2006:

(Dollars in millions)

	MMI/CMHI		GI/SRI		Total	
Collections:						
Premiums	$	1,909	$	913	$	2,822
Notes	$	46	$	593	$	639
Property	$	3,543	$	180	$	3,723
Interest Earned from U.S Treasury	$	1,462	$	187	$	1,649
Subsidy	$	890	$	6	$	896
Reestimates	$	3,507	$	361	$	3,868
Other	$	303	$	206	$	509
Total	**$**	**11,660**	**$**	**2,446**	**$**	**14,106**

Note 19. Budgetary Resources – Non-expenditure Transfers

The following table presents the composition of FHA's non-expenditure transfers for fiscal year 2007:

(Dollars in millions)

	MMI/CMHI		GI/SRI		Total	
Transfers:						
Salaries, Administrative Expenses, and Working Capital	$	240	$	369	$	609
Total	**$**	**240**	**$**	**369**	**$**	**609**

Note 20. Budgetary Resources – Obligations

The following table presents the composition of FHA's obligations for fiscal year 2007:

(Dollars in millions)

	MMI/CMHI	GI/SRI	Total
Obligations:			
Claims	$ 5,340	$ 1,003	$ 6,343
Single Family Property Management Contracts	$ 360	$ 17	$ 377
Contract Obligations	$ 40	$ 142	$ 182
Subsidy	$ 214	$ 1,134	$ 1,348
Downward Reestimates	$ 554	$ 1,746	$ 2,300
Upward Reestimates	$ 1,351	$ 109	$ 1,460
Interest on Borrowings	$ 263	$ 115	$ 378
Other	$ 68	$ 170	$ 238
Salaries, Administrative Expenses and Working Capital	$ -	$ -	$ -
Total	**$ 8,190**	**$ 4,436**	**$ 12,626**

The following table presents the composition of FHA's obligations for fiscal year 2006:

(Dollars in millions)

	MMI/CMHI	GI/SRI	Total
Obligations:			
Claims	$ 5,530	$ 983	$ 6,513
Single Family Property Management Contracts	$ 448	$ 25	$ 473
Contract Obligations	$ 46	$ 202	$ 248
Subsidy	$ 889	$ 514	$ 1,403
Downward Reestimates	$ 103	$ 180	$ 283
Upward Reestimates	$ 3,404	$ 361	$ 3,765
Interest on Borrowings	$ 342	$ 115	$ 457
Other	$ 85	$ 181	$ 266
Salaries, Administrative Expenses and Working Capital	$ 370	$ 240	$ 610
Total	**$ 11,217**	**$ 2,801**	**$ 14,018**

NOTE 21. Reconciliation of Net Cost of Operations to Budget

This note (formerly the Statement of Financing) links the proprietary data to the budgetary data. Most transactions are recorded in both proprietary and budgetary accounts. However, because different accounting bases are used for budgetary and proprietary accounting, some transactions may appear in only one set of accounts.

	2007	2006
RESOURCES USED TO FINANCE ACTIVITIES		
Obligations Incurred	$ 12,626	$ 14,018
Spending Authority from Offsetting Collections and Recoveries	(11,468)	(14,108)
Offsetting Receipts	(2,759)	(677)
Transfers In / Out	(445)	(1,692)
Imputed Financing from Costs Absorbed by Others	37	23
TOTAL RESOURCES USED TO FINANCE ACTIVITIES	**$ (2,009)**	**$ (2,436)**
RESOURCES THAT DO NOT FUND THE NET COST OF OPERATIONS		
Undelivered Orders and Adjustments	$ 90	$ (124)
Revenue and Other Resources	12,668	13,064
Purchase of Assets	(9,879)	(7,228)
Appropriation for prior year Re-estimate	(1,460)	(3,768)
TOTAL RESOURCES NOT PART OF NET COST OF OPERATIONS	**$ 1,419**	**$ 1,944**
TOTAL RESOURCES USED TO FINANCE THE NET COST (SURPLUS) OF OPERATIONS	**$ (590)**	**$ (492)**
COMPONENTS OF THE NET COST (SURPLUS) OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD		
Upward Re-estimate of Credit Subsidy Expense	$ 4,870	$ 2,683
Downward Re-estimate of Credit Subsidy Expense	(817)	(2,268)
Changes in Loan Loss Reserve Expense	(127)	(739)
Changes in Bad Debt Expenses Related to Uncollectible Pre-Credit Reform Receivables	(9)	(5)
Reduction of Credit Subsidy Expense from Endorsements and Modifications of Loan Guarantees	(1,032)	(1,380)
Gains or Losses on Sales of Credit Program Assets	56	54
Other	18	66
TOTAL COMPONENTS OF THE NET COST (SURPLUS) OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD	**$ 2,959**	**$ (1,589)**
NET COST (SURPLUS) OF OPERATIONS	**$ 2,369**	**$ (2,081)**

Required Supplementary Information

Schedule A: Intragovernmental Assets

FHA's intragovernmental assets, by federal entity, are as follows for the periods ending September 30, 2007 and 2006:

(Dollars in millions)

Agency	Fund Balance with U.S. Treasury	Investments in U.S. Treasury Securities	Other Assets
U.S. Treasury	$ 9,559	$ 22,481	$ -
HUD	-	-	4
FY 2007 Total	$ 9,559	$ 22,481	$ 4
U.S. Treasury	$ 10,568	$ 22,012	$ -
HUD	-	-	24
FY 2006 Total	**$ 10,568**	**$ 22,012**	**$ 24**

Schedule B: Intragovernmental Liabilities

FHA's intragovernmental liabilities, by federal entity, are as follows on September 30, 2007 and 2006:

(Dollars in millions)

Agency	Borrowings from U.S. Treasury	Other Liabilities
U.S. Treasury	$ 4,573	$ 3,657
FY 2007 Total	**$ 4,573**	**$ 3,657**
U.S. Treasury	$ 6,258	$ 2,486
FY 2006 Total	**$ 6,258**	**$ 2,486**

Required Supplementary Information

Schedule C: Comparative Combining Statement of Budgetary Resources by FHA Program for September 30, 2007 and September 30, 2006:

(Dollars in millions)	MMI/CMHI 2007	MMI/CMHI 2006	GI/SRI 2007	GI/SRI 2006	Total 2007	Total 2006
BUDGETARY RESOURCES						
Unobligated Balance Carried Forward						
Beginning of period	$ 26,367	$ 26,746	$ 3,055	$ 2,747	$ 29,422	$ 29,493
Recoveries of Prior Year Obligations	127	56	86	47	213	103
Budget Authority:						
Appropriations received	413	418	841	863	1,254	1,281
Borrowing Authority	2	536	615	361	617	897
Spending Authority from Offsetting Collections:						
Earned						
Collected	9,004	11,660	2,157	2,446	11,161	14,106
Receivable from Federal Sources	63	(62)	35	(39)	98	(101)
Unfilled Customer Orders	-	-	(4)	-	(4)	-
Net Transfers	(369)	-	(240)	-	(609)	-
Permanently Not Available	(1,919)	(1,769)	(687)	(569)	(2,606)	(2,338)
TOTAL BUDGETARY RESOURCES	**$ 33,688**	**$ 37,585**	**$ 5,858**	**$ 5,856**	**39,546**	**$ 43,441**
STATUS OF BUDGETARY RESOURCES						
Obligations Incurred	$ 8,190	$ 11,218	$ 4,436	$ 2,800	$ 12,626	$ 14,018
Unobligated Balance-Apportioned	537	1,082	643	1,211	1,180	2,293
Unobligated Balance Not Available	24,961	25,285	779	1,845	25,740	27,130
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 33,688**	**$ 37,585**	**$ 5,858**	**$ 5,856**	**$ 39,546**	**$ 43,441**
CHANGE IN OBLIGATED BALANCES						
Obligated Balance, Net, Beginning of Period:						
Unpaid Obligations Carried Forward	$ 1,476	$ 1,442	$ 881	$ 888	$ 2,357	$ 2,330
Receivable from Federal Sources Carried Forward	(203)	(262)	(11)	(52)	(214)	(314)
Obligations Incurred	8,190	11,218	4,436	2,800	12,626	14,018
Gross Outlays	(8,101)	(11,129)	(4,372)	(2,760)	(12,473)	(13,889)
Obligated Balance Transfers, Net:		-		-		-
Recoveries of Prior Year Obligations	(127)	(56)	(86)	(47)	(213)	(103)
Change in Receivable from Federal Sources	(63)	62	(31)	39	(94)	101
Obligated Balance, Net, End of Period:						
Unpaid Obligations	1,435	1,477	861	880	2,296	2,357
Receivable from Federal Sources	(263)	(203)	(44)	(11)	(307)	(214)
Outlays:						
Disbursements	8,101	11,129	4,372	2,760	12,473	13,889
Collections	(9,004)	(11,660)	(2,157)	(2,446)	(11,161)	(14,106)
Subtotal	(903)	(531)	2,215	314	1,312	(217)
Less: Offsetting Receipts	-	-	2,759	677	2,759	677
NET OUTLAYS	**$ (903)**	**$ (531)**	**$ (544)**	**$ (363)**	**$ (1,447)**	**$ (894)**

Required Supplementary Information

Schedule D: Comparative Combining Budgetary Resources by Appropriation for the MMI/CMHI Program–Fiscal Year 2007

(Dollars in millions)	86 0183	86x4070	86x4587 & 86x4242	86x0236	MMI/CMHI Total
BUDGETARY RESOURCES					
Unobligated Balance Carried Forward					
Beginning of period	$ 43	$ 47	$ 4,318	$ 21,959	$ 26,367
Recoveries of Prior Year Obligations	16	26	85	-	127
Budget Authority:					
Appropriations received	413	-	-	-	413
Borrowing Authority	-	-	2	-	2
Spending Authority from Offsetting Collections:					
Earned					
Collected	-	59	7,221	1,724	9,004
Receivable from Federal Sources	-	-	-	63	63
Unfilled Customer Orders	-	-	-	-	-
Net Transfers	981	-	-	(1,350)	(369)
Permanently Not Available	(17)	-	(1,902)	-	(1,919)
TOTAL BUDGETARY RESOURCES	**$ 1,436**	**$ 132**	**$ 9,724**	**$ 22,396**	**$ 33,688**
STATUS OF BUDGETARY RESOURCES					
Obligations Incurred	$ 1,390	$ 68	$ 6,732	$ -	$ 8,190
Unobligated Balance-Apportioned	4	15	518	-	537
Unobligated Balance Not Available	42	49	2,474	22,396	24,961
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 1,436**	**132 $**	**9,724 $**	**22,396 $**	**33,688**
CHANGE IN OBLIGATED BALANCES					
Obligated Balance, Net, Beginning of Period:					
Unpaid Obligations Carried Forward	$ 82	$ 233	$ 1,161	$ -	$ 1,476
Receivable from Federal Sources Carried Forward	-	(1)	(2)	(200)	(203)
Obligations Incurred	1,390	68	6,732	-	8,190
Gross Outlays	(1,385)	(62)	(6,654)	-	(8,101)
Obligated Balance Transfers, Net:					
Recoveries of Prior Year Obligations	(16)	(26)	(85)	-	(127)
Change in Receivable from Federal Sources	-	-	-	(63)	(63)
Obligated Balance, Net, End of Period:					
Unpaid Obligations	71	212	1,152	-	1,435
Receivable from Federal Sources	-	-	(2)	(261)	(263)
Outlays:					
Disbursements	1,385	62	6,654	-	8,101
Collections	-	(59)	(7,221)	(1,724)	(9,004)
Subtotal	1,385	3	(567)	(1,724)	(903)
Less: Offsetting Receipts	-	-	-	-	-
NET OUTLAYS	**$ 1,385**	**$ 3**	**$ (567)**	**$ (1,724)**	**$ (903)**

Required Supplementary Information

Schedule D: Comparative Combining Budgetary Resources by Appropriation for the MMI/CMHI Program–Fiscal Year 2006

(Dollars in millions)

	86 0183	86x4070	86x4587 & 86x4242	86x0236	MMI/CMHI Total
BUDGETARY RESOURCES					
Unobligated Balance Carried Forward					
Beginning of period	$ 50	$ 38	$ 3,395	$ 23,263	$ 26,746
Recoveries of Prior Year Obligations	11	44	1	-	56
Budget Authority:					
Appropriations received	418	-	-	-	418
Borrowing Authority	-	-	536	-	536
Spending Authority from Offsetting Collections:					
Earned					
Collected	-	48	9,450	2,162	11,660
Receivable from Federal Sources	-	-	-	(62)	(62)
Unfilled Customer Orders	-	-	-	-	-
Net Transfers	3,404	-	-	(3,404)	-
Permanently Not Available	(22)	-	(1,747)	-	(1,769)
TOTAL BUDGETARY RESOURCES	**$ 3,861**	**$ 130**	**$ 11,635**	**$ 21,959**	**$ 37,585**
STATUS OF BUDGETARY RESOURCES					
Obligations Incurred	$ 3,816	$ 84	$ 7,318	$ -	$ 11,218
Unobligated Balance-Apportioned	1	2	1,079	-	1,082
Unobligated Balance Not Available	44	44	3,238	21,959	25,285
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 3,861**	**$ 130**	**$ 11,635**	**$ 21,959**	**$ 37,585**
CHANGE IN OBLIGATED BALANCES					
Obligated Balance, Net, Beginning of Period:					
Unpaid Obligations Carried Forward	$ 94	$ 266	$ 1,082	$ -	$ 1,442
Receivable from Federal Sources Carried Forward	-	-	(2)	(260)	(262)
Obligations Incurred	3,816	84	7,318	-	11,218
Gross Outlays	(3,818)	(74)	(7,237)	-	(11,129)
Obligated Balance Transfers, Net:	-	-	-	-	-
Recoveries of Prior Year Obligations	(11)	(44)	(1)	-	(56)
Change in Receivable from Federal Sources	-	-	-	62	62
Obligated Balance, Net, End of Period:					
Unpaid Obligations	83	233	1,161	-	1,477
Receivable from Federal Sources	-	(1)	(1)	(201)	(203)
Outlays:					
Disbursements	3,818	74	7,237	-	11,129
Collections	-	(48)	(9,450)	(2,162)	(11,660)
Subtotal	3,818	26	(2,213)	(2,162)	(531)
Less: Offsetting Receipts	-	-	-	-	-
NET OUTLAYS	**$ 3,818**	**$ 26**	**$ (2,213)**	**$ (2,162)**	**$ (531)**

Required Supplementary Information

Schedule E: Comparative Combining Budgetary Resources by Appropriation for the GI/SRI Program–Fiscal Year 2007

(Dollars in millions)

	86 0200	86x4072	86x4077 & 86x4105	GI/SRI Total
BUDGETARY RESOURCES				
Unobligated Balance Carried Forward				
Beginning of period	$ 182	$ 160	$ 2,713	$ 3,055
Recoveries of Prior Year Obligations	11	36	39	86
Budget Authority:				
Appropriations received	426	413	2	841
Borrowing Authority	-	15	600	615
Spending Authority from Offsetting Collections:				
Earned				
Collected	-	274	1,883	2,157
Receivable from Federal Sources	-	(6)	41	35
Unfilled Customer Orders	-	-	(4)	(4)
Net Transfers	(240)	-	-	(240)
Permanently Not Available	(101)	(173)	(413)	(687)
TOTAL BUDGETARY RESOURCES	**$ 278**	**$ 719**	**$ 4,861**	**$ 5,858**
STATUS OF BUDGETARY RESOURCES				
Obligations Incurred	$ 175	$ 484	$ 3,777	$ 4,436
Unobligated Balance-Apportioned	28	140	475	643
Unobligated Balance Not Available	75	95	609	779
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 278**	**$ 719**	**$ 4,861**	**$ 5,858**
CHANGE IN OBLIGATED BALANCES				
Obligated Balance, Net, Beginning of Period:				
Unpaid Obligations Carried Forward	$ 102	$ 564	$ 215	$ 881
Receivable from Federal Sources Carried Forward	-	(6)	(5)	(11)
Obligations Incurred	175	484	3,777	4,436
Gross Outlays	(165)	(442)	(3,765)	(4,372)
Obligated Balance Transfers, Net:				
Recoveries of Prior Year Obligations	(11)	(36)	(39)	(86)
Change in Receivable from Federal Sources	-	6	(37)	(31)
Obligated Balance, Net, End of Period:				
Unpaid Obligations	100	571	190	861
Receivable from Federal Sources	-	-	(44)	(44)
Outlays:				
Disbursements	165	442	3,765	4,372
Collections	-	(274)	(1,883)	(2,157)
Subtotal	165	168	1,882	2,215
Less: Offsetting Receipts	-	-	-	2,759
NET OUTLAYS	**$ 165**	**$ 168**	**$ 1,882**	**$ (544)**

Required Supplementary Information

Schedule E: Comparative Combining Budgetary Resources by Appropriation for the GI/SRI Program–Fiscal Year 2006

(Dollars in millions)	86 0200	86x4072	86x4077 & 86x4105	GI/SRI Total
BUDGETARY RESOURCES				
Unobligated Balance Carried Forward				
Beginning of period	$ 216	$ 35	$ 2,496	$ 2,747
Recoveries of Prior Year Obligations	14	28	5	47
Budget Authority:				
Appropriations received	680	183	-	863
Borrowing Authority	-	9	352	361
Spending Authority from Offsetting Collections:				
Earned				
Collected	-	426	2,020	2,446
Receivable from Federal Sources	-	6	(45)	(39)
Unfilled Customer Orders	-	-	-	-
Net Transfers	-	-	-	-
Permanently Not Available	(59)	(68)	(442)	(569)
TOTAL BUDGETARY RESOURCES	**$ 851**	**$ 619**	**$ 4,386**	**$ 5,856**
STATUS OF BUDGETARY RESOURCES				
Obligations Incurred	$ 668	$ 459	$ 1,673	$ 2,800
Unobligated Balance-Apportioned	22	138	1,051	1,211
Unobligated Balance Not Available	161	22	1,662	1,845
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 851**	**$ 619**	**$ 4,386**	**$ 5,856**
CHANGE IN OBLIGATED BALANCES				
Obligated Balance, Net, Beginning of Period:				
Unpaid Obligations Carried Forward	$ 99	$ 608	$ 181	$ 888
Receivable from Federal Sources Carried Forward	-	(1)	(51)	(52)
Obligations Incurred	668	459	1,673	2,800
Gross Outlays	(652)	(474)	(1,634)	(2,760)
Obligated Balance Transfers, Net:	-	-	-	-
Recoveries of Prior Year Obligations	(14)	(28)	(5)	(47)
Change in Receivable from Federal Sources	-	(6)	45	39
Obligated Balance, Net, End of Period:				
Unpaid Obligations	101	564	215	880
Receivable from Federal Sources	-	(6)	(5)	(11)
Outlays:				
Disbursements	652	474	1,634	2,760
Collections	-	(426)	(2,020)	(2,446)
Subtotal	652	48	(386)	314
Less: Offsetting Receipts	-	-	-	677
NET OUTLAYS	**$ 652**	**$ 48**	**$ (386)**	**$ (363)**

OIG
REPORT

This report is a condensed version of a more detailed report issued separately on November 8, 2007 by HUD, OIG entitled, "Audit of the Federal Housing Administration's Financial Statements for Fiscal Years 2007 and 2006" (2008-FO-0002). The report is available at HUD, OIG's Internet site at http://www.hud.gov/offices/oig/reports/files/ig08F0002.pdf.

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audit report

Issue Date November 8, 2007	
Audit Case Number 2008-FO-0002	

TO: Brian D. Montgomery, Assistant Secretary for Housing-Federal Housing Commissioner, H

FROM: Robert McGriff, Director, Financial Audits Division, GAF

SUBJECT: Audit of the Federal Housing Administration's Financial Statements for Fiscal Years 2007 and 2006

In accordance with the Government Corporation Control Act as amended (31 U.S.C. 9105), the Office of Inspector General engaged the independent certified public accounting firm of Urbach Kahn and Werlin LLP (UKW) to audit the fiscal year 2007 and 2006 financial statements of the Federal Housing Administration (FHA). The contract required that the audit be performed according to Generally Accepted Government Auditing Standards (GAGAS).

UKW is responsible for the attached auditors' report dated October 29, 2007 and the conclusions expressed in the report. Accordingly, we do not express an opinion on FHA's financial statements or conclusions on FHA's internal controls or compliance with laws and regulations. Within 30 days of this report, UKW expects to issue a separate letter to management dated October 29, 2007 regarding other matters that came to its attention during the audit.

This report includes both the Independent Auditors' Report and FHA's principal financial statements. Under Federal Accounting Standards Advisory Board (FASAB) standards, a general-purpose federal financial report should include as required supplementary information a section devoted to Management's Discussion and Analysis (MD&A) of the financial statements and related information. The MD&A is not included with this report. FHA plans to separately publish an annual report for fiscal year 2007 that conforms to FASAB standards.

The report contains two material weaknesses and one significant deficiency in FHA's internal controls. The Department and FHA disagreed with UKW's assessment that these two weaknesses in internal controls over financial reporting were material weaknesses. The Department reported no material weaknesses for Federal Managers' Financial Integrity Act (FMFIA) reporting in its fiscal year 2007 PAR. In addition, FHA reported no material weaknesses in its fiscal year 2007 Annual Management Report's Annual Assurance Statement on Internal Controls over Financial Reporting.

This year's report contains 16 new recommendations. As part of the audit resolution process, we will record management's decisions for the 16 new recommendations in the Department's Audit Resolution and Corrective Action Tracking System (ARCATS).

We appreciate the courtesies and cooperation extended to the UKW and OIG audit staffs during the conduct of the audit.

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Urbach Kahn & Werlin LLP
CERTIFIED PUBLIC ACCOUNTANTS

INDEPENDENT AUDITORS' REPORT

Inspector General
United States Department of Housing and Urban Development

Commissioner
Federal Housing Administration

We have audited the accompanying consolidated balance sheets of the Federal Housing Administration (FHA), a wholly owned government corporation within the United States Department of Housing and Urban Development (HUD), as of September 30, 2007 and 2006, and the related consolidated statements of net cost, changes in net position, and the combined statements of budgetary resources (Principal Financial Statements) for the years then ended. The objective of our audits was to express an opinion on these financial statements. In connection with our audits, we also considered FHA's internal control over financial reporting and tested FHA's compliance with laws and regulations that could have a direct and material effect on its financial statements.

Summary

We concluded that FHA's Principal Financial Statements are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

Our consideration of internal control over financial reporting resulted in the following matters being identified as significant deficiencies:

- A risk assessment and systems development plan are needed for FHA's Home Equity Conversion Mortgage systems and transaction controls
.
- HECM credit subsidy cash flow model needs improvement
- FHA system security controls need to be strengthened

We consider the first two findings to be material weaknesses. We found no reportable instances of noncompliance with laws and regulations.

This report (including Appendices A through D) discusses: (1) these conclusions and our conclusions relating to other information presented in the Annual Management Report, (2) management's responsibilities, (3) our objectives, scope and methodology, (4) management's response and our evaluation of their response, and (5) the current status of prior year findings and recommendations.

Opinion on the Principal Financial Statements

In our opinion, the Principal Financial Statements referred to above present fairly, in all material respects, the financial position of FHA as of September 30, 2007 and 2006, and its net cost, changes in net position, and combined budgetary resources for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Consideration of Internal Control

In planning and performing our audits, we considered FHA's internal control over financial reporting and compliance (internal control) as a basis for designing our audit procedures that are appropriate in the circumstances and to comply with Office of Management and Budget (OMB) audit guidance, but not for the purpose of expressing an opinion on the effectiveness of FHA's internal control. Accordingly, we do not express an opinion on FHA's internal control.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a deficiency in internal control, or a combination of deficiencies, that adversely affects FHA's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of FHA's Principal Financial Statements that is more than inconsequential will not be prevented or detected by FHA's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that result in a more than remote likelihood that a material misstatement of the Principal Financial Statements will not be prevented or detected by FHA's internal control. Because of inherent limitations in internal controls, misstatements, losses, or noncompliance may nevertheless occur and not be detected.

Our consideration of internal control was for the limited purpose described in the first paragraph above and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, we noted certain matters, summarized below and more fully described in Appendix A, involving the internal control and its operation that we consider to be significant deficiencies, the first two of which are considered material weaknesses:

A risk assessment and systems development plan are needed for FHA's Home Equity Conversion Mortgage systems and transaction controls

FHA maintains a number of different system platforms for processing Home Equity Conversion Mortgage (HECM) endorsements, premiums, claims and assigned notes. These systems are not automatically integrated and require significant compensating manual controls to ensure the accuracy and reliability of financial information being reported in the general ledger. They are neither compliant with federal loan financial management system requirements nor with federal information technology security requirements, including regulations for the safeguarding of personally identifiable information. The HECM program is growing rapidly, comprises almost 20 percent of the $905 million single family upfront premium collections and has resulted in over $500 million in HECM notes now assigned and being serviced by FHA. The balance of assigned notes is estimated by FHA to exceed $1 billion within one year. We believe this growth in a manually intensive control environment greatly increases the risk of material errors in financial reporting.

FHA has issued a Request for Information from commercial vendors regarding the availability of existing reverse mortgage system solutions.

HECM credit subsidy cash flow model needs enhancement

FHA has developed a cash flow model to estimate the net present value of future HECM cash flows, which is recorded as a Liability for Guaranteed Loans in the Principal Financial Statements. This model contains projected cash flows for premiums, pre-foreclosure sales claims, mortgage note assignments, terminations, post-assignment drawdowns and terminated loan note recoveries. FHA uses the limited historical experience available and management assumptions to calculate the conditional rates for most of these complex HECM loan events. We noted significant discrepancies between projected and actual program events which may be caused by changes in interest rates and other external variables. We found management has not effectively documented its assessment of statistical correlations between these various macroeconomic variables that appear to be having a significant impact on the program's experience, including house price appreciation, short term interest rates, and borrower characteristics including gender, age, and mobility patterns due to the limited historical experience for the program. FHA also had not effectively documented its sensitivity analysis of the model and did not have an effective process to document its conclusions regarding the results of its validation review and what changes to the models are needed to improve the model's predictability. FHA has indicated that they are currently assessing new pricing and termination models, the results of which will improve future cash flow estimates.

We also found that the model contained improper calculations relating to terminated note recoveries and was not compliant with federal accounting standards regarding OMB discounting requirements for cash flow models for direct loan and loan guarantee programs. FHA has adjusted the accompanying financial statements to reflect the material adjustments to the related Liability for Guaranteed Loans caused by these errors.

FHA system security controls need to be strengthened

FHA has not yet implemented a federal information security risk management framework in accordance with federal standards. FHA's information system security officer did not have authority and processes in place to ensure FHA system security meets federal and Departmental requirements. FHA program offices and system owners also did not fully understand their system security responsibilities due to an ineffective organizational authority, insufficient staff resources, and inadequate security training. FHA has also not yet resolved a number of system vulnerabilities that result in weakened controls over financial system data.

Additional detail and the related recommendations for these findings are provided in Appendix A of this report. The full text of management's response is included in Appendix B. We did not perform audit procedures on FHA's written response to the significant deficiencies and material weaknesses and accordingly, we express no opinion on it. Our assessment of management's response is included in Appendix C. The current status of prior year findings and recommendations is included in Appendix D.

We also noted other less significant matters involving FHA's internal control and its operation, which we have reported to the management of FHA in a separate letter, dated October 29, 2007.

Compliance with Laws and Regulations

The results of our tests of compliance with laws and regulations disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 07-04, as described below. Providing an opinion on compliance with laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

The HUD Office of the Chief Financial Officer and CFO Appropriation General Counsel are currently investigating potential Anti-Deficiency Act violations associated with the commitment limitation for FHA's General Insurance/Special Risk Fund programs. No final legal determination regarding these potential compliance matters have been made.

Other Information

The information in the Management's Discussion and Analysis and Required Supplementary Information sections is not a required part of the Principal Financial Statements, but is supplementary information required by the Federal Accounting Standards Advisory Board and OMB Circular A-136, *Financial Reporting Requirements*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

With respect to the internal control objective relating to the performance measures reported in the Management's Discussion and Analysis (MD&A), we obtained an understanding of the design of internal control relating to the existence and completeness assertions and determined whether they have placed in operation, as required by OMB Bulletin No. 07-04. Our procedures were not designed to provide an opinion on the effectiveness of FHA's internal control over reported performance measures, and, accordingly, we do not provide an opinion on the effectiveness of FHA's internal control over these reported performance measures.

Management Responsibilities

Management is responsible for the information in the Annual Management Report, including the preparation of: (1) the Principal Financial Statements in conformity with accounting principles generally accepted in the United States of America, (2) Management's Discussion and Analysis (including the performance measures), and (3) Required Supplementary Information. Management is also responsible for establishing, maintaining and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers Financial Integrity Act of 1982 (FMFIA) are met, ensuring that FHA's financial management systems substantially comply with the Federal Financial Management Improvement Act of 1996 (FFMIA) and complying with applicable laws and regulations.

Objectives, Scope and Methodology

Our responsibility is to express an opinion on FHA's Principal Financial Statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and OMB Bulletin No. 07-04. Those standards and OMB Bulletin No. 07-04 require that we plan and perform the audit to obtain reasonable assurance about whether the Principal Financial Statements are free of material misstatement.

An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audits provide a reasonable basis for our opinion. In planning and performing our audits, we considered FHA's internal control over financial reporting (internal control) by obtaining an understanding of FHA's internal control, determined whether internal controls had been placed in operation, assessed control risk, and performed tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 07-04 and *Government Auditing Standards*. We did not test all internal controls relevant to operating objectives as broadly defined by FMFIA, such as those controls relevant to ensuring efficient operations.

Our audit procedures were not designed to test the requirements of OMB Bulletin No. 07-04 relating to FFMIA which are not applicable to FHA. Compliance with FFMIA will be evaluated and reported on by the HUD Office of Inspector General (OIG) in connection with their audit of the consolidated financial statements of HUD. We limited our tests of compliance to the provisions described above and we did not test compliance with all laws and regulations applicable to FHA.

Distribution

This report is intended solely for the information and use of the HUD OIG, the management of HUD and FHA, OMB, the Government Accountability Office and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

Urbach Kahn & Werlin LLP

Washington DC
October 29, 2007

Appendix A
Significant Deficiencies and Material Weaknesses

In our report dated October 29, 2007, we described the results of our audits of the consolidated balance sheets of the Federal Housing Administration (FHA), a wholly owned government corporation within the United States Department of Housing and Urban Development (HUD), as of September 30, 2007 and 2006, and the related consolidated statements of net cost, changes in net position, and the combined statements of budgetary resources (Principal Financial Statements) for the years then ended. The objective of our audits was to express an opinion on these financial statements. In connection with our audits, we also considered FHA's internal control over financial reporting and tested FHA's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on its financial statements. The following presents additional detail on the internal control matters discussed in that report.

1. A risk assessment and systems development plan needed for FHA's Home Equity Conversion Mortgage systems and transaction controls.

FHA's systems for processing Home Equity Conversion Mortgage (HECM) transactions are not automatically integrated and require significant compensating manual controls to ensure the accuracy and reliability of financial information being reported in the general ledger. These application systems or databases are neither compliant with federal loan financial management system requirements nor with federal IT security requirements, including regulations for the safeguarding of personally identifiable information.

FHA did not have a comprehensive documented program level risk assessment that evaluates the current HECM program environment and related infrastructure. An effective risk assessment, like a strategic plan, would document management's expectations for the future of the program and assess the potential risks to FHA and HUD related to program management, lender monitoring and oversight, funding, fraud risks, business processes, internal controls and system requirements. FHA has expanded its Quality Assurance Division (QAD) lender reviews to evaluate compliance of lenders' HECM loan endorsement processes, but does not document how these lender reviews correlate to the assessed program risks.

FHA maintains a separate system for HECM loan, endorsement and premium billing data. Although the system is integrated with FHASL, we found no system-based or manual audit trail for authorization or review of premium billing adjustments.

The following IT general control issues were also noted for the HECM endorsement and premium billing system:

- ✓ A configuration management plan was not in place.
- ✓ The application is not capable of generating audit logs.
- ✓ Interface agreements/memoranda of understanding were not in place for all systems that interface with HECM (i.e. FHA Connection, CHUMS and the premiums servicer).
- ✓ Inadequate segregation of duties (i.e. System Owner and System Security Administrator are the same individual for the system and two HECM developers have concurrent access to development and production)

- ✓ System security vulnerabilities which are discussed for FHA as a whole in Finding 3.

Requests for reverse mortgage note assignments are sent to an independent contractor for review, validation and processing. Acceptance of note assignments in the form of approval letters are sent to the lenders. These letters are included with other information in a claim request package which is sent by the lender to FHA for review, approval and claim payment determination. Data on approved claims are accumulated in an Access database. Information from each claim request package is separately entered onto a standard form for payment processing.

Queries from the Access database are used to summarize payment transactions for monthly postings to the general ledger. FHA has extensive manual reconciliation procedures to ensure the accuracy and reliability of the aggregate balances of monthly transaction postings; however, FHA did not adequately document supervisory reviews of these reconciliations. During our audit of the September 30, 2007 balance of assigned HECM notes, UKW determined that FHA had not recorded the balance of approved and assigned notes for which lenders had not yet filed claims for insurance benefits. Management has elected not to record the corresponding $29 million adjustment to the Loans Receivable and Related Foreclosed Property, Net and Accounts Payable balances on the Principal Financial Statements. This unrecorded adjustment does not affect our opinion on those statements.

Upon acceptance of the assigned note, FHA is responsible for future borrower advances or fixed payments, accruing interest and fees and termination of the note upon the borrower's death, refinancing of the loan or sale of the home. The balance of outstanding notes held by FHA at September 30, 2007 exceeds $550 million and is expected to grow to over $1 billion in fiscal year 2008. FHA's contractor uses a database to track borrower personal data, the note balance and summarizes interest and premium non-cash transactions and note recoveries for manual posting by FHA. The business processes related to note servicing were neither documented nor assessed as part of FHA's OMB Circular A-123 management control documentation and annual assurance efforts. FHA also has manual controls over the processing of terminated note proceeds. FHA's contractor has not performed a system controls audit of this database. This system is also not compliant with federal system requirements for loan programs.

FHA's HECM pilot program was introduced in 1989. The current systems and business processes were developed based on the anticipated minimal program activity at that time. Growth in the program was modest until 2001 when endorsements began growing in excess of 50 percent per year. The HECM program now comprises almost 20 percent of the $900 million in single family upfront premium collections. Current models project the future cash transactions required to be processed by FHA for the HECM program will exceed $45 billion over the next 30 years, without considering the effect of future endorsements.

We believe this rate of growth in the number of transactions and the current volume of business being processed manually creates a risk that the current control structure will not be able to detect a material error in the financial statements. Management has represented to us that they consider $50 million as the materiality threshold for their assessment regarding the effectiveness of their controls.

The Office of Single Family Housing and the FHA Comptroller have issued a Request for Information to identify potential vendors that can provide a cost effective web-based reverse mortgage management system.

Recommendations to FHA's Deputy Assistant Secretary for Finance and Budget to address the above in fiscal 2008 include:

1a. Coordinate with the Acting Deputy Assistant Secretary for Single Family Housing to compile and document a comprehensive program risk assessment of the HECM program based on anticipated program volume, and activity. (New)

1b. Coordinate with HUD's Acting Chief Information Officer and the Acting Deputy Assistant Secretary for Single Family Housing to establish a comprehensive system functional requirements document in accordance with HUD guidance for the new HECM system based on anticipated future volumes of transactions. (New)

1c. Coordinate with HUD's Acting Chief Information Officer to complete a full assessment of the Privacy Act requirements for the HECM notes database and its contractor. (New)

1d. Complete a full assessment of the effectiveness of the existing controls (including an Independent Type II review of the service provider under AICPA Statement on Auditing Standards No. 70, *Service Organizations*) over the notes database given the sensitivity of the data and the anticipated growth in reported assigned note balances and transactions. (New)

1e. Develop and implement automated system interfaces between the current HECM claims and notes systems and FHASL, if the new system(s) cannot be implemented timely. (New)

2. HECM credit subsidy cash flow model needs enhancement

Federal accounting standards require that the net liability related to federal loan guarantee programs be presented in the financial statements at the net present value of future cash flows. OMB guidance outlines stringent procedures to be followed by each agency in developing cash flow models to calculate the total cost of each program each year (credit subsidy cost) as well as the net present value of future cash flows, also known as the subsidy reestimate. FHA develops complex cash flow models in Excel using Visual Basic programming for each major FHA program area.

As discussed above, FHA's HECM systems and business processes were developed based on the anticipated program activity at that time. Growth in the program was modest until 2001 but endorsements have been growing in excess of 50 percent per year for the last five years. The current model now estimates $45 billion in undiscounted future cash flows for the HECM program which represents 40 percent of the future cash flows for all existing FHA programs.

Due to the unique programmatic aspects of reverse mortgages, FHA has developed a separate model for the HECM program. This model contains projected cash flows for premiums, pre-foreclosure sales claims, assignments, terminations, post-assignment borrower drawdowns and terminated note recoveries. FHA uses the limited prior policy years of historical experience and management assumptions to calculate the conditional event rates for use in the HECM cash flow model.

FHA's HECM program performance is extremely sensitive to certain macroeconomic factors including short term interest rates, house price appreciation, and borrower characteristics including gender, age, and mobility patterns. During our audit, we noted significant variances between projected and actual cash flows caused by recent changes in interest rates and its effect on assignments and premiums. We found that FHA did not provide us with fully documented analysis of these variances or the relationships between these external variables and program performance. We also found certain technical errors in the model, as discussed below. FHA is currently assessing new pricing and termination models, the results of which are expected to improve future cash flow estimates.

Premiums
Actual premium cash flows for FY2007 (annualized using March 31 data) were 12 percent lower than projected in the prior year model (without considering the current cohort's variance which was due to underestimated FY2006 endorsements). Variances in the earliest cohorts were significantly higher but not material overall. FHA's FY2007 validation review also noted this discrepancy but did not adequately investigate, analyze and explain the causes for this discrepancy to determine whether any corrections to the model were required. During our audit, UKW noted a 54 percent overstatement between the number of active HECM loans reported for the 1992-1999 cohorts in the model and the number of loans remitting premium payments to FHA.

Conditional Termination Rates
FHA uses a single variable for projecting pre-assignment terminations in the cash flow model, which includes loans terminating due to assignment, as well as voluntary (e.g. borrower relocation or refinancing) and involuntary (e.g. borrower death) termination. FHA has not fully documented any statistical correlations between macroeconomic factors and non-assignment related terminations to illustrate how these factors may impact future termination rate assumptions. FHA has not yet documented the impact of other recent studies on HECM program experience on the cash flow model. These studies, including one recently completed by HUD's Office of Policy Development and Research to assist investors to assess the investment risk in reverse mortgage loans, found FHA's termination data does not distinguish between voluntary termination (move-out) and involuntary termination (mortality or incapacitation) and that FHA's models appear to underestimate terminations.

Assignments
Lenders may assign the HECM loan to FHA once the unpaid balance reaches 98 percent of the calculated maximum claim amount as determined at loan endorsement.

We noted actual assignments for FY2007 ($140 million annualized using March 31, 2007 data) exceeded those projected in the FY2006 model ($80 million) by 75 percent. The FY2007 model may have corrected for some of this variance as it currently projects peak assignments to occur in policy year 7 whereas historically peak assignment years were around policy year 11. This dramatic shift is due to the low initial interest rates for loans endorsed in FY2004 to FY2006 and increasing variable interest rates, which are causing loans to reach 98 percent of their maximum claim amount much sooner. FHA has neither effectively documented whether better estimates of interest rate changes would have reduced these variances nor documented what other external factors (e.g. interest rates or the overall housing market) may impact actual assignment rates to FHA.

Post-Assignment Terminations
UKW also found that FHA does not use a separate post-assignment termination experience rate assumption in the cash flow model. Due to the lack of sufficient historical data on post-assignment terminations, FHA's cash flow model assumes all assigned notes will be held for six years and uses a historical average of recovery/assignment ratios to calculate recovery cash flows. Incorporating historical termination data and other macroeconomic variables into this assumption may result in significant changes in recovery cash flow projections.

FHA also uses a median long-term house price appreciation rate assumption of four percent within the model. This assumption is inconsistent with the house price appreciation projections published by Global Insights and used in FHA's MMI forward mortgage model. FHA calculations indicated that the use of these lower assumptions will not materially impact the liability estimate. These calculations were not performed as part of a comprehensive sensitivity analysis.

During the audit, management identified that the HECM model inappropriately included cash flows from existing assigned notes. FHA has adjusted the accompanying financial statements to reflect the $511 million increase to the related Liability for Guaranteed Loans caused by this error.

Discounting
The cash flow model improperly discounted cash flows to the beginning of the cohort year rather than the end of the financial reporting year. This error artificially reduced the present value of note recoveries relative to the value of assignments. FHA has adjusted the accompanying financial statements to reflect the $189 million reduction to the related Liability for Guaranteed Loans caused by this error.

The HECM model was also not using OMB guidance relating to the use of budget assumptions for discount rates and actual discount rates for the 2001 – 2007 cohorts. FHA has adjusted the accompanying financial statements to reflect the $166 million reduction to the related Liability for Guaranteed Loans caused by this error.

Credit Subsidy
The cash flow model used the maximum claim amount rather than the cumulative amount of borrower drawdowns in its calculation of the credit subsidy rate. The model also did not use the Credit Subsidy Calculator (CSC2) for determining discount rates as required by OMB.

Validation
FHA completed a validation review of the HECM cash flow model in June 2007 and noted discrepancies discussed above regarding premiums and assignments. Management's conclusions did not indicate whether changes to the model or its assumptions were needed to address the findings. There is no evidence that the model or its assumptions for FY2007 were revised as a result of these validation findings. FHA also did not document its review of a sensitivity analysis in connection with the validation review.

Accordingly, we believe the limited historical data available, the program's rapid growth, the lack of sufficient documentation on how macroeconomic factors impact the various program events, the $866 million in aggregate modeling errors identified and the lack of sufficient analysis of program results combine to present more than a remote risk of material errors in financial reporting not being identified by FHA's internal control over the credit subsidy cash flow model estimates. Management has represented to us that they consider $50 million as the materiality threshold for purposes of their assessment regarding the effectiveness of their controls.

Recommendations to address the above include:

2. We recommend the Deputy Assistant Secretary for Finance and Budget request the Director of the Office of Evaluation to:

    a. Enhance its documentation on how specific assignment and termination rates are calculated and how macroeconomic projections are incorporated
    b. Document the results of the current pricing and termination model reviews and their effect on the methodology for calculating future cash flow reestimates
    c. Document any impact on the FY2007 HECM liability reestimate as a result of changes in the methodologies for calculating future cash flow estimates
    d. Document FHA's conclusion on how recent HUD studies on HECM experience can be used to improve the calculation of the model's calculated assumptions
    e. Establish new validation review procedures to compare the actual premium collections and post-assignment terminations to the balances in the model
    f. Document the use OMB approved CSC2 calculator in the model
    g. Ensure the propriety of the discounting algorithm used in next year's model
    h. Reevaluate the assumption for calculating note recoveries to better reflect the "crossover risk" in the recovery cash flows
    i. Incorporate the use of disbursements into the calculation of the credit subsidy rate
    j. Incorporate sensitivity analysis variables directly within the cash flow model and document management's assessment of the results of the sensitivity analysis.
    k. Develop a more formal process for documenting management's conclusions regarding required model modifications as a result of the annual validation process. (New)

3. FHA system security controls need improvement.

FHA has not yet implemented a federal information security risk management framework required by federal policy. The framework, as defined by the National Institute for Standards and Technology (NIST), is a risk-based approach to security control selection and specification. It consists of information security actions, processes, roles, and activities that consider effectiveness, efficiency, and constraints due to applicable federal laws, directives, executive orders, policies, standards, and HUD regulations.

FHA's information system security officer (security officer) did not have the management authorities and processes necessary to ensure that information security within FHA systems was aligned with business objectives consistent with Federal Information Security Management Act (FISMA) and HUD requirements.

Misalignment between FHA management authorities and HUD Information Technology (IT) Security Policy resulted in poor implementation of information security controls that protect FHA's applications and data. Further, FHA program offices and system owners did not fully understand their various system security responsibilities due in part to a lack of proper organizational authorities and personnel resources. Without this framework in place, FHA management cannot ensure that its systems, data, and assets are adequately protected against theft, loss, or destruction.

HUD IT Security Policy - Handbook 2400.25, REV-1, establishes the information security policy for HUD. The policy prescribes responsibilities, practices, and conditions that directly or indirectly promote security in the development, operation, maintenance, and support of all HUD IT resources.

In addition, the HUD IT Security Policy - Handbook 2400.25, REV-1, defines "system owners" as individuals who use IT to help fulfill the business requirements necessary to achieve the mission needs within their program area of responsibility and are responsible for the successful operation of IT systems within their program area. These designated owners are ultimately accountable for the security of the IT systems and programs under their control.

FHA has not yet corrected known IT security vulnerabilities and updated the required security documents. FHA program area staff indicated that they did not have the staff or contractor resources to perform the needed tasks to resolve the information security weaknesses. Risks to its data will continue to exist until funding to correct the vulnerabilities is available.

FHA management has indicated that as of September 30, 2007 they have made progress on addressing the system deficiencies previously identified in the Plans of Actions and Milestones for 36 major Housing and FHA systems. FHA management has stated that the number of open system deficiencies has been reduced from 1,116 in July 2007 to 498 at September 30, 2007 for a 55 percent reduction. Additionally, FHA has stated that over 75 percent of the security documents for Housing and FHA have been updated to meet current federal standards. HUD OIG has indicated that they have not evaluated the support for the closing of the vulnerabilities or the updated security documents, but will do so in fiscal year 2008.

While FHA had made progress in closing out open vulnerabilities, it could not ensure that all systems would be adequately protected in the near term and that the high impact vulnerabilities were being closed out. FHA is working with HUD's Office of the Chief Information Officer's Office of Information Technology Security Information Assurance and Compliance to develop a schedule of information technology security activities. Identified tasks that remain include:

- Update risk assessments
- Conduct security training and awareness
- Conduct annual self-assessments
- Update security plans and contingency plans
- Resolve all "plan of actions and milestones" weaknesses or create risk acceptance plans.

FHA program management noted that funding for most of its systems had been limited to operations and maintenance for several years and that no development money had been available for these systems. This condition was due to overall funding issues regarding HUD's working capital fund, which also impacted FHA. FHA saw a reduction in funding from $71.3 million in fiscal year 2004, which included $41.7 million for development, to $43.4 million in fiscal year 2007, which included $7.2 million for development.

With insufficient funding for all of its needs in fiscal year 2007, FHA decided to fund basic operations and maintenance and critical business needs and to freeze funding for development activity to ensure that current systems were operational. As FHA considered information security a development activity, it did not have the funding necessary to resolve its many outstanding information security vulnerabilities.

The lack of information security funding impacts the level of effort and quality of an individual application's security documentation, as well as the ability to engage the resources (i.e. staff) needed to close out known open information security vulnerabilities.

Details and Recommendations can be found in a separate OIG audit report.[1]

<u>User Access</u>
In prior years, OIG recommended that HUD develop an action plan to fully implement the HUD Online User Registration System to ensure that all user data are tracked and require system administrators to register users and their access level into this database. In response, HUD implemented the Centralized HUD Account Management Process (CHAMP) on January 31, 2007 to serve as a data repository and a workflow management component of the service desk to ensure requests are forwarded in the proper order to all organizations that have a part in approving or assigning user account rights and privileges.

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[1] Audit Report No. 2008-DP-0002, Review of FHA Controls Over Its Information Technology Resources, dated October 31, 2007

During FY2007, FHA validated its current authorized user list for major applications (including FHASL) and provided these user lists to OCIO to incorporate into CHAMP. FHA has also begun to record change requests through CHAMP.

OCIO has developed interim procedures to reconcile CHAMP information with the database that contains background investigation data for all employees and contractors. This reconciliation process is intended to identify users with potentially unauthorized or inappropriate access levels to HUD's systems (e.g. users granted above-read access without the appropriate background check). However, the reconciliation is a tedious manual process that cannot identify all users because CHAMP does not contain all user data including legacy data. As a result, some unauthorized users may escape detection.

Details and Recommendations can be found in a separate OIG audit report.[2]

[2] Audit Report No. 2007-DP-0004, Fiscal Year 2006 Review of Information Systems In Support of the Financial Statement Audits dated February 22, 2007

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Appendix B
Management's Response

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

November 1, 2007

MEMORANDUM FOR: Urbach Kahn & Werlin LLP

Ronald Y. Spraker

FROM: Ronald Y. Spraker, Deputy Assistant Secretary for Finance and Budget, HW

SUBJECT: Response to UKW's Fiscal Year 2007 FHA Audit Report

I am pleased to present Federal Housing Administration (FHA) management's responses to your audit report on the fiscal year 2007 FHA financial statements.

General Comments

FHA welcomes the opportunity to comment on this report. We are pleased that UKW noted the resolution of all our prior year internal control report findings. Also, we appreciate UKW reviewing and taking into consideration our comments on their initial draft report. However, of the two material weaknesses identified by UKW, we continue to believe that one is unsupported and therefore unwarranted, and that the detailed narrative associated with the other is inaccurate and needlessly portrays the HECM program negatively.

Report on Internal Controls – Material Weaknesses

1. FHA's systems for processing Home Equity Conversion Mortgage (HECM) transactions need improvement.

FHA does not concur with the materiality of this finding. As noted by the auditors themselves, FHA has significant compensating controls to ensure the accuracy and reliability of HECM financial information. It is difficult to understand how this could be classified as a material weakness when FHA's controls are effective and working as designed.

As stated by the auditors, a material weakness is a significant deficiency, or combination of significant deficiencies, that result in a **more than remote** likelihood that a **material misstatement** of the Principal Financial Statements will not be prevented or detected by FHA's internal control. We fail to see how the controls over our manual processes are deficient such that it rises to the level of a material weakness.

The auditors also discuss in Appendix A, the potential growth of the HECM program from $500 million to $1 billion:

> ***We believe this rate of growth in the number of transactions and the current volume of business being processed manually creates a risk that the current control structure will not be able to detect a material error in the financial statements. Accordingly, we believe that the above combination of deficiencies presents more than a remote risk of material errors in financial reporting not being identified by FHA's internal control.***

We disagree with the assumption that an increase in the number of HECM transactions will lead to an increase in errors -- especially since the auditors found no errors in their sampling of HECM transactions.

Again, during their sampling of transactions, no errors were found. As noted in their report, the auditors did identify an adjustment that had not been recorded. However, this adjustment had been identified by FHA's internal controls and FHA was working on a specific detailed resolution to properly record the adjustment. FHA management decided to defer the adjustment until all supporting information could be analyzed. If a generic adjustment had been recorded, it would have only increased total assets by .08% and total liabilities by .18% with no change to net cost or net position. These insignificant changes do not result in a material misstatement and they were detected by FHA's internal controls. While FHA does agree that improvements are needed to more fully automate the processes and accounting of this expanding program, the controls currently in place are effective in detecting and preventing material misstatements.

Over the last several years the HECM program has grown significantly. FHA has used its existing systems and developed manual processes to handle this increased growth. Internal controls have been a major focus in developing our procedures.

For example, FHA routinely performs numerous reconciliations that demonstrate that the HECM financial data is complete and accurate. We have conducted numerous A-123 and Financial Statement audits. FHA has reviewed HECM transactions including source documents and reconciliations, as well as reconciliations between the source systems, cash ledgers, and the general ledger. No exceptions were noted in these reviews.

The auditor's discussion indicates a concern about system compliance with federal financial management and IT security requirements. FHA has integrated its mixed financial and programmatic systems, including the systems supporting HECM, with a Federal Systems Integration Office (FSIO) compliant core financial system. The integration of these systems provides FSIO compliance overall, as documented in our A-127 and A-123 reviews. All transactional activity, including HECM premiums and notes servicing, is recorded in FHASL in accordance with FSIO standards. Additionally, FHASL records and reports activities in compliance with Federal accounting standards and credit reform accounting.

The auditor's discussion includes many references to a HECM database, which mischaracterizes the systems that support the HECM program. This characterization suggests that automated controls and business processes are not supported. However, all of the systems that support HECM transactional activity are systems with automated controls and businesses processes. For example, HECM notes management activity is processed through an external servicer, referred to as the SMART service. SMART was developed to provide comprehensive loan servicing processes necessary to meet HUD guidelines for servicing the various HUD loan programs. The system is required to provide accounting level detail on forward and reverse mortgages; case-tracking ability; report generating capability; query functions; database management and the capability to interface with the appropriate HUD systems. Additionally, the SMART contractor is required to maintain the security and integrity of its systems, for providing systems maintenance, training and technical support to the various users. SMART services also include access controls to the SMART data. All users must be approved by the HUD GTR and then are given access by the system administrator.

Internal testing of the SMART service has been on-going. An assessment of the service began on November 9, 2006 and was completed on January 9, 2007 by Cherry, Bekaert & Holland, LLP, an independent firm. The assessment revealed that the contractor's SMART system is able to completely process mortgage transactions for both forward and reverse mortgages, including interest, appreciation, amortization and other calculations in conformance with HUD handbooks, circulars, mortgagee letters, and other written guidance or directives from HUD. The report includes several recommendations on system documentation improvements.

In the area of HECM claims, FHA is using a desktop program to track and record HECM claims. The number of HECM claims has increased dramatically and FHA has developed adequate internal controls to ensure claim payments are accurate.

FHA recognizes that our current HECM systems need to be improved. To address this issue, during FY 2007, FHA sent out a Request for Information to determine contractor capabilities for an integrated HECM process. During FY 2008, FHA plans to initiate procurement activities to obtain a HECM services to provide an integrated process.

Many of the concerns listed in the audit report are addressed by FHA's existing extensive compensating controls. The effectiveness of these controls and the absence of errors relating to FHA's HECM financial records demonstrate that the risks associated with FHA's HECM systems and controls do not rise to a material level.

Regarding the recommendations, FHA will request additional information in order to fully understand what is being recommended and will provide a more detailed response at a later date.

2. HECM credit subsidy cash flow model needs enhancement.

FHA does not concur that FHA's HECM cash flow models constitute a material weakness.

The Home Equity Conversion Mortgage (HECM) product is nowhere better understood than at FHA. The HECM product and actuarial pricing model were developed at HUD in 1989. HUD and FHA staff have written the majority of reports to Congress and research publications regarding the HECM product. Furthermore, FHA is currently involved in extensive research on the HECM program re-examining the original pricing model and developing termination models. It is using actual program experience and techniques, such as logistic regression and stochastic simulations, to see if adjustments are needed. A HECM working group, consisting of Ph.D. economists, senior financial economists, and the developers of the original pricing model, meets weekly to discuss and review HECM modeling efforts.

The HECM cash flow model was developed, with the assistance of the original developers of the HECM product and contractor support, to reflect the current and future cash flows of the HECM program. The cash flow model is regularly reviewed and has evolved in response to historical program experience, published research, and management's understanding of the program. The cash flow model takes advantage of all historical program experience available, makes use of proxy data if no historical experience exists, and uses management assumptions based on economic theory to estimate the liability for loans guaranteed.

FHA appreciates the effort that UKW invested in review of the HECM cash flow model, but disagrees with the findings of the material weakness. This response addresses each of UKW's observations in succession. The first section titled "Overview" addresses UKW's observations taken as a whole, the second section titled "Individual Responses to Audit Findings" provides FHA's response to each specific audit observation, and the third section titled "FHA Response to Recommendations" counters each of UKW's recommendations.

Overview

UKW Applies Forward Mortgage Expectations to Reverse Mortgages

UKW mistakenly applies assumptions garnered from the Nation's decades of experience with forward mortgages to reverse mortgages. It expects interest rates and house price appreciation, commonly used to explain forward mortgage claim and prepayment behavior, to explain reverse mortgage behavior. In contrast, in its most recent HECM study completed in August 2007, FHA found that the primary drivers of reverse mortgage termination are the borrower's age, gender and policy year, while macroeconomic factors including house price appreciation rate and interest rate are secondary drivers.

UKW expects changes in interest rates and house price appreciation rates to affect HECM loan terminations, but the direction of the hypothesized relationship is often unclear. Will borrowers prepay their mortgages more rapidly to realize the remaining equity in their properties because their equity is growing, or because it is declining? Why would changes in interest rates motivate prepayments or move-outs? Interest rates and house price appreciation rates presumably have no impact on death or disability rates. If interest rates rise, unpaid balances will grow more rapidly, but this is an accounting, not a behavioral matter that drives HECM terminations. Unlike forward mortgage terminations, which are very sensitive to interest rates and house price appreciation rates, HECM terminations are primarily actuarially driven by borrower age, gender, and policy year. FHA acknowledges that interest rates affect the rate and number of HECM loan assignments. In fact, FHA utilizes Global Insight's interest rate forecast to project the growth of future average unpaid loan balances at assignment and to determine the probabilities of future assignments for existing cohorts.

UKW has not adequately considered the unique character of reverse mortgages. Although interest rates and house price appreciation rates undoubtedly influence some aspects of reverse mortgagor behavior, the impacts are unlikely to be the same as those affecting forward mortgagor behavior. Reverse mortgagor behavior is uniquely filtered through the elderly borrowers' life experiences as they struggle to use their equity to remain in their homes. Some of the patterns of behavior will become known only as the historical experience of FHA's borrowers accumulates.

UKW Overlooks the Numerous Uses that FHA Makes of Econometric Analysis

UKW observes: "We found management has not effectively documented its assessment of statistical correlations between these various macroeconomic variables that appear to be having a significant impact on the program's experience, including house price appreciation, short term interest rates, and borrower characteristics including gender, age, and mobility patterns due to the limited historical experience for the program." FHA strongly disagrees with this assessment. Throughout the 17 years of its program experience, FHA and PD&R staff have prepared or overseen numerous studies and reports to Congress that have assessed the adequacy of the assumptions used in the original HECM pricing model and have developed models to compare termination expectations to actual historical experience. Many of these studies examined the impact of macroeconomic factors on program performance, and findings from these studies have guided the development and evolution of FHA's HECM cash flow models.

FHA developed its pricing model in 1989. Assuming a given premium structure, the model solves for principal limit factors which represent the net present value of the payments that a borrower can receive under a HECM, expressed as a fraction of the maximum claim amount, based on the borrowers' age and the "expected average interest rate" (defined as the applicable 10-year Treasury rate plus lender's margin). It includes assumptions about the average rate and the variance of house price appreciation as well as actuarial mortality rates by age. Historical experience was not available to test the assumptions of this pioneering program in 1989. However, subsequent reports to Congress and more recent work to update the 1989 pricing model (see below) show that the original assumptions were quite reasonable. Contrary to UKW's expectation that some of these assumptions should vary with current and projected interest rates and house price appreciation rates, the principal limit factors are the HECM program's equivalents to maximum loan-to-value ratios, and as such should remain stable from year-to-year. At the present time, FHA has a project underway to test the original pricing assumptions against a growing body of historical experience and to consider alternatives to the current premium structure that could lower front-end costs to the borrower[1].

Termination models are yet another type of model. At the most modest level, termination models describe the actual historical termination probabilities per loan policy year. These data, used in FHA's HECM cash flow model, have been published by HUD staff because they are of great interest to the reverse mortgage industry and potential investors in HECM-backed securities. With the accretion of historical data, FHA has undertaken more sophisticated termination modeling efforts, examining the impact of various loan-specific and macroeconomic

[1] The project utilizes the approach of optimization via stochastic simulation, where loan terminations, house price appreciation rate and interest rate are stochastically modeled.

factors on termination behavior. These efforts were described to the auditor, but ignored by them in reaching their conclusions that FHA had not sufficiently documented its use of macroeconomic modeling. In fact, FHA's August 2007 study shows that sufficient data exist to model the first six years of a book of reverse mortgage loans, but after that data limitations[2] lead to erratic results. FHA has repeatedly tested these results in its cash flow model and plans to make use of them when the findings mature.

At several points, UKW notes that "FHA is currently assessing new pricing and termination models, the results of which are expected to improve future cash flow estimates," an observation incompatible with its finding of material weakness.

Individual Responses to Audit Findings

The following section will address each of the audit findings:

Audit Finding: Premiums

> Actual premium cash flows for FY2007 (annualized using March 31 data) were 12% lower than projected in the prior year model (without considering the current cohort's variance which was due to underestimated FY2006 endorsements). Variances in the earliest cohorts were significantly higher but not material overall. FHA's FY2007 validation review also noted this discrepancy but did not adequately investigate, analyze and explain the causes for this discrepancy to determine whether any corrections to the model were required. During our audit, UKW noted a 54% overstatement between the number of active HECM loans reported for the 1992-1999 cohorts in the model and the number of loans remitting premium payments to FHA.

FHA Response:

The Fiscal Year 2006 Model overestimated total premium collections by 0.21% or $198,000 for the HECM portfolio. For Cohorts 2002 to 2005, which includes 84% of the endorsements from all Cohorts before 2006, the model overestimates premium collection by 4%. UKW notes the high variance in the earlier cohorts as being not material overall (only 16% endorsements for Cohort 1992 to 2001) but still includes it in its analysis. FHA believes that, given the small data set available on HECM loans, it is doing an extremely good job of estimating annual premiums for the HECM portfolio.

Audit Finding: Conditional Termination Rates

> FHA uses a single variable for projecting pre-assignment terminations in the cash flow model, which includes loans terminating due to assignment, as well as voluntary (e.g. borrower relocation or refinancing) and involuntary (e.g. borrower death) termination. FHA has not fully documented any statistical correlations between macroeconomic factors and non-assignment related terminations to illustrate how these factors may impact future termination rate assumptions. FHA has not yet documented the impact of other recent studies on HECM program experience on the cash flow model. These studies, including one recently completed by HUD's

[2] As of September 2007, only 6.9% of all loans ever endorsed in the HECM program have loan age greater than six years.

> Office of Policy Development and Research to assist investors to assess the investment risk in reverse mortgage loans, found FHA's termination data does not distinguish between voluntary termination (move-out) and involuntary termination (mortality or incapacitation) and that FHA's models appear to underestimate terminations. FHA is currently assessing new pricing and termination models, the results of which are expected to improve future cash flow estimates.

FHA Response:

FHA uses all historical termination data to create its conditional termination rates per policy year in the cash flow model. FHA does not distinguish between pre-assignment and post-assignment terminations because both types of terminations are driven by very similar factors--for example, borrower's attained age and policy year. Pre-assignment terminations, also known as Type I Claims, are the very small number of claims that occur prior to loan assignment where the house value is insufficient to cover the mortgage balance. UKW expects interest rates and house price appreciation rates to influence the Type I Claims. In fact, these claims are generally due to circumstances beyond the control of the borrower. Unless a borrower dies or is unable to remain in the home, there is no incentive for the borrower to terminate the HECM loan just because the loan balance has grown to exceed the house value. Rather, the rational behavior for a borrower is to remain in the home and continue to draw payments. FHA believes that the model is doing a sufficient job of predicting the number of Type I Claims.

FHA has created a terminations model for HECM that incorporates macroeconomic factors, including house price appreciation and interest rate changes, but shows that the primary drivers of loan terminations are loan-specific characteristics, including borrower's age, gender, and policy year. FHA is using these variables in the current terminations model that determines the survival probabilities based on actual loans terminations for each policy year. FHA consistently reviews these variables and their impact on the projected future assumptions and cash flows. These finding have been documented in studies written and directed by the HUD and FHA staff involved with the development and refinement of FHA's HECM cash flow models.

Audit Finding: Assignments

> Lenders may assign the HECM loan to FHA once the unpaid balance reaches 98% of the calculated maximum claim amount as determined at loan endorsement. We noted actual assignments for FY2007 ($140 million annualized using March 31, 2007 data) exceeded those projected in the FY2006 model ($80 million) by 75%. The FY2007 model may have corrected for this some of this variance as it currently projects peak assignments to occur in policy year 7 whereas historically peak assignment years were around policy year 11. This dramatic shift is due to the low initial interest rates for loans endorsed in FY2004 to FY2006 and increasing variable interest rates, which are causing loans to reach 98% of their maximum claim amount much sooner. FHA has neither effectively documented whether better estimates of interest rate changes would have reduced these variances nor documented what other external factors (e.g. interest rates or the overall housing market) may impact actual assignment rates to FHA.

FHA Response:

FHA acknowledges that recent interest rate increases may cause unpaid loan balances (UPB) to reach the 98% maximum claim amount faster than in previous years. FHA has incorporated interest rate assumptions in determining future UPB projections in the cash flow model and changed its assumption regarding peak assignment from policy year 11 to policy year 7. Additionally, FHA believes that interest rates are the key driver of assignment rates, while the other external factors have minimal impact on assignments.

Audit Finding: Post-Assignment Terminations

> UKW also found that FHA does not use a separate post-assignment termination experience rate assumption in the cash flow model. Due to the lack of sufficient historical data on post-assignment terminations, FHA's cash flow model assumes all assigned notes will be held for six years and uses a historical average of recovery/assignment ratios to calculate recovery cash flows. Incorporating historical termination data and other macroeconomic variables into this assumption may result in significant changes in recovery cash flow projections.
>
> FHA also uses a median long-term house price appreciation rate assumption of four percent within the model. This assumption is inconsistent with the house price appreciation projections published by Global Insights and used in FHA's MMI forward mortgage model. FHA calculations indicated that the use of these lower assumptions will not materially impact the liability estimate. These calculations were not performed as part of a comprehensive sensitivity analysis.
>
> During the audit, management identified that the HECM model inappropriately included cash flows from existing assigned notes. FHA has adjusted the accompanying financial statements to reflect the $511 million increase to the related Liability for Guaranteed Loans caused by this error.

FHA Response:

As noted in the FHA response to Claim Type I audit finding above, FHA uses all historical termination data to create its conditional termination rates per policy year in the cash flow model. FHA does not distinguish between pre-assignment and post-assignment terminations because (i) both types of terminations are driven by very similar factors--for example, borrower's attained age and policy year, and (ii) the small number of post-assignment terminations does not warrant a separate analysis (only 2,100 post-assignment terminations since the inception of the HECM program). Based on its extensive research in terminations mentioned above, FHA found that loan-level characteristics are the primary drivers of terminations (for both pre-assignment and post-assignment), but macroeconomic factors are clearly secondary drivers. Due to the limited historic data for older loans, FHA has concluded that it is premature to incorporate macroeconomic variables to predict conditional termination rates in the cash flow model. FHA believes that its current termination modeling approach is more than sufficient.

UKW is incorrect in its understanding that FHA uses the 4% house price appreciation (HPA) rate in its cash flow model. Based on a sensitivity analysis that FHA performed and explained to UKW, HECM is actually using an implied 1.28% annual HPA rate compounded each year. FHA has repeatedly emphasized that it conducts sensitivity analyses on HPA periodically to ensure the soundness of its assumptions.

In contrast to forward mortgages, reverse mortgages have not been terminated at the time that they are assigned to HUD, and so, they are not included in a recovery on assets model. The assigned note continues to accrue interest, premium, and service fee in addition to any payouts to the borrower. FHA initially accounted for these assets in the HECM cash flow model. Subsequently, FHA made a decision to remove these loans from the cash flow model and account for them separately as assets for purposes of the reestimates. As a result, FHA reduced the liability for HECM loans by $511 million, an amount offset by the recognition of $525 million as assets in the reestimates calculation. This decision was made after FHA has submitted the FY 2007 models to the auditors. FHA brought this accounting change to the attention of the auditors, and provided them with an updated model at that time. This change has no impact on the performance of HECM loans or the model. It recognizes the unique nature of HECM loan assignments.

Audit Finding: Discounting and Credit Subsidy

> The cash flow model improperly discounted cash flows to the beginning of the cohort year rather than the end of the financial reporting year. This error artificially reduced the present value of note recoveries relative to the value of assignments. FHA has adjusted the accompanying financial statements to reflect the $189 million reduction to the related Liability for Guaranteed Loans caused by this error.
>
> The HECM model was also not using OMB guidance relating to the use of budget assumptions for discount rates and actual discount rates for the 2001 – 2007 cohorts. FHA has adjusted the accompanying financial statements to reflect the $166 million reduction to the related Liability for Guaranteed Loans caused by this error.
>
> The cash flow model used the maximum claim amount rather than the cumulative amount of borrower drawdowns in its calculation of the credit subsidy rate. The model also did not use the Credit Subsidy Calculator (CSC2) for determining discount rates as required by OMB.

FHA Response:

FHA updated a discounting formula to correctly reflect the net present valued cash flows. The change did not affect any aspect of performance of the HECM program and was related only to the discounting of future cash flows. The change corrected an overestimate of HECM liability by $189 million.

HECM loans are disbursed based on borrower preferences over an extended period of time. Because of the complexity of the disbursement schedule and the limited amount of historical data, FHA has used the maximum claim amount as a proxy for total disbursements. FHA believes that this approach best reflects the nature of the program. Believing that FHA should base its credit subsidy estimates on disbursements over the life of the loan, the auditors cited OMB guidance and urged FHA to change its discounting method from using the single effective rate basket of zero (BOZ) discount factors to the budget BOZ discount factors. FHA made the changes requested by the auditors, which resulted in a presumed decrease of $166 million in liability. Although FHA made the change, it will raise this topic with OMB during this year's discussions of technical budget and modeling issues. OMB has not objected to the use of the maximum claim amount for credit subsidy modeling in previous years. FHA believes that once

OMB reviews this issue, there is a high probability that the single effective rate will be put back in the model. The basket of zero discount rates are directly downloaded from the CSC2 for all Cohorts as required by OMB.

Audit Finding: Validation

> FHA completed a validation review of the HECM cash flow model in June 2007 and noted discrepancies discussed above regarding premiums and assignments. Management's conclusions did not indicate whether changes to the model or its assumptions were needed to address the findings. There is no evidence that the model or its assumptions for FY2007 were revised as a result of these validation findings. FHA also did not document its review of a sensitivity analysis in connection with the validation review.

FHA Response:

FHA annually compares projected and actual cash flows and documents the results in the validations report. This year, FHA found variances in a few of the HECM variables, like pre-assignment and assignment claims, which were documented in FHA's plans for revisions to its FY 2007 model. Given the brief duration of the HECM program, FHA expects variances in the short-term, but expects them to subside in the long-term.

FHA Response to Recommendations

Audit Recommendation: Enhance its documentation on how specific assignment and termination rates are calculated and how macroeconomic projections are incorporated
FHA Response: FHA will further document how specific assignment and termination rates are calculated and how macroeconomic projections are incorporated in its models.

Audit Recommendation: Document the results of the current pricing and termination model reviews and their effect on the methodology for calculating future cash flow reestimates.
FHA Response: FHA will further document the results of the current pricing and termination model reviews and their effect on the methodology for calculating future cash flow reestimates.

Audit Recommendation: Document any impact on the FY2007 HECM liability reestimate as a result of these changes
FHA Response: FHA has already calculated the FY 2007 HECM liability reestimate in the course of the FY 2007 audit.

Audit Recommendation: Document FHA's conclusion on how recent HUD studies on HECM experience can be used to improve the calculation of the model's calculated assumptions how recent HUD studies on HECM experience can be used to improve the calculation of the model's calculated assumptions
FHA Response: FHA will continue to incorporate the results of HUD studies on the HECM program in its cash flow model assumptions.

Audit Recommendation: Establish procedures to compare the actual premium collections and post-assignment terminations to the balances in the model

FHA Response: FHA already incorporates program data as appropriate into its cash flow model.

Audit Recommendation: Use the OMB approved CSC2 calculator in the model
FHA Response: FHA already uses the CSC2 calculator for HECM credit subsidy estimation.

Audit Recommendation: Ensure the propriety of the discounting algorithm used in next year's model
FHA Response: FHA will ensure the propriety of its discounting formulas.

Audit Recommendation: Reevaluate the assumption for calculating note recoveries to better reflect the "crossover risk" in the recovery cash flows
FHA Response: FHA will continue to improve its method for estimating note recoveries as historical data accumulates.

Audit Recommendation: Incorporate the use of disbursements into the calculation of the credit subsidy rate
FHA Response: FHA will discuss with OMB the wisdom of using disbursements for the calculation of the HECM credit subsidy rate.

Audit Recommendation: Document a sensitivity analysis of the variables within the cash flow model
FHA Response: FHA has performed and will continue to perform innumerable sensitivity analyses of variables in the cash flow model.

Audit Recommendation: Develop a more formal process for documenting management's conclusions regarding required model modifications as a result of the annual validation process.
FHA Response: FHA already has a formal process for documenting management's conclusions regarding needed model changes. It takes the form of a memo for signature by the DAS for Finance and Budget describing the current year's proposed changes to the cash flow model.

Report on Internal Controls – Significant Deficiencies

3. FHA system security controls need improvement.

FHA concurs with this finding. FHA management has already taken actions to implement the information security risk-based management framework recommended by Office of Inspector General auditors. The Deputy Assistant Secretaries for the Office of Single Family Housing, the Office of Multifamily Housing, and Office of Finance and Budget have already designated Information System Security Officers (ISSOs) for their respective lines of business. This will improve dissemination and coordination of security requirements. The Office of Housing's ISSO has met with the designated program office ISSOs, discussed their roles and responsibilities, and developed standard operating procedures for managing IT security compliance requirements.

Appendix B
Management's Response

The Office of Housing and FHA have focused management attention across all offices to address system deficiencies previously identified in the Plans of Actions and Milestones (POA&Ms) for 36 major Housing and FHA systems and reduced the number of weaknesses by 55%. We continue to review the POA&M weaknesses and will see substantial reductions as additional security documents are updated and completed. Some control weaknesses may not be closed by November 30th because these changes will require additional IT development resources.

Appendix C
UKW's Assessment of Management's Response

UKW has obtained and reviewed FHA management's response to the findings and recommendations made in connection with our audit of FHA's 2007 Principal Financial Statements, which is included as Appendix B. We did not perform audit procedures on FHA's written response to the significant deficiencies and material weaknesses and accordingly, we express no opinion on it. Our assessment of management's responses is discussed below.

Assessment of management's response to significant deficiency (material weakness) No. 1:

We appreciate management's concern over the expression of the HECM internal controls as a material weakness. We believe that Statement of Auditing Standards (SAS) No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, was developed to help auditors proactively identify and report risks to reliable financial reporting rather than waiting for actual errors to occur before reporting the weaknesses to management. SAS 112 states: "*The significance of a control deficiency depends on the potential for a misstatement, not on whether a misstatement actually has occurred. Accordingly, the absence of identified misstatement does not provide evidence that identified control weaknesses are not significant deficiencies or material weaknesses*."

We acknowledge that the classification of this matter as a material weakness is a matter of professional judgment and is not clear cut. We have conducted several discussions with management to clarify the definition of materiality as it related to management assertions and assessment of materiality for evaluating internal controls. However, we believe the factors described in the finding provide a reasonable basis for our determination.

We believe that the first steps have been undertaken for a long term solution, but we do not believe the recommendations are unclear and are concerned that FHA has not committed to implementing all or any of the proposed recommendations which are aimed at mitigating the control risks for the short term and enhancing the effectiveness of the implementation of any new or modified HECM systems.

A comprehensive program risk assessment should document the anticipated program environment in the near term and the resource requirements needed to support its needs. In a manually intensive business process environment, this assessment should focus on documenting how FHA can ensure it has adequate personnel to ensure the HECM transactions related to endorsements, note assignments, borrower payments, and note terminations can be recorded timely and accurately with the anticipated significant increases in transaction volume. OMB Circular A-130, *Management of Federal Information Resources*, states:

> *Establish oversight mechanisms that require periodic review of information systems to determine how mission requirements might have changed, and whether the information system continues to fulfill ongoing and anticipated mission requirements. These mechanisms must also require information regarding the future levels of performance, interoperability, and maintenance necessary to ensure the information system meets mission requirements cost effectively;*

Appendix C
UKW's Assessment of Management's Response

A functional systems requirement document is a technical design of a system which must consider the future systems operational and control environment to be effective or else the new system, once implemented, may not be capable of handling the transaction or user volume required.

We were not provided or made aware of the management review of the SMART system referred to by either the contractor or FHA but, based on the description provided, this review does not appear to provide the written audit assurance on the general systems and privacy controls required by Feferal regulation.

Implementing automated interfaces with FHASL could significantly reduce the amount of duplicated data entry now performed and reduce the risk of data error.

Assessment of management's response to significant deficiency (material weakness) No. 2:

As with the first finding above, we believe there are a number of factors that combine to lead to our assessment of the HECM cash flow model reestimate process as a material weakness. As indicated by management's response, there is a tremendous amount of effort currently underway in evaluating the assumptions of the HECM program now that there is more historical data for analysis. We look forward to seeing this additional information incorporated into the documentation and analysis of future HECM subsidy reestimates.

However, the nature and extent of management's analysis and documentation provided for audit review in support of its HECM program FY2007 reestimate calculation had not significantly changed from prior years despite the growth in the program and is not as extensive as that provided in support of the other FHA single family or multifamily program subsidy models. We believe insufficient analysis was a contributing factor to the three material technical errors in the model. The rapid growth in the program volume combined with changes in interest rates and the decline in the overall housing market complicates effective analysis of the model's results. This greatly increases the risk for errors in the estimation methodology not being detected timely.

FHA's responses to our recommendations do not fully address our concerns as documented. Recommendation 2c addresses documenting whether there would be any monetary impact to the current year liability if the enhancements to the models were implemented for FY2007. While the impact of technical model changes is normally documented in FHA's decomposition process, significant changes in liabilities caused solely by changes in the estimation methodology may be relevant to the readers of the FY2008 financial statements.

Recommendation 2e focuses on additional tests to be performed as part of the annual validation review whereby premium data from the HECM premium billing system (F12) and actual post-assignment terminations from SMART can be compared to the prior year's projected volume to enhance management's assessment of the models performance.

Recommendation 2f is to incorporate the use of the CSC2 calculator into the complete model documentation submitted for audit to enhance our review and assessment of compliance with OMB policy.

Recommendation 2j is aimed at obtaining a documented sensitivity analysis similar to that already generated for each of the four single family and eighteen multifamily risk categories. FHA should incorporate this sensitivity analysis functionality directly into the cash flow models for routine analysis by management and auditors.

Recommendation 2k is to enhance the linkage between the variances observed and conclusions drawn in the annual validation review, management's overall conclusions regarding the effectiveness of the model and the decisions regarding any enhancements needed to the model as documented in the Deputy Assistant Secretary for Finance and Budget (DAS) memo.

We have clarified the language in our recommendations in response to management's comments related to recommendations 2c, 2e, 2f and 2k.

Assessment of management's response to significant deficiency No. 3:

While management has concurred with the finding, their response does not provide specific information on the actions taken to implement a risk-based management framework. Management has also not outlined the plan for correcting the remaining system vulnerabilities, or indicated whether the designated Information System Security Officers (ISSOs) will be responsible for completing the remaining tasks (i.e. risk assessment updates, self assessments, security plan updates, etc.).

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Appendix D
Status of Prior Year Findings and Recommendations

Our assessment of the current status of reportable conditions and material weaknesses identified in prior year audits is presented below:

Prior Finding/Recommendation	***Type***	***Fiscal Year 2006 Status***
1a. FHA's Assistant Secretary for Housing should implement interim Headquarters and field control policies and procedures to ensure that effective funds control is maintained until full implementation and integration of the subsidiary application systems is accomplished	2006 Reportable Condition	Resolved. FHA has incorporated Headquarters and field funds control policies and procedures.
1b. FHA's Assistant Secretary for Housing should effectively coordinate with HUD's Office of the Chief Procurement Officer to ensure expired or inactive contracts are promptly closed out and that any excess funds, including the $107,176,596 identified in the FY2006 audit, are deobligated timely		Resolved. FHA has deobligated about $107,169,096 of the $107,179, 596 expired or inactive contracts in FY 2007. The remaining $7,500 could not be deobligated due to legal issues. UHY did not identify any material expired or inactive contracts to be deobligated in FY 2007.
2a. The HUD Chief Information Officer should ensure that the Deputy Chief Information Officer for Security maintain current and complete records of User Access Request (UAR) forms for all FHA application systems.	2006 Reportable Condition	Issue has been substantially resolved by FHA. However, assurance over access security cannot be obtained without fully implementing recommendation 2b. Remaining issues are included in the FY 2007 Management Letter
2b. The FHA Comptroller should ensure that each FHA application owner reviews and updates their user access list annually and reconciles their records with the ADP Security Office. The UAR forms should be electronically stored by the HITS contractor in a non-editable format in the Lotus Notes environment.		See Finding No. 3 Partially resolved. FHA management has updated their user access lists for recording in CHAMPS. The OCIO plan is to migrate all the data to the new CHAMPS repository for central user access by September 2008. Our remaining recommendations to FHA are included in the FY2007 Management Letter.
3a. The HUD Chief Information Officer should ensure that the disaster recovery backup plans maintained by the HITS contractor are updated to include FHASL. The backup plans should also be tested to ensure data can be restored within the contractually required timeframe.	2006 Reportable Condition	Resolved. The disaster recovery backup plans were successfully tested in March 2007 and again in September 2007.

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