audit report

OFFICE OF INSPECTOR GENERAL

Issue Date	February 29, 2000
Audit Case Number	00-FO-131-0002

TO: William Apgar, Assistant Secretary for Housing-Federal Housing Commissioner, H

FROM: James A. Heist, Director, Financial Audits Division, GAF

SUBJECT: Audit of the Federal Housing Administration's Fiscal Year 1999 Financial Statements

This report presents the results of KPMG LLP's (KPMG) audit of the Federal Housing Administration's (FHA) financial statements for the year ended September 30, 1999. We concur with KPMG's opinion, that the financial statements present fairly, in all material respects, FHA's financial position as of September 30, 1999, and its net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations, for the year then ended.

FHA is headed by HUD's Assistant Secretary for Housing-Federal Housing Commissioner, who reports to the Secretary of the Department of Housing and Urban Development (HUD). FHA is organized into four major mortgage insurance fund activities, with the Mutual Mortgage Insurance Fund, which provides single family insurance, as the largest activity. The Assistant Secretary for Housing is also responsible for administering significant non-FHA programs, such as the Section 8 Rental Assistance, Section 202 Supportive Housing for the Elderly and Section 811 Supportive Housing for Persons with Disabilities programs. Activities relating to these other programs are not included in FHA's financial statements, but are covered in HUD's agency-wide financial statements.

Audit Scope and OMB Audit Requirements

This audit was conducted in accordance with *Government Auditing Standards* and was performed according to the requirements of the Chief Financial Officers (CFO) Act and Office of Management and Budget (OMB) Bulletin No. 98-08, *Audit Requirements for Federal Financial Statements,* as amended. To complete this audit, we contracted with the independent certified public accounting firm of KPMG. We approved the scope of the audit work, monitored its progress at key points, reviewed KPMG's working papers, and performed other procedures we deemed necessary. OMB's audit requirements in Bulletin No. 98-08, as amended, exceed *Government Auditing Standards*, primarily in three areas. These relate to:

- expanding the review of FHA's internal controls,
- reviewing FHA's performance measures, and
- reporting under of the Federal Financial Management Improvement Act (FFMIA) of 1996.

To address the first additional OMB requirement, we engaged KPMG to expand their review of FHA's internal controls. The section discussing internal controls presents the results of this work. With respect to the other additional requirements, FHA will be reporting their performance measures at the HUD consolidated level. With respect to FFMIA, the reporting requirements do not apply to the FHA audit, but will be reported at the HUD consolidated level.

Results of KPMG's Audit

In addition to KPMG's unqualified opinion on FHA's financial statements, KPMG reported two material weaknesses and five reportable conditions on internal controls. KPMG's report discusses each of these conditions in detail, provides an assessment of actions taken by FHA to mitigate them and makes recommendations for corrective actions. During the course of the audit, KPMG also identified several matters which, although not material to the financial statements, are being separately communicated to us and FHA management.

Recommendations and Follow-up on Prior Audits

In audit reports on FHA's prior years' financial statements, various recommendations were presented to address FHA's internal control weaknesses. While FHA has taken certain actions to address these recommendations, corrective actions were incomplete. In accordance with the Department's Audits Management System, we will continue to track the resolution of these prior years' audit recommendations. KPMG's recommendations from their Fiscal Year 1999 audit cover many of the same issues described in prior audits. FHA's management should review all outstanding recommendations and determine a correct course of action which responds to the current status of all open findings.

To the extent that these recommendations do not substantially repeat recommendations issued under prior audits of FHA's financial statements, we will issue a separate memorandum restating and numbering these recommendations to facilitate their tracking in the Departmental Automated Audits Management System.

Comments of FHA Officials

On February 4, 2000 we provided a draft of KPMG's report to FHA officials for their review and comment. KPMG has summarized FHA's response under each applicable material weakness and reportable condition with FHA's full response included as Appendix D of KPMG's report.

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

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KPMG
2001 M Street, NW
Washington, DC 20036

INDEPENDENT AUDITORS' REPORT

To the Inspector General,
U.S. Department of Housing and Urban Development:

We have audited the accompanying consolidated balance sheets of the Federal Housing Administration (FHA) as of September 30, 1999 and 1998, and the related consolidated statements of net cost and changes in net position, the combining statements of budgetary resources, and the combined statements of financing (hereinafter collectively referred to as "financial statements") for the years then ended. The objective of our audits was to express an opinion on the fair presentation of FHA's 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.

In our opinion, FHA's financial statements as of and for the years ended September 30, 1999 and 1998, are presented fairly, in all material respects, in conformity with generally accepted accounting principles.

As a result of our consideration of internal control over financial reporting for fiscal year 1999, we noted reportable conditions in the following seven areas, the first two of which we also considered material weaknesses:

- Controls over budgetary funds and funds control must be improved,
- FHA's information technology systems must be enhanced to more effectively support FHA's business processes,
- FHA must continue to place more emphasis on early warning and loss prevention for insured mortgages,
- FHA must continue actions to safeguard and quickly resolve Secretary-held Single Family mortgage notes,
- FHA must sufficiently monitor and account for its Single Family property inventory,
- FHA must improve its review process for estimating reserves for the insured portfolio, and
- FHA/HUD must enhance the design/operation of controls over information systems security and application data integrity.

Our opinion on FHA's financial statements, our consideration of internal control over financial reporting, our tests of FHA's compliance with certain provisions of laws and regulations and our responsibilities are discussed in the remainder of our report.

OPINION ON FINANCIAL STATEMENTS

In our opinion, the accompanying 1999 and 1998 financial statements present fairly, in all material respects, the financial position of FHA as of September 30, 1999 and 1998, and its net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations, for the years then ended, in conformity with generally accepted accounting principles.

INTERNAL CONTROL OVER FINANCIAL REPORTING

We noted certain matters involving internal control over financial reporting and its operation that we consider to be material weaknesses under standards established by the American Institute of Certified Public Accountants (AICPA).

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions under standards issued by the AICPA, and, accordingly, would not necessarily disclose all reportable conditions that are material weaknesses. Reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of internal control over financial reporting that, in our judgment, could adversely affect FHA's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Material weaknesses, as addressed in Appendix A, exist in two major interrelated areas. The material weaknesses are:

- **Controls over budgetary funds and funds control must be improved.** FHA must perform analyses and reconciliations of all of its obligation systems, to ensure that all obligated amounts are properly recorded and that funds control is maintained and implemented in all systems. This process directly relates to ensuring that budgetary status and accounting information is complete, accurate, and available to management for decision-making purposes.

- **FHA's information technology systems must be enhanced to more effectively support FHA's business processes.** HUD and FHA are conducting day-to-day business with legacy based systems, several of which directly impact FHA's financial activity and necessitate financial transactions to be processed through non-integrated systems, requiring manual analysis and summary entries to be posted to FHA's general ledger. FHA's and HUD's inability to implement modern information technology adversely affects the internal controls related to accounting and reporting financial activities.

Five reportable conditions that are not considered material weaknesses are addressed in Appendix B. These reportable conditions are summarized as follows:

- **FHA must continue to place more emphasis on early warning and loss prevention for insured mortgages.** FHA needs to continue to reduce the frequency and loss severity of defaults on insured mortgages by improving its monitoring of financial and delinquency data to identify and cure troubled multifamily mortgages and by expanding the use of loss mitigation tools and improving the effectiveness of monitoring processes for the single family insured portfolio.

- **FHA must continue actions to safeguard and quickly resolve Secretary-held Single Family mortgage notes.** FHA has taken positive steps to address inadequate servicing and management of defaulted mortgage notes in fiscal year 1999. However, further improvements in servicing of notes assigned to FHA need to be taken to safeguard the value of these assets until the notes are sold as planned.

- **FHA must sufficiently monitor and account for its Single Family property inventory.** FHA has taken positive steps to control weaknesses which exist in FHA's single family property acquisition, management, and disposition functions. However, more needs to be done to reduce single family inventory in a manner that maximizes the return to FHA while preserving and protecting these properties.

- **FHA must improve its review process for estimating reserves for the insured portfolio.** FHA needs to continue to improve its Liability for Loan Guarantees estimation review process, to reduce the number of adjustments to the models and assumptions by strengthening the quality assurance controls used to ensure accurate recording and reporting.

- **FHA/HUD must enhance the design/operation of controls over information systems security and application data integrity.** FHA/HUD has taken steps to address prior year control weaknesses in the EDP control environment. For example, FHA/HUD has implemented improved processes for controlling the modification of application software programs. However, control weaknesses still exist in system and application access controls, and application data integrity.

All of the above matters were reported in our prior year report. While Appendices A and B describe progress that has been made in each of these areas, they remain as material weaknesses or reportable conditions, as they have not been completely resolved since the date of our report. These conditions were considered in determining the nature, timing, and extent of audit tests applied in our audit of the 1999 financial statements. We have not considered internal control over financial reporting subsequent to the date of this report.

We also noted other matters involving internal controls and their operation during our audit, which have been reported to FHA's management in a separate letter.

COMPLIANCE WITH LAWS AND REGULATIONS

The results of our tests of compliance with laws and regulations disclosed no instances of noncompliance required to be reported herein under *Governmental Auditing Standards* and Office of Management and Budget (OMB) Bulletin 98-08, *Audit Requirements for Federal Financial Statements*, as amended.

As reported in prior years, FHA was not in full compliance with certain data requirements of the Federal Credit Reform Act of 1990. Specifically, FHA's Single Family periodic premiums systems could not generate the required case-specific cash flow data required to re-estimate its subsidies. During fiscal year 1999, FHA maintained case-level detail on the billings, but not the collections of its Single Family periodic premiums, and used that information to more accurately calculate Credit Reform subsidies. In September 1999, FHA completed system modifications to capture case-level collections data on these premiums. As a result, there are no further actions required regarding this matter.

Other Matters Under Investigation. An investigation is being conducted by the Office of the Inspector General of the Department of Housing and Urban Development in conjunction with the United States Attorney General's Office that involves alleged improprieties related to procurement, contracts, and the sales of Secretary-held notes. The investigation could reveal other violations of laws and regulations. In addition to this issue, there are other matters currently under investigation. However, the ultimate resolution of these matters cannot presently be determined.

RESPONSIBILITIES

Management's Responsibility. The Chief Financial Officers (CFO) Act of 1990 requires federal agencies to report annually to Congress on their financial status and any other information needed to fairly present the agencies' financial position and results of operations. To meet the CFO Act reporting requirements, FHA prepares annual financial statements. FHA is an agency operated by the U.S. Department of Housing and Urban Development (HUD).

Management has the responsibility for:

- preparing the financial statements in conformity with generally accepted accounting principles;
- establishing and maintaining internal controls over financial reporting; and
- complying with applicable laws and regulations.

In fulfilling these responsibilities, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies and procedures. The objectives of internal control over financial reporting are to provide management with reasonable, but not absolute, assurance that:

- transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in conformity with generally accepted accounting principles;
- assets are safeguarded against loss from unauthorized acquisition, use or disposition; and
- transactions are executed in accordance with laws governing the use of budget authority and other laws and regulations that could have a direct and material effect on the financial statements.

Auditors' Responsibility. Our responsibility is to express an opinion on the 1999 and 1998 financial statements of FHA based on our audits. We conducted our audits in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin No. 98-08, as amended. Those standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement and presented fairly in accordance with generally accepted accounting principles. We believe that our audits provide a reasonable basis for our opinion. Our audits were not designed to test the requirements of OMB Bulletin No. 98-08 relating to the *Federal Financial Management Improvement Act* (FFMIA) or performance measures, which were not considered applicable at the FHA level. FFMIA requirements and performance measures will be reviewed and reported on at the HUD consolidated level.

In planning and performing our audit of the financial statements of FHA, we considered internal control over financial reporting by obtaining an understanding of FHA's significant internal controls, determined whether these 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 98-08, as amended. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982, such as those controls relevant to ensuring efficient operations. The objective of our audit was not to provide assurance on internal control over financial reporting. Consequently, we do not provide an opinion on internal controls.

As part of obtaining reasonable assurance about whether FHA's financial statements are free of material misstatement, we performed tests of FHA's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of the financial statement amounts. We limited our tests of compliance to these provisions and did not test compliance with all laws and regulations applicable to FHA. However, providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit, and accordingly, we do not express such an opinion.

In order to fulfill these responsibilities, we:

- examined, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements;
- assessed the accounting principles used and significant estimates made by management;
- evaluated the overall financial statement presentation; and
- tested compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts.

Because of inherent limitations in internal controls, misstatements, losses or noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of internal controls to future periods is subject to the risk that internal control procedures may become inadequate because of changes in conditions, or that the effectiveness of the design and operation of policies and procedures may deteriorate.

Distribution. This report is intended solely for the information and use of the HUD Office of the Inspector General, the management of FHA and HUD, OMB, and Congress and is not intended to be and should not be used by anyone other than those specified parties.

February 24, 2000

INTRODUCTION

Material weaknesses and reportable conditions in FHA's internal control, as of and for the year ended September 30, 1999, are summarized in the categories discussed below:

Material Weaknesses:

Controls over budgetary funds and funds control must be improved. FHA must perform analyses and reconciliations of all of its obligation systems, to ensure that all obligated amounts are properly recorded and that funds control is maintained and implemented in all systems. This process directly relates to ensuring that budgetary status and accounting information is complete, accurate, and available to management for decision-making purposes.

FHA's information technology systems must be enhanced to more effectively support FHA's business processes. HUD and FHA are conducting day-to-day business with legacy based systems, several of which directly impact FHA's financial activity and necessitate financial transactions to be processed through non-integrated systems, requiring manual analysis and summary entries to be posted to FHA's general ledger. FHA's and HUD's inability to implement modern information technology adversely affects the internal controls related to accounting and reporting financial activities.

Reportable Conditions:

FHA must continue to place more emphasis on early warning and loss prevention for insured mortgages. FHA needs to continue to reduce the frequency and loss severity of defaults on insured mortgages by improving its monitoring of financial and delinquency data to identify and cure troubled multifamily mortgages and by expanding the use of loss mitigation tools and improving the effectiveness of monitoring processes for the single family insured portfolio.

FHA must continue actions to safeguard and quickly resolve Secretary-held Single Family mortgage notes. FHA has taken positive steps to address inadequate servicing and management of defaulted mortgage notes in fiscal year 1999. However, further improvements in servicing of notes assigned to FHA need to be taken to safeguard the value of these assets until the notes are sold as planned.

FHA must sufficiently monitor and account for its Single Family property inventory. FHA has taken positive steps to control weaknesses which exist in FHA's single family property acquisition, management, and disposition functions. However, more needs to be done to reduce single family inventory in a manner that maximizes the return to FHA while preserving and protecting these properties.

FHA must improve its review process for estimating reserves for the insured portfolio. FHA needs to continue to improve its Liability for Loan Guarantees estimation review process, to reduce the number of adjustments to the models and assumptions by strengthening the quality assurance controls used to ensure accurate recording and reporting.

FHA/HUD must enhance the design/operation of controls over information systems security and application data integrity. FHA/HUD has taken steps to address prior year control weaknesses in the EDP control environment. For example, FHA/HUD has implemented improved processes for controlling the modification of application software programs. However, control weaknesses still exist in system and application access controls, and application data integrity.

All of the material weaknesses and reportable conditions described above have been previously reported. We acknowledge that FHA and HUD have taken actions towards addressing all of these conditions. However, as reported in prior years, implementing sufficient change to mitigate the internal control weaknesses is a multiyear task due to the complexity of the issues and impediments to change that FHA and HUD face. These impediments involve interaction with large numbers of relevant constituencies outside of HUD and resource constraining actions, which can affect the timing of corrective action plan implementation.

The material weaknesses listed above do not include a separate weakness related to FHA's staff and administrative resource issues, as was included in the fiscal year 1998 internal control report. Significant issues remain relating to the monitoring aspects of financial and operational processes in the management of the insurance portfolio, notes, and acquired property. Staff and administrative resource issues are discussed as contributing causes of the other reportable conditions included in this report.

FHA's staffing and administrative resource issues are not fully resolved, however, primarily due to the continued outsourcing of labor intensive functions, there has been sufficient progress to warrant our reassessment of those issues. While the ultimate resolution of these issues has not yet been fully realized FHA's staffing and administrative resources are now more focused on monitoring activities relating to outsourced functions.

The internal control weaknesses discussed in this report, and FHA's progress toward correcting these weaknesses, are discussed in the context of FHA's existing statutory and organizational structure. As of the date of this report, it is unclear how future legislative and budgetary changes will impact FHA, and what effect such changes may have on FHA's ability to implement existing or future corrective action plans.

The following sections describe each material weakness as of and for the period ended September 30, 1999; our recommendations; FHA management's response to the material weakness and recommendations; and our assessment of that response. Appendix B includes a similar discussion of each reportable condition described above, respectively. Appendix C describes the statistical sampling methodologies applied during our review of internal controls over the Multifamily insurance portfolio, and Single Family properties. The full text of management's response is included as Appendix D.

CONTROLS OVER BUDGETARY FUNDS MUST BE IMPROVED

During the fiscal year ended September 30, 1999, FHA continued to improve the documentation of processes implemented to conform to generally accepted accounting principles that are applicable for Federal entities, as promulgated by the Federal Accounting Standards Advisory Board (FASAB). However, further improvement in financial systems and processes are needed to ensure that accounting and budget information are properly presented and accurate and timely information is available to management for funds control and decision-making purposes. Improving budgetary and accounting controls requires related improvements to FHA's financial systems, which is further discussed in the following material weakness, *FHA's Information Technology Systems Environment Must be Enhanced to More Effectively Support FHA Business Processes*. During the fiscal year ended September 30, 1999, we noted the following weaknesses in FHA's budgetary and accounting processes:

- **Budgetary reporting of appropriation symbol 86X4077 was misstated by approximately $64 million.** The SF-133, *Report on Budget Execution,* dated November 19, 1999, submitted to OMB by HUD's Chief Financial Officer's Office did not include an automatic apportionment of authority with respect to the interest payment to U.S. Treasury which occurred at fiscal year end. This reporting error occurred because correct and timely information was not available due to the lack of integrated and reconciled budgetary and accounting systems and processes. OMB Circular No. A-34, *Instructions on Budget Execution* (1999) Section 34.5 provides that "in credit financing accounts, additional amounts for the payment of interest to Treasury are automatically apportioned." FHA and the HUD CFO Office are developing a plan to implement funds control in all FHA systems and processes to ensure future reporting is accurate. This plan, which has been partially completed as of the date of our report, will be provided to OMB. Once the plan is fully developed, implementation will be monitored by FHA, HUD, and OMB. If not fully and successfully implemented, OMB may take further action, in accordance with the requirements of OMB Circular A-34.

- **Obligations needed to be reviewed and reconciled.** Although FHA fully reconciled obligation activity during the fiscal year, they did not fully reconcile the ending balance of commitments and obligations resulting from underwriting activity during fiscal year 1999 and prior years. At our request, FHA reconciled the subsidiary ledger, Credit Subsidy Control System (CSCS) to the Multifamily Insurance System (F47) and the general ledger (MSA).

As a result of the reconciliation, additional items amounting to approximately $16 million were identified as expended and were subsequently recorded in the financial statements.

We also identified, and FHA recorded an adjustment for, contracts for FHA's Multifamily Pre-Demonstration Program of $21 million that were recorded as obligations in two separate systems, CSCS and FHA Contract Tracking System (FHACTS), supporting different appropriation accounts. Additionally, although low in amount, three contracts were identified in FHACTS where funds were disbursed in excess of obligated amounts. Finally, we noted that FHA had not recorded approximately $19 million and $168 million in accounts payable and unliquidated obligations, respectively, relating to its Marketing and Management contractors, and at our request adjusted the financial statements for these items.

- **FHA's general ledger budgetary obligation accounts were not fully supported.** During fiscal year 1999, FHA analyzed its general ledger and developed a documented crosswalk to the SGL to prepare both the financial statements and the SF-133s, *Report on Budget Execution*. FHA also implemented the budgetary-related SGL accounts in its general ledger. However, the subsidiary systems that contain the transaction detail activity supporting the SGL did not provide reports which were properly reconciled to the general ledger. In addition, detailed reports supporting the aggregate amounts recorded to the general ledger and SF-133s were not maintained. OMB Circular A-127 requires that transaction detail be available to support the SGL account entries.

Recommendations to address the above weaknesses include:

- Implement a reconciliation and review process for the ending balance of all obligations to related systems, to ensure that budgetary status and accounting information is complete, accurate and timely provided to management for both SF-133 and financial statement reporting;

- Complete the development of a plan to implement funds control in all FHA systems and processes, submit it to OMB, and implement the plan; and

- Revise the process in place for the preparation of SF-133's to include consideration of preparation and review by the Comptroller's Office.

In addition, we continue to recommend that FHA:

- Reconcile the accounting and budget systems for loan guarantee commitments and endorsements, to ensure all credit subsidy amounts are recorded properly; and

- Implement the processes or systems necessary to ensure FHA's compliance with the SGL at the transaction level.

Management's Response

Management agrees with this finding and the associated recommendations. Further discussion, and the progress of planned initiatives, is included in management's response in Appendix D.

KPMG's Assessment of Management's Response

We concur with management's response.

FHA'S INFORMATION TECHNOLOGY SYSTEMS MUST BE ENHANCED TO MORE EFFECTIVELY SUPPORT FHA'S BUSINESS PROCESSES

For a number of years, weaknesses have been reported in FHA's financial management system environment. FHA's and HUD's inability to acquire more modern information technology has continued to deter FHA's efforts to be a more efficient and effective housing credit provider. Until a comprehensive new integrated information technology environment is implemented and available throughout HUD, FHA will continue to be forced to collect data and report information in less efficient ways.

During fiscal year 1999, FHA made some improvements to its system environment to support business processes, including enhancements to the Real Estate Management System (REMS) to provide additional multifamily reporting functionality, and implementation of the Single Family Premium Collection System - Periodic (SFPCS-P) to provide integrated single family billing, collection, and cash flow accounting for credit reform reporting.

Despite these efforts, there are additional improvements that are needed. FHA and HUD are conducting day-to-day business with legacy-based systems, several of which directly impact FHA's financial activity and require financial transactions to be processed through non-integrated systems, necessitating manual analysis and summary entries to be posted to FHA's general ledger. In addition, key FHA systems, including CSCS, FHACTS, and Program Accounting Support/Letter of Credit Collection System (PAS/LOCCS) do not provide the functionality required to sufficiently manage and account for system transactions in accordance with federal regulations, including the Office of Management and Budget's (OMB) Circular A-127, *Financial Management Systems*, and OMB Circular A-130, *Management of Federal Information Systems.* Finally, HUD continues to report material system non-conformances in its *Fiscal Year 1999 Accountability Report*, several of which relate to FHA systems.

FHA recognized the need for systems improvement efforts in the December 1999 document *FHA Vision of Financial Management*, in which the current state of FHA financial management is modeled and several phases of improvements are documented. Planned improvements include providing additional automated interfaces between FHA financial systems and the FHA general ledger. However, no detailed plans or estimated completion dates have yet been assigned to the tasks identified in the *FHA Vision of Financial Management*.

Finally, project planning for FHA's other systems implementation efforts should be improved. For example, FHA system information maintained in HUD's Information Technology Investment Portfolio System (I-TIPS) does not contain detailed project tasks, expected deliverables, project milestones, or references to the integration of data standards between systems. In addition to being sound business practices, these planning elements are required by HUD's capital planning methodology.

Recommendations to address the above include:

- Ensure that the FHA systems environment is given a high priority during the drafting of the *HUD Enterprise Architecture*, which is HUD's information technology investment planning methodology, currently under development. These planning efforts should ensure that the cost/benefit of currently operating FHA systems is considered and should assess where new systems or enhancements to existing systems can be implemented to better support FHA business and financial operations.

- Develop detailed FHA systems project planning information to be included in HUD's I-TIPS process. This planning information should also complement FHA systems included in *HUD's Enterprise Architecture*.

- Develop a complete approach to support the *FHA Vision of Financial Management*, and ensure that this plan is linked to the *HUD Enterprise Architecture*.

- Ensure that FHA systems are developed and maintained in accordance with HUD's System Development Methodology (which incorporates both OMB Circular A-127 and A-130).

Management's Response

Management agrees with this finding and the associated recommendations. Further discussion, and the progress of planned initiatives, is included in management's response in Appendix D.

KPMG's Assessment of Management's Response

We concur with management's response.

FHA MUST CONTINUE TO PLACE MORE EMPHASIS ON EARLY WARNING AND LOSS PREVENTION FOR INSURED MORTGAGES

During 1999, FHA made notable progress in its ability to monitor its insured portfolio and, as a result, this comment was reclassified from a material weakness in our fiscal year 1998 report to a reportable condition in our fiscal year 1999 report. Although progress was made regarding early warning and loss prevention during fiscal year 1999, as of September 30, 1999, FHA had not yet fully implemented certain new initiatives to identify and manage risks in its insured portfolios effectively. FHA also needs to increase its use and analysis of other data now available to identify and resolve high risk underwriting practices. Timely identification of troubled insured mortgages and lenders with inadequate underwriting practices are key elements of FHA's efforts to target resources to insured mortgages and lenders that represent the greatest financial risks to FHA. Troubled insured mortgages and potentially problem lenders must be identified before FHA can institute loss mitigation techniques and lender enforcement measures that can reduce eventual claims.

We noted progress in the implementation of FHA's early warning and loss prevention initiatives for the Multifamily portfolio. Specifically, FHA made progress in the following Multifamily areas:

- **Standardized physical inspection process.** With the implementation of the Real Estate Assessment Center (REAC), HUD has created a standardized physical inspection protocol that enables both project managers and Office of Housing management to assess the quality of the Multifamily portfolio on a national basis, and implement a risk-based monitoring strategy.

- **Substantial increase in number of physical inspections.** As of September 30, 1999, approximately 6,800 insured projects had been inspected by the REAC, with a total of over 10,100 (or 70 percent of the portfolio) inspected by December 31, 1999, out of a portfolio of approximately 14,400 insured projects.[1] This represents a substantial increase in the number of physical inspections over prior years, and improves FHA's ability to manage its multifamily portfolio effectively.

- **Exigent health and safety notifications.** With the new physical inspection protocol, all urgent health and safety issues are delivered to the on-site property manager immediately after the inspection is complete. Prompt notification of health and safety problems enables property managers to correct deficiencies quickly, and improve living conditions for the tenants.

To assess FHA's controls over early warning and loss prevention, we selected a statistically representative, nation-wide sample of insured projects, to test various attributes relating to the

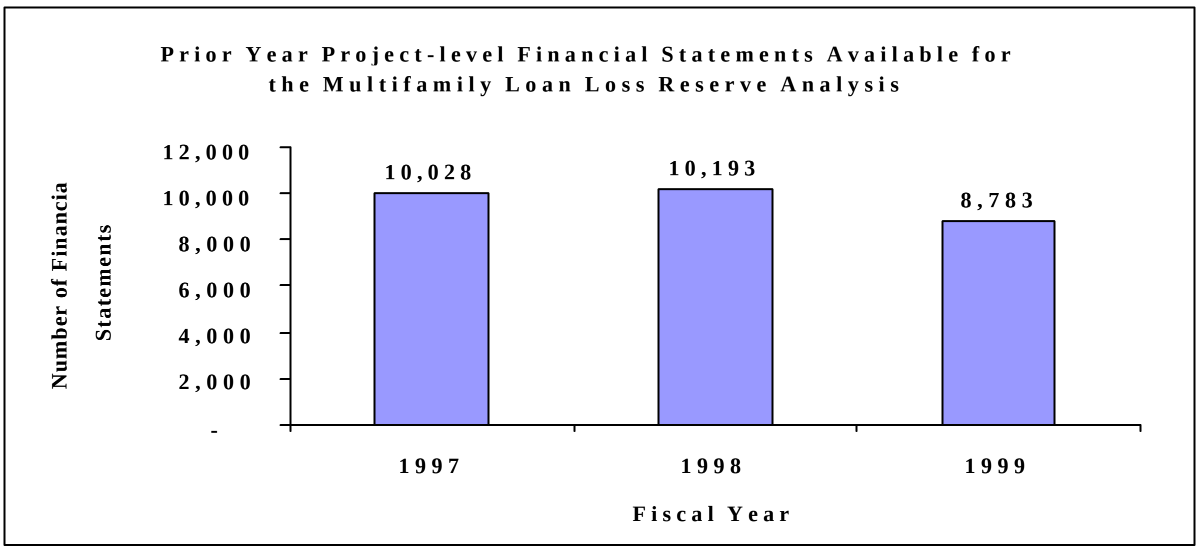
[1] This inventory includes all insured first mortgages, both Multifamily and Healthcare projects, excluding Section 242 Hospitals, and risk sharing projects.

quality of FHA's insured portfolio management. Our methodology is further described in Appendix C. The deficiencies we noted were related to the following initiatives:

- **Financial assessment process within the REAC.** As of September 30, 1999, over 7,800 Multifamily project owners submitted financial statements to REAC for electronic analysis by the Financial Assessment Subsystem (FASS). However, delays were encountered with the rollout of the FASS, which resulted in:

  - *A decrease in the number of financial statements available to Multifamily and the Office of the Comptroller.* Only 8,783 fiscal year 1998 financial statements were available for the multifamily loan loss reserve analysis.[2] As depicted in Exhibit 1, this represents an overall decrease from fiscal year 1998 (by approximately 1,400 project-level financial statements) in the total number of financial statements available for analysis.

Exhibit 1



Source: FHA's Multifamily Loan Loss Reserve Analysis

  - *FHA's failure to financially monitor the insured portfolio during the fiscal year.* Due to difficulties encountered by property managers and owners in submitting their financial statements electronically, HUD moved the due date for submission of financial statements from March 31 to August 31, 1999. Once financial statements were submitted, Multifamily delayed releasing the data to project managers until training could be performed to instruct them on how to use that data. Distribution of financial statement results, by Multifamily Hub, started on September 30, 1999, the last day of the fiscal year, and is currently ongoing. As a result, current financial information was not available to project managers during fiscal year 1999. Therefore, financial assessments of insured

[2] Approximately 1,200 project-level financial statements were received between September 30, 1999 and December 14, 1999, bringing the total received to approximately 9,900 financial statements.

projects were not performed during fiscal year 1999, and follow-up on any financial issues subsequently identified could not occur until at least 9 months (e.g., most projects submitted December 31, 1998 financial statements) after a project's fiscal year end.

- **Electronic submission of delinquency data for insured multifamily projects.** During fiscal year 1999, FHA began collecting multifamily delinquency data from mortgagees electronically. However, due to technical difficulties, project managers in the field were not able to consistently access this delinquency information to monitor their portfolio.

The Office of Single Family Housing has also made progress towards improving its early warning and loss prevention processes. This progress includes:

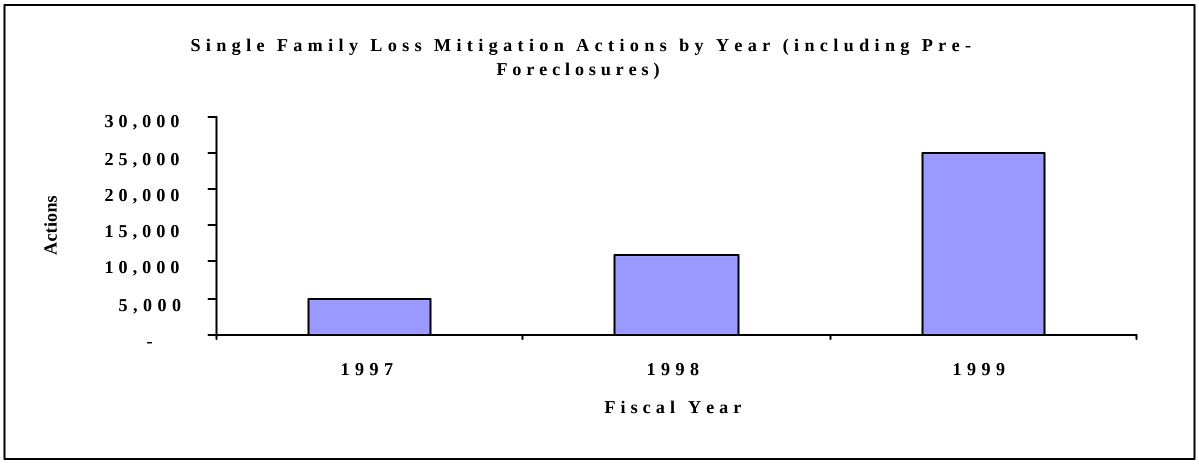
- **Neighborhood Watch and Credit Watch implemented.** Through Neighborhood Watch and Credit Watch, FHA has the ability to trend claim and default data by lender, and impose sanctions on problem lenders. During fiscal year 1999, Single Family issued its first terminations to lenders with excessive claim rates, and followed up with its second set of terminations in early fiscal year 2000.

- **Quality assurance reviews increased.** Using the analyses performed by Neighborhood Watch, Single Family identified lenders with high default rates for underwriting and origination reviews by the Quality Assurance Division. The number of reviews performed during fiscal year 1999 increased by 112 percent over fiscal year 1998, to 932 reviews. These reviews resulted in numerous corrective actions against lenders, including indemnifications and referrals to the Mortgagee Review Board.

- **Use of loss mitigation expanded.** The number of seriously delinquent loans that have avoided foreclosure through relief measures provided by loss mitigation tools is increasing. As depicted in Exhibit 2, the total number of loss mitigation interventions has more than doubled in each of the last three fiscal years. To determine the success of the program, Single Family has begun to track the ultimate outcome of loans that enter the loss mitigation program.

- **Development of the Lender Assessment Subsystem (LASS) of the REAC began.** During fiscal year 1999, FHA began the development of the LASS, a subsystem of the REAC that will assess the financial stability of approved lenders through the analysis of financial indicators obtained using EDI. Through this analysis, FHA will be able to identify potentially problem lenders, and take actions to ensure that these lenders do not cause increased losses to the insurance fund.

Exhibit 2



Source: Single Family Claims Paid by Fund Report (Single Family Accounting)

However, there are still certain Single Family controls that need to be improved. These controls include:

- **Appraisals on FHA insured single family mortgages.** As noted in previous reports, problems have been identified in obtaining accurate appraisals on insured mortgages. In an effort to correct these problems, HUD is implementing an appraisal reform program, which includes mandatory tests to become an FHA-approved single family appraiser. HUD is also implementing a single family appraisal review process within the REAC to focus on monitoring and enforcement of problem appraisers. This quality assurance review process is scheduled for implementation in fiscal year 2000.

- **Post-claim reviews.** During prior fiscal years, an FHA contractor performed post-claim reviews of closed claims. Because single family claims are paid electronically, post-claim reviews are critical in ensuring that expenses claimed by mortgagees are allowable. These reviews found that lenders submitted approximately $4.4 million in inappropriate expenses claimed per year in fiscal years 1997 and 1998, and resulted in refunds to the insurance fund from lenders. In January 1999, the post-claim review contract expired and FHA has not yet awarded a subsequent contract to perform this work. As a result, FHA recoveries from this review process declined 43 percent in fiscal year 1999, as compared to fiscal year 1998. In addition to increasing recoveries from lenders, the post-claim review process also has the ability to function as the main compliance review procedure for loss mitigation.

- **Post-endorsement technical reviews.** We noted that while Homeownership Center (HOC) staff and technical review contractors performed post-endorsement technical reviews during fiscal year 1999, there was little analysis and lender follow-up based on the results of these reviews, even though certain lenders were identified with inadequate underwriting practices. Although there is some communication of these results to Quality Assurance (QA) staff, there were approximately 150,000 post-endorsement technical reviews performed nationwide during fiscal year 1999 compared to 932 QA reviews. Due to the significant number of reviews performed, the post-endorsement technical reviews could be used to provide meaningful feedback on a large number of FHA partners.

- **Triple claim legislation.** During fiscal year 1998, in order to enforce loss mitigation policies, Congress passed legislation enabling Single Family to impose penalties up to three times the amount of any insurance benefits claimed by a lender should the lender fail to consider the use of loss mitigation for defaulted loans. Single Family has yet to develop implementing regulations to assess these penalties, and as a result, has not yet used the penalties as a tool to promote loss mitigation.

Recommendations to address the above continue to include:

- Continue training Multifamily project managers on FASS and release all 1998 multifamily project financial statement data for use in the field. In addition, FHA should complete two years (both 1998 and 1999) of financial statement submissions, scoring, and follow-up on risky or problem projects by the end of fiscal year 2000.

- Continue with efforts to develop systems to electronically capture multifamily payment history information reported by all mortgagees, and provide project managers access to this data. Monetary penalties for mortgagees who fail to report should be considered to promote reporting compliance.

- Implement the EDI transmission of key financial ratios, adjusted net worth calculations, and other liquidity and equity measures by FHA-approved mortgagees. This will eliminate the time-intensive process of manually inputting the information into a database to track and review lender's financial stability, and can be performed in conjunction with FHA's initiative to eventually require lender's to electronically submit financial information for annual recertification.

- Develop a process to further incorporate results of the post-endorsement technical review process with other available monitoring tools, to immediately identify and take corrective action against problem lenders, underwriters, and appraisers. This analysis could be incorporated in LASS.

- Implement revisions to the single family appraisal process to enhance appraiser monitoring and enforce the quality assurance process.

- Implement policies and procedures to carry out the legislation enabling FHA to impose a penalty of three times the amount of any single family insurance benefits claimed by a lender should the lender fail to engage in loss mitigation activities.

In addition, we recommend that FHA:

- Implement a post-claim review process until the post-claim review contract is awarded. Once FHA awards the post-claim review contract, the contractor should begin with those fiscal year 1999 claims that had not yet been reviewed by FHA. FHA should also consider use of the post-claim review process to assess lender compliance with loss mitigation. The post-claim review process could be expanded to determine whether a lender considered (and documented) the use of loss mitigation alternatives for defaulted loans.

- Continue to expand the use of loss mitigation through training and outreach programs with Single Family approved lenders.

Management's Response

Management generally agrees with KPMG's assessment of this issue. In addition to describing in detail the initiatives listed in the preceding section, their response also updates FHA's progress on programs that continued after September 30, 1999, including the distribution of multifamily project-level financial information to project managers in the field. Management, however, does not agree with KPMG's assessment of the continued improvements needed to eliminate this reportable condition for the Single Family portfolio, including both the continued expansion of loss mitigation, and the implementation of EDI in lender assessment. Further discussion is included in management's response in Appendix D.

KPMG's Assessment of Management's Response

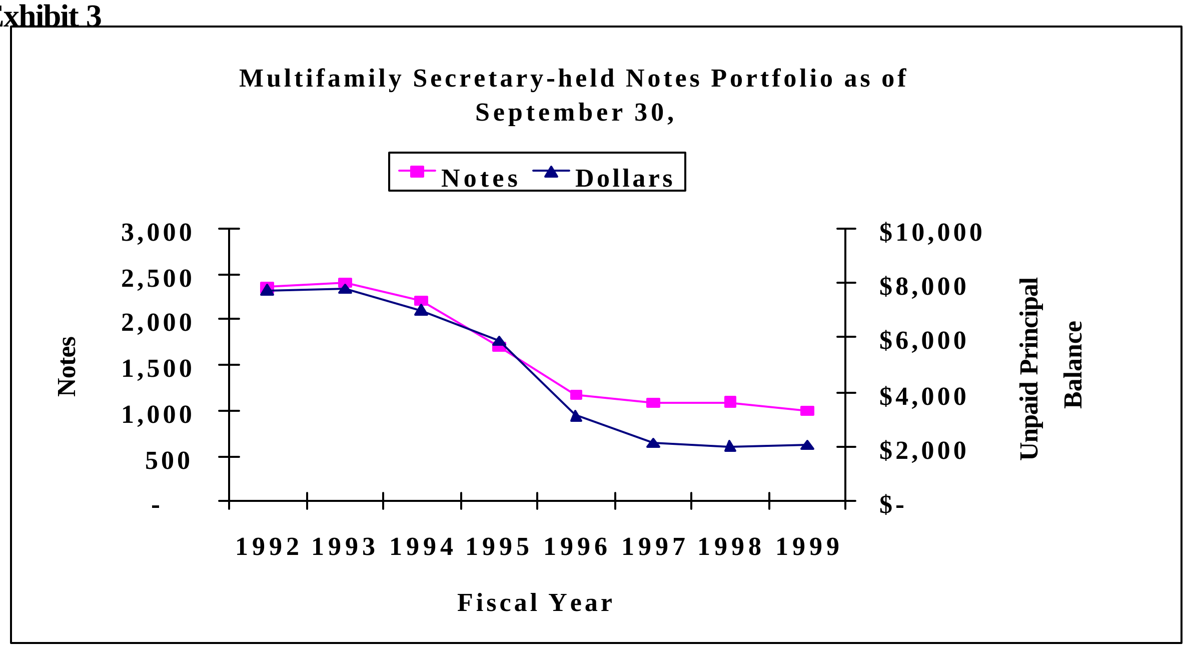
We continue to believe that additional progress is needed to eliminate this reportable condition. Although the fiscal year 2000 progress on initiatives described in management's response has the potential of improving the status of this reportable condition, these programs were not in place during fiscal year 1999, and it is too early to determine their impact on resolving this condition.

FHA MUST CONTINUE ACTIONS TO SAFEGUARD AND QUICKLY RESOLVE SINGLE FAMILY SECRETARY-HELD MORTGAGE NOTES

Since 1994, FHA has made significant progress to reduce its Secretary-held note portfolio. Through the note auction program, FHA was able to sell approximately $5 billion in Multifamily and $3 billion in Single Family Secretary-held mortgage notes. Although no note sales were conducted in fiscal years 1998 and 1999, additional efforts have been made to reduce the impact of the Secretary-held note portfolios on FHA's limited resources including outsourcing the servicing of the Secretary-held note portfolios. FHA has also been successful in obtaining authority to resume the mortgage note auction program in fiscal year 2000.

In fiscal year 1998, FHA successfully outsourced the servicing of its Multifamily Secretary-held note portfolio to an external contractor. This has enabled FHA to reallocate resources that had been dedicated to processing billings, collections, escrows, and other transactions for the portfolio. In addition, due to the low number of assignments and foreclosures, the inventory of Multifamily Secretary-held notes (in both unpaid principal balance and number of notes) has remained constant over the last several years, as depicted in Exhibit 3. As for the current portfolio, FHA received proposals in December 1999 for a transaction financial advisor to conduct a sale of a portion of the remaining Secretary-held portfolio. The first sale is tentatively scheduled to occur prior to the end of fiscal year 2000. The outsourcing, coupled with the anticipated sale, has improved FHA's ability to manage its portfolio to the extent that we no longer consider Multifamily Secretary-held mortgage notes to be a reportable condition.

Exhibit 3



Source: Office of Housing- FHA Comptroller

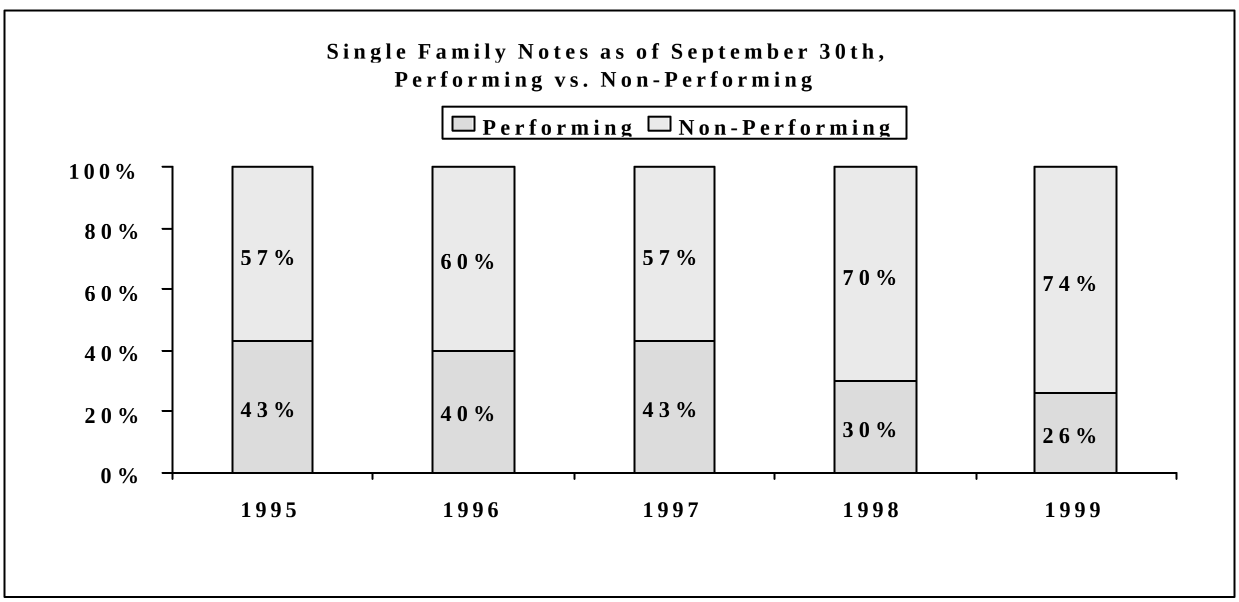
As for Single Family Secretary-held notes, FHA's management of the portfolio has also improved since fiscal year 1998. In our prior year report, we indicated that servicing of the Single Family Secretary-held note portfolio was deficient. For delinquent loans, FHA did not initiate foreclosure and did not aggressively pursue other servicing alternatives (i.e., workout plans, increased collection efforts). To improve the servicing of the portfolio, as well as alleviate staffing and administrative resource issues, FHA outsourced the servicing of the Single Family Secretary-held note portfolio in April 1999.

Since the servicing was outsourced, there have been improvements in the portfolio. Cash collections related to principal and interest have increased by $6 million or 18 percent over fiscal year 1998 to $40 million in fiscal year 1999 while the unpaid principal balance of the portfolio decreased by approximately 5 percent to $647 million. However, there were several significant deficiencies related to the portfolio that remained outstanding as of September 30, 1999. These deficiencies include:

- **The servicing of the portfolio needs to be improved.** The servicing contractor incurred delays in receiving initial files and documentation. Also, the quality of the files provided to the contractor was poor, and as a result, over five months passed after contract award before servicing of the portfolio began in the fourth quarter of fiscal year 1999. Because of these delays, over 2,500 loans, or 22 percent of the portfolio, were not being actively serviced as of September 30, 1999. While we understand that many of the delays were caused by contracting issues beyond the control of the contractor or FHA, the effects of these delays adversely affected FHA's ability to manage these assets and prevent further losses to the fund.

- **The quality of the portfolio continued to deteriorate.** As depicted in Exhibit 4, the percentage of the portfolio classified as performing has continued to decrease. The performing portion of the portfolio (classified as those loans that are current either under the terms of the original mortgage or subsequent forbearance agreements) decreased from 30 percent at September 30, 1998, to 26 percent at September 30, 1999.

Exhibit 4



Source: Single Family Note GAAP Extracts

We understand that during most of fiscal year 1999, the contractor focused on performing due diligence over the loan files in an effort to prepare the loans for the loan sale program. Once the due diligence was completed in August 1999, the contractor began to actively service the portfolio.

As with Multifamily, Single Family anticipates resuming the note sale program as soon as possible. Proposals for transaction financial advisors were submitted in December 1999, and FHA awarded the contract in February 2000. Currently, FHA plans to include the majority of the single family Secretary-held note portfolio in a sale planned for the second quarter of calendar year 2000.

Recommendation

We continue to recommend that FHA conduct mortgage note auctions to reduce b oth the single family and multifamily mortgage note inventory.

Management's Response

Management concurs with KPMG's assessment of the Multifamily Secretary-held portfolio. As for the Single Family Secretary-held portfolio, management concurs with KPMG's recommendation, but also provides additional commentary on the reasons behind the delays incurred in servicing the portfolio. In their response, management details the progress made by their servicing contractor in performing due diligence and increasing the collections on the portfolio, as well as the monitoring process in place over the contractor. Management also concurs with KPMG's recommendation for the sale of both the Single Family and Multifamily Secretary-held portfolios, as soon as possible. Further discussion is included in management's response in Appendix D.

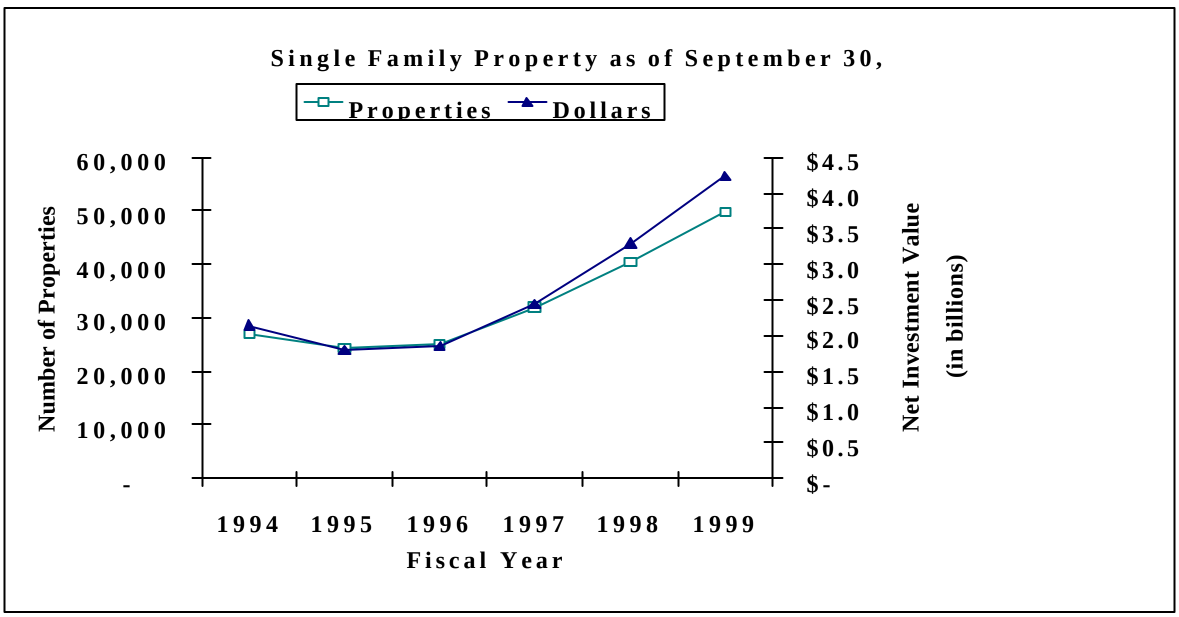
KPMG's Assessment of Management's Response

KPMG acknowledges that Single Family has several requirements in servicing the portfolio, and although the ultimate objective of selling the portfolio is the same, the individual requirements may come into conflict (i.e., due diligence versus active servicing). Regardless of the performance of FHA's servicing contractor, we found that during fiscal year 1999, the quality of the portfolio had deteriorated, causing the continued reporting of this reportable condition.

FHA MUST SUFFICIENTLY MONITOR AND ACCOUNT FOR SINGLE FAMILY PROPERTY INVENTORY

During fiscal year 1999, we continued to observe conditions relating to the Single Family property portfolio that need to be improved to maximize the return to FHA while preserving and protecting these properties. At September 30, 1999, FHA's single family property inventory reached a high of 49,793 properties, an increase of 10,423 properties compared to September 30, 1998. The total net investment value was $4.24 billion, an increase of $950 million compared to September 30, 1998 as shown in Exhibit 5. Additionally, the number of properties remaining in inventory more than one year increased by 2,117 properties, or 64.2 percent, to 5,412 properties. Although FHA's Marketing and Management (M&M) contracts, discussed below, were implemented during the fiscal year, total sales in fiscal year 1999 compared to fiscal year 1998 decreased by 1,780 properties, even though more properties were available for sale. These results were caused by both the control weaknesses we identified and poor performance of a terminated M&M contractor who was responsible for nearly 50 percent of single family property inventory.

Exhibit 5



Source: Single Family Acquired Asset Management System

During March and April 1999, the responsibilities associated with daily Single Family Secretary-owned property operations were shifted to M&M contractors. As a part of the planned transition process, the M&M contractors were required to research all properties held in inventory and perform other actions such as appraisals and relisting, as appropriate. The M&M contractors also arrange for and supervise the management, operations, repairs, maintenance, and rental of single family properties.

Because this major outsourcing initiative occurred mid-year, FHA did not begin to see results until the end of the fiscal year, due to transition and start up challenges. However, we noted that during the period that the M&M contractors managed the Single Family property portfolio there was both an increase in sales price and recovery rates for properties sold.

Oversight of M&M contractors is performed both at the HOCs and at Headquarters. Each month, the M&M contractors receive a performance assessment which is the result of case file reviews by contractors, Special Property Inspector physical inspections, and government oversight observations. As a result of its monitoring and oversight controls, FHA terminated the poor-performing M&M contractor, noted above, as of September 22, 1999.

We selected a statistically representative nationwide sample of properties to test property management and marketing processes at the contractor level. Our methodology is further described in Appendix C. Deficiencies we noted included:

- **Property maintenance and upkeep.** A statistical sample of single family properties indicates that 28 percent of the properties in inventory had one or more of the following issues: 1) properties were unsecured; 2) properties were not marked as Government Owned and/or For Sale; and 3) properties contained hazardous material and debris.

- **Processing delays.** All delays in the management process, whether during acquisition or disposition, impede FHA's ability to dispose of properties in a timely manner, while having an adverse affect on the future sales value of the properties. Because certain activities are dependent on the completion of others, it is essential that property managers strictly adhere to HUD guidelines with respect to established time parameters. A statistical sample of property case files indicates that 43 percent of properties experienced significant delays in processing. For example, delays in assigning an appraiser ranged from 6 days to 196 days and delays in approving a property disposition program ranged from 16 days to 111 days.

- **Single Family Acquired Asset Management System (SAMS) data integrity issues.** A statistical sample of property case files indicates that 9 percent of properties experienced one or more of the following errors: 1) records in SAMS were not associated with valid Secretary-owned properties; and 2) appraisal amounts in SAMS were incorrect.

- **SAMS processing issues.** Although most of the M&M contractors use proprietary systems to assist them in monitoring and accounting for properties as they progress through the property disposition process, FHA's accounting and reporting for single family property is driven completely by information in the SAMS system. Therefore, when the cases are not properly moved through the ten SAMS property steps, SAMS reports do not reflect the actual status of the property.

- **Closing services.** A statistical sample indicates that 9 percent of cases in inventory at September 30, 1999 would experience significant delays in closing (e.g., 21 to 100 days). Closing agents that are not sufficiently monitored or assessed routine liquidating damages have no motive to correct inadequate performance. To the extent that closing agents do not close contracts timely, the risk of cancelled sales and other bottlenecks in processing increases.

Recommendations to address the above weaknesses include:

- Concentrate efforts to identify, investigate, and delete bad case numbers from SAMS. This should be a priority effort that involves personnel from Headquarters, Single Family HOCs, and M&M contractors.

- Continue to develop comprehensive oversight tools and management reports to facilitate effective monitoring of the M&M contractors, while providing practical and useful feedback to the contractors. Consider the use of statistical sampling in the oversight process for case file review. While these reports and tools should be utilized to identify the M&M contractors with performance issues, FHA should additionally devise a method of penalizing those that routinely do not comply. Such a mechanism will effectively communicate the importance of strictly adhering to HUD Guidelines.

Management's Response

In their response, management does not fully agree with KPMG's assessment of Single Family property controls during fiscal year 1999. Management cites improved control processes in place during the fiscal year, including physical inspections, case file reviews, and management reports, that have enhanced FHA's ability to monitor its property portfolio. Additionally, management notes that the overall inventory has been declining in every contract area subsequent to September 30, 1999. Further discussion is included in management's response in Appendix D.

KPMG's Assessment of Management's Response

We acknowledge that new internal control processes were implemented during fiscal year 1999, as a result of the transition to property management and marketing contractors. We also observed that Single Family property inventory began declining after year end. However, during fiscal year 1999, and as of September 30, 1999, deficiencies still existed in FHA's ability to monitor and safeguard properties and to maximize the return to the insurance fund.

FHA SHOULD IMPROVE THE REVIEW PROCESS FOR ESTIMATING RESERVES FOR THE INSURED PORTFOLIO

The potential future losses related to FHA's central business of providing mortgage insurance is accounted for in the financial statements in the Liability for Loan Guarantee (LLG). As required under Credit Reform, this liability is comprised of both liquidating and financing accounts. During FY 1999, FHA has made progress in developing documentation and refining their processes for estimating and accounting for the LLG. However, we noted several deficiencies that were not detected through FHA's internal control processes. These resulted in approximately $940 million in adjustments to the LLG, resulting in a net increase in the reserve of $718 million. These errors were ultimately corrected for financial statement purposes. Examples of the errors we noted include:

- **MMI Financing LLG.** We noted several calculation errors that resulted in modeling changes. We identified an incorrect discount rate resulting in a $18 million decrease adjustment and an error in the calculation of the average mortgage amount resulting in a $55 million increase adjustment. Additionally, we noted that an incorrect upfront premium factor was used in calculating the weighted average up-front premium, resulting in a $10 million increase adjustment.

- **Single Family GI/SRI Financing LLG.** We noted that the loss mitigation assumptions used in the Single Family GI/SRI LLG estimate were not consistent with those used to estimate the MMI LLG. We re-estimated the LLG using historical data and assumptions similar to those used in the MMI LLG calculation. This recalculation resulted in a $20 million decrease adjustment. We also identified an incorrect discount rate resulting in a $1 million decrease adjustment and an error in the recovery calculation resulting in a $130 million increase adjustment. Additionally, we noted that the insurance in force amounts were not updated for fiscal year 1999 for one risk category, resulting in an increase adjustment of $19 million.

- **Multifamily GI/SRI Financing LLG.** We identified an inconsistent, undocumented change in the methodology to calculate the note sale recovery rate. For fiscal year 1999, FHA excluded historical third party sale data from the calculation of note sale recoveries, whereas in fiscal year 1998, this information was included in the calculation of the assumption. The revision of the note sale recovery rate to include third party sales resulted in a $50 million increase adjustment to the LLG. We also identified two instances where FHA used an incorrect discount rate in their calculation of the Multifamily LLG.

- **Multifamily Liquidating LLG.** We identified several errors in the estimate of the Multifamily Liquidating LLG (Loan Loss Reserve or LLR) that were not identified through FHA's internal review process. In FY99, the "Projects in Default Reserve" was incorrectly calculated, resulting in a $72 million decrease adjustment for the reserve. In addition, FHA was inconsistent in applying the recovery rates used to calculate liquidating LLR and the financing LLG. The use of consistent recovery rate assumptions in both the liquidating and financing portion of the reserves resulted in a $237 million increase adjustment to the unassisted base reserve and a $322 increase adjustment to the hospital reserve. We also identified two other immaterial errors made in the calculation of the Multifamily LLR, relating to incorrect weight being applied to the Operating Cost to Total Revenue ratio for the Other Rental Audit Group and the exclusion of 729 insured projects from the initial risk ranking of the insured portfolio.

Although each discrepancy noted by KPMG was detected through the audit process and corrected to generate the final financial statement balance, the number, magnitude, timing, and nature of these errors highlights the need for FHA to improve its internal controls over the reserve estimation process.

Recommendation

We recommend that FHA improve the internal review processes for the LLG estimate to prevent errors.

Management's Response

Management agrees with this finding and the associated recommendations. Further discussion, and the progress of planned initiatives, is included in management's response in Appendix D.

KPMG's Assessment of Management's Response

We concur with management's response.

FHA/HUD MUST ENHANCE THE DESIGN/OPERATION OF CONTROLS OVER INFORMATION SYSTEMS SECURITY AND APPLICATION DATA INTEGRITY

FHA management relies heavily on computerized information systems to process the large volume of data required for its diverse operation. These systems not only process accounting data for functions including processing, servicing, and asset disposition, but for sensitive cash receipt and disbursement transactions. Therefore, it is essential that FHA ensure a proper control environment to prevent unauthorized access and ensure complete and accurate processing of data.

We reviewed information system controls in place for general and application systems supporting FHA's financial processing. We noted that FHA/HUD has taken steps to address prior year control weaknesses in the EDP control environment. For example, FHA/HUD has implemented improved processes for controlling the modification of application software programs. However, control weaknesses still exist in system and application access controls, and application data integrity. Specifically, we noted the following weaknesses:

System and Application Access Control. Certain logical access controls need improvement to provide a more secure EDP environment. This includes the implementation of controls to prevent unauthorized access to sensitive files and the completion of security related documentation required by federal regulations. Examples of weaknesses include:

- HUD has not provided adequate protection over sensitive programs and files on the Unisys mainframe systems, on which many FHA systems are processed. Using low privileged user accounts, we were able to access programs and files containing sensitive information about FHA customers and sensitive system activities.

- REMS, an FHA Multifamily database used for financial reporting and decision making activities, lacks key security controls such as forced password changes and segregation of duties between field office Security Administrators and data entry personnel.

- FHA Connection, an extremely sensitive Internet-based interface that allows lending institution employees to access mission critical FHA systems, lacks key security elements required by the Office of Management and Budget (OMB) Circular A-130, *Management of Federal Information Resources*.

Application Data Integrity. Application data integrity controls should be improved to ensure that financial data being relied upon by FHA management is complete and accurate.

- FHA's SAMS lacks a key database control to ensure that data is not corrupted when the system postings are aborted.

- Periodic reconciliations to source data are not performed for REMS, which receives data feeds from many multifamily systems on a daily, monthly, and on-line basis. Periodic reconciliation of these feeds is important to ensure that REMS data is complete and accurate.

Recommendations to address the above weakness continue to include:

- Controls should be enhanced to provide reasonable assurance that computer resources (mainframe data and application data) are protected from unauthorized modification, disclosure, loss, or impairment, and are operated in accordance with established federal security requirements.

In addition, we recommend that

- Controls be enhanced to ensure that SAMS and REMS data being relied upon by FHA management is complete and accurate.

Management's Response

Management generally agrees with this finding and the associated recommendations. Further discussion, and the progress of planned initiatives, is included in management's response in Appendix D.

KPMG's Assessment of Management's Response

We concur with management's response.

KPMG'S STATISTICAL SAMPLING METHODOLOGY

KPMG developed a statistically valid sampling approach to test internal controls over the Multifamily insured and Single Family Secretary-owned property portfolios during fiscal year 1999. This approach enabled KPMG to take the results of our sample, calculate a reasonable estimate of the occurrence of exceptions over the entire sampled population, and conclude on the status of FHA's internal controls over each inventory. A description of our sampling methodology for each issue is described below.

Multifamily Insured Project Sample.
In selecting our national sample, we used a multi-staged cluster sampling approach. First, we stratified the population by Multifamily Hub, and then selected the four Hubs with the largest insured portfolios (in number of projects) for detailed testing. Next, we randomly selected four additional Hubs for detailed testing based on a random number generator. These eight Hubs comprise approximately 51 percent of the entire insured portfolio.[3] Based on the population of the eight Hubs, KPMG calculated a desired sample size of 320.

Prior to the final selection of Multifamily projects, we then stratified the population of each of the eight Hubs into projects with less than 150 units and projects with 150 or more units to ensure that both large and small projects were selected for testing. To select our total sample, we used a random number generator to select 40 insured mortgages from each Hub's inventory (15 insured mortgages from the high unit tier, and 25 insured mortgages from the low unit tier) to create a total sample size of 320 insured mortgages. Based on our sample methodology process, we were able to obtain a valid statistical sample of the national Multifamily insured portfolio, and through testing that sample, form reasonable conclusions regarding FHA's early warning and loss prevention processes, nationwide.

Single Family Secretary-owned Property Sample.
For Single Family Property, we developed a sampling methodology that is statistically based, and can provide a projection of exception occurrences to the population being sampled. The methodology selected is designed as a dual-purpose sample to allow a focus on attributes and possible indicators of weakness in internal controls while determining the reasonableness of the recorded inventory amount.

KPMG selected our sample from the Single Family property inventory on hand at August 31, 1999. In calculating our sample size, we used known data on the population and the geographic regions (Homeownerhip Center or HOC areas), and desired confidence levels, precision, and expected error rates. For the purpose of our sample, we used a 90 percent confidence level with 5 percent precision, and estimated an error rate of 50 percent. The expected error rate of 50 percent generates a sample size which protects the auditor from the risk of under sampling.

[3] All samples of insured properties were taken as of August 31, 1999.

Based on the information listed above, we calculated a sample size of 225 single family properties. A multi-stage sampling approach was used. These properties were further divided into the four HOC regions (first stage) then into district offices (second stage) and specific properties (third stage), with 25 to 80 sample properties selected from each HOC region. KPMG selected individual sample items from each district within each region using a random number generator. Based on our sample methodology process, KPMG was able to obtain a valid statistical sample of the national Single Family property portfolio, and through testing that sample, develop reasonable conclusions regarding FHA's Single Family property inventory controls.

MEMORANDUM FOR: KPMG LLP

FROM: William C. Apgar, Assistant Secretary for Housing-Federal Housing
Commissioner, H

SUBJECT: Response to KPMG's Fiscal Year 1999 FHA Audit Report

FHA management hereby presents to you our responses to your February 24, 2000 audit report on the fiscal year 1999 FHA financial statements prepared under generally accepted accounting principles.

General Comments

During the fiscal year 1998 audit, FHA prepared financial statements based on accounting standards applicable to federal agencies for the first time in its history and obtained an unqualified opinion. During fiscal year 1999, FHA continued to reform the way it does business based on the vision laid out in the HUD 2020 Management Reform Plan. Using this vision, FHA made substantial progress in addressing the material weaknesses in the fiscal year 1998 audit report. We are pleased that KPMG recognized the progress we achieved and eliminated two of the four fiscal year 1998 material weaknesses, while significantly narrowing the scope of a third.

On the first material weakness, which related to FHA's staff and administrative resources, KPMG found that "there has been sufficient progress to warrant our reassessment of those issues" and eliminated the condition from the report. On the second material weakness, which related to FHA's early warning and loss prevention, KPMG found that "FHA made notable progress in its ability to monitor its insured portfolio and, as a result, this comment was reclassified from a material weakness in our fiscal year 1998 report to a reportable condition in our fiscal year 1999 report." Finally, the third material weakness, which related to FHA's Federal basis and budgetary accounting, was revised to focus only on budgetary funds and funds control because "FHA continued to improve" its Federal basis accounting.

We are also pleased that KPMG recognized FHA's effort to better conform with the requirements of Credit Reform. Specifically, we successfully implemented the Single Family Premium Collection Subsystem-Periodic (SFPCS-P) on September 17, 1999, which was a major accomplishment for the Department. Finally, we thank KPMG for carefully considering FHA's comments about the fiscal year 1998 audit and responding with more in-depth analysis and more detailed recommendations in the fiscal year 1999 audit.

Detailed responses to specific conditions identified in the report are presented below.

Report on Internal Controls – Material Weaknesses

Controls Over Budgetary Funds and Funds Control Must be Improved.

FHA agrees with this finding and the associated recommendations. We are aggressively pursuing the objectives of supporting the Department's system integration efforts generally and integrating FHA's budget and accounting systems in particular.

We have added budgetary accounting to our subsidiary ledger, which now captures all financial transactions. FHA has both short and long-term plans to address this weakness. First, to immediately improve funds control, FHA and the HUD CFO developed a plan to check for funds availability on a summary basis, at the apportionment level, prior to a disbursement.

FHA has also developed long-range system improvement initiatives. Development of functional requirements for a Joint Financial Management Improvement Program (JFMIP) compliant subsidiary ledger, activity based costing (ABC) and implementation of budgetary accounting within FHA's accounting system are significant on-going efforts. These are important components of FHA's overall plan for improvement.

The *FHA Vision of Financial Management Improvement* (December 6, 1999) outlines the agency's plan to fully modernize its financial management systems and operations. FHA plans to begin market research for a new subsidiary ledger that will comply with JFMIP Core Financial System Requirements by May 2000. These requirements ensure that the new system will be able to perform federal basis and budgetary accounting and capture transactions daily at the detail level.

Over the last year, FHA eliminated a previous budgetary accounting material weakness. In fiscal years 1998 and 1999, federal basis financial statements and SF 133 (Report on Budget Execution) preparation processes were documented with all required sources of budgetary system information and crosswalks identified. As an interim measure to transaction level budgetary accounting, FHA will implement budgetary accounting within its general ledger accounting system. U.S. Standard General Ledger (SGL) budgetary journal vouchers will be prepared based on proprietary transactions. The journal vouchers will be processed in FHA's system resulting in a US SGL compliant budgetary Trial Balance. The budgetary Trial Balance will be used to generate all FHA SF 133s. It is FHA's intention to implement KPMG's recommendation that the Comptroller prepare and review all SF-133s prior to the submission to HUD's CFO Office.

To address our weakness of reconciling the ending balance of commitments and obligations, FHA plans to verify and fully reconcile all ending balances. This will involve working with the field offices to verify obligated and unobligated balances and making the appropriate adjustments in our subsidiary ledger. In addition, FHA plans to reconcile budgetary activity monthly to ensure ongoing consistency. Plans are underway to correct systemic deficiencies in credit subsidy tracking and execution through the Development Application Processing System. Full implementation is expected in October 2000.

FHA's Information Technology Systems Must be Enhanced to More Effectively Support FHA's Business Processes.

FHA agrees with this finding and the associated recommendations. We recognized the need for modernization of FHA financial systems and operations in developing the *FHA Vision of Financial Management Improvement*. As KPMG recommends, FHA is in the process of developing a complete approach to this plan. We are currently documenting the detailed functional requirements for a JFMIP compliant subsidiary ledger with plans to begin the systems acquisition process in May 2000. The new subsidiary ledger will enable FHA to meet HUD departmental reporting requirements while maintaining responsibility for its own accounting and financial reporting.

Report on Internal Controls – Reportable Conditions

FHA Must Continue to Place More Emphasis on Early Warning and Loss Prevention for Insured Mortgages.

FHA appreciates KPMG's statement that "FHA made notable progress in its ability to monitor its insured portfolio and, as a result, this comment was reclassified from a material weakness in our fiscal year 1998 report to a reportable condition in our fiscal year 1999 report." FHA has continued to implement reforms in order to resolve this condition during fiscal year 2000.

Multifamily

Monitoring

The Report recognizes the progress made during FY 1999, such as the REAC standardized physical inspection process, the substantial increase in physical inspections performed, and the initiation of Exigent Health and Safety notifications. Overall, in the two years since its conception, REAC has given HUD a state-of-the-art monitoring tool for its multifamily portfolio. Utilizing the REMS system, multifamily field offices are now monitoring and following up identified deficiencies in the properties with serious physical deficiencies or significant health and safety concerns. To emphasize and track progress on this follow-up, the FY 2000 Business and Operating Plan (BOP) for Multifamily includes a new goal to bring 95 percent of the properties with REAC scores of 31-59 into compliance within 90 days of the date of inspection referral from REAC.

While the Report recognizes the significant progress that has been made on physical inspections, there is less recognition of the progress made in financial assessments. As of January 31, 2000, REAC had received 15,597 FASS submissions, of which 6,485 were closed by the system as having no compliance conditions. Furthermore, during FY 1999, REAC had already begun analysis of financial statements, with many of them resolved because no compliance conditions were found. This monitoring should be recognized since it contradicts the heading, "FHA's failure to financially monitor the insured portfolio during the fiscal year", which implies no monitoring of the portfolio at all.

With the recent completion of training for the field offices, all financial statements have now been released to the field offices for their follow-up. Housing decided that transition to receipt and follow-up of REAC audited financial statement (AFS) assessments should be accomplished in conjunction with field staff training on REAC's financial system. Therefore, release of financial data was coordinated with the schedule for training the field staff. Training and AFS assessment release schedule for the Multifamily Hub Offices at eighteen sites was completed on February 17, 2000.

Monitoring Information

The Real Estate Management System (REMS) has been critical to the oversight and monitoring of the multifamily portfolio. Without REMS, the compilation of data and coordination of actions generated by the HUD 2020 centers (especially REAC, DEC, and FMC) would not have been achievable. REMS was fully implemented in the Multifamily program area as an integrated system that comprises all of the business activity related to multifamily (MF) asset management. The implementation of this system replaced a number of manual and automated systems and for the first time contains all information on MF projects in one place. Additionally, REMS provides comprehensive report capabilities.

Payment History Information

The Multifamily Delinquency and Default Reporting (MDDR) System, a noteworthy monitoring improvement in the reporting of multifamily payments, was implemented in FY 1999. Mortgagees with multifamily insured loans are now required to submit electronically information regarding mortgage delinquencies, defaults, reinstatements, elections to assign, and withdrawals of assignment elections, and related information. The MDDR is being phased in over a two-year period and will greatly shorten the time it takes for HUD staff to identify mortgage payment problems and take immediate remedial actions. The Department plans to take any actions necessary, including financial penalties if so warranted, to ensure compliance with the electronic reporting system.

<u>Single Family</u>

FHA is pleased to see KPMG recognized the substantial progress made to implement and enhance several approaches to early warning and loss prevention for insured mortgages. In FY 1999, FHA's most significant efforts included:

- **A dramatic increase in the use of FHA's Loan Loss Mitigation tools**. Over the last year, FHA lenders helped more than 26,000 families avoid foreclosure -- nearly two-and-a-half times the number of families benefiting from the program in FY 1998. In FY 1999, more than 80 percent of all FHA's loss mitigation actions helped families stay in their home, through use of a special forebearance, mortgage modification or partial claim.

- **Implementation of Credit Watch**, a powerful, new system for monitoring lenders' performance and taking appropriate enforcement actions. Since implementing this new system in May, 1999, FHA has terminated, or proposed termination of, 41 different lenders and placed another 106 lenders on probationary status;

- **Implementation of comprehensive reform of the FHA appraisal process**, including new mandatory exams for all appraisers, enhanced property condition assessment requirements, and new methods of monitoring and evaluating appraiser performance.

- **Enhancements to Neighborhood Watch, a web-based software application that gives lenders the ability to police themselves.** This new system identifies lenders and loan characteristics that have a high rate of default and claim within the first two years of origination. As many as 500 lenders access this new system a day to facilitate internal quality assurance operations.

FHA disagrees that further increases in the use of loss mitigation is a necessary condition to addressing this reportable condition in the future. Although FHA anticipates continued growth in the program, we also believe that our current level of performance exceeds industry standards. For example, Fannie Mae recently announced that FY 1999 was a banner year for their loss mitigation program, with approximately 15,000 loan modifications and workouts – far fewer than FHA's more than 26,000 actions.

FHA does not believe that implementation of treble damages is essential to our early warning and loss prevention efforts. We anticipate that treble damages will be a rarely used sanction, only applied to the most egregious cases involving mortgagees with a pattern and practice of failing to engage in loss mitigation. FHA intends to follow Congress' direction by implementing this new enforcement tool and work with the lending industry to develop a fair and deliberate set of regulations. However, given the already high level of loss mitigation actions achieved by FHA, implementation of this tool should not be a requirement to eliminate this reportable condition in the future.

FHA also objects to KPMG's recommendations that we implement EDI transmission of key financial data from FHA-approved mortgagees. As stated elsewhere in the report, FHA needs to carefully weigh its system priorities. This careful consideration ensures that initiatives with the most benefit for program operations and management receive critical funding. We are not convinced that the proposed EDI effort meets this test. Mortgagee financial data is currently captured in a database. This recommendation only seeks to improve the efficiency of its capture. We agree that FHA should assess whether changes in this data would serve as an early warning tool. However, the assessment must be based on existing data matched against mortgagee deficiencies and enforcement actions. Moreover, we already have an early indicator of financial instability in late payment patterns of Mortgage Insurance Premiums. In addition, EDI submissions significantly tax the financial and technical capacity of the vast majority of FHA originating mortgagees.

FHA believes KPMG's recommendation to further incorporate results of the post-endorsement technical review process with other available monitoring tools may have limited effect. FHA already uses data from post-technical reviews to inform the process of targeting lenders for monitoring. While there may be room for improvement in enhancing the level of information exchange between the divisions which oversee post-technical reviews and lender monitoring reviews, these are two very different processes. Post-technical reviews primarily involve basic due diligence on loans in the FHA portfolio. In contrast, a lender monitoring review is more qualitative and in-depth. FHA will continue to look for opportunities from the post-technical reviews to better identify and target lenders for more extensive monitoring. We are currently developing more formalized reporting between the Divisions to ensure (1) increased scrutiny of new cases from mortgagees with past problems, (2) increased likelihood of scheduling an on-site review of mortgagees that have had poor Technical ratings, and (3) better preparation for on-site reviews.

FHA Must Continue Actions to Safeguard and Quickly Resolve Secretary-Held Single Family Mortgage Notes.

We appreciate KPMG's recognition of the improvements made in "FHA's ability to manage its portfolio to the extent that we no longer consider Multifamily Secretary-held mortgage notes to be a reportable condition." Despite this progress, FHA continues to pursue efforts to resolve any remaining issues. In FY 2000, Multifamily will continue a goal in its Business and Operating Plan (BOP) to address the inventory of Secretary-held multifamily notes. Multifamily Housing initiated a goal in the FY 1999 BOP to bring 75 percent of the Secretary-held notes that were 3 months or more delinquent under control (i.e., under a workout agreement, in foreclosure, or designated for a note sale). Of the 167 notes, the multifamily field offices brought 82 percent, under control, exceeding the 75 percent goal.

KPMG acknowledges that FHA has improved its servicing of Single Family Notes. However, KPMG did not recognize many of FHA's accomplishments in FY 1999. FHA prioritized comprehensive due diligence of the FHA single family notes portfolio at the start of the new servicing contract. KPMG classified the entire period that due diligence was performed as a "delay". The report states that due to this "delay", 22 percent of the portfolio was not being serviced. However, as a result of the due diligence effort, much of the portfolio was found to involve vacant properties, or erroneous case records now being purged from the system.

As a result of this comprehensive due diligence effort, FHA also continues to see improvements in servicing under this contract. At present, 35 percent of FHA's Single Family Secretary-held notes are under a forbearance plan, 13 percent are serviced under the terms of the note, four percent are in bankruptcy, 27 percent are in foreclosure, and for 21 percent the contractor has issued the Notice of Intent to foreclose. Since contract start-up in April, 1999, routine monthly collections have averaged $75.4 million, or $630 per account. This emphasis on sustaining cash flow from assets is critical to preparing sub-performing/non-performing assets for sale.

Finally, KPMG did not acknowledge the Department's new, aggressive management control program over the servicing contractor's actions, which includes specialized oversight of various servicing functions by two Government Technical Representatives, and 5 Government Technical Monitors.

Despite these areas of disagreement, FHA agrees with KPMG's recommendation to conduct mortgage note auctions to reduce the portfolio of single family notes. FHA has taken aggressive action to sell these notes by June 2000. We currently have a program financial advisor on board to advise FHA on the asset sale matters. We also have recently awarded a contract to a transaction specialist to conduct the note sale. Shortly, we will have a due diligence contractor on board to prepare the notes for sale. We have obtained the services of two FDIC employees who have extensive note sale backgrounds to assist FHA in obtaining the maximum recovery possible in these sales.

FHA Must Sufficiently Monitor and Account for its Single Family Property Inventory.

FHA is concerned that KPMG fails to recognize the full value of our new comprehensive oversight tools and management reports for monitoring the new property management and marketing (M&M) contractors. In FY 1999, FHA developed an extensive new system for monitoring and evaluating contractors' performance. This system includes detailed inspections of the physical condition of ten percent of properties and audits ten percent of case files in all contract areas, on a monthly basis. The results of these reviews, along with daily property listing, sales and closing reports, are analyzed by FHA staff on a regular basis and summarized in comprehensive monthly progress reports provided to each contractor. Through this process, FHA now collects an unprecedented level of information on the condition and status of its REO property inventory – an important improvement in addressing this reportable condition, which is described as pertaining to FHA's ability to monitor and account for properties. While we recognize that there still is room to improve the efficiency of the REO operation, we believe FHA has greatly enhanced its ability to monitor and account for properties.

Several of KPMG's criticisms of FHA operations appear to point toward opportunities for improved efficiencies in processing, rather than to concerns over our ability to monitor the portfolio or impose appropriate management controls. FHA identified its primary focus in FY 1999 as the development of new and improved management controls.

After an initial start-up period of approximately two to three months, the M&M contractors sold properties more quickly and at a much higher rate of return than HUD did under the previous system. For example, in the first six months of operation, the M&M contractors increased FHA's average gross property sales price by more than 25 percent over FY 1998 return levels. In the first quarter of FY 2000, these positive results continued, with the M&M contractors selling more than 20,000 properties over the three month period, an increase of more than 25 percent over FY 1999 sales levels.

KPMG accurately reports that the inventory of HUD homes nationwide increased in FY 1999 due to the M&M contractors start-up period and the poor performance of one contractor; however, the report does not fully recognize the downward trend in inventory over the last half of the fiscal year – a trend that has accelerated in FY 2000. During the initial two to three months of the M&M initiative (which was launched in April, 1999) FHA instructed all contractors to pull properties off the market and focus on re-inspection, removal of debris and completion of repairs, the reappraisal of the properties and the development of revised marketing approaches. While properties began to be re-listed in large numbers in May and June 1999, the full cycle of property sales did not begin until July 1999. From July, 1999 forward, the overall inventory of homes has been declining in all contract areas, other than those managed by InTown Management Group. Following termination of InTown's contracts in September, 1999, the inventory has been declining in every contract area, and overall the national inventory has been reduced from a peak of approximately 52,000 homes in July, 1999, to approximately 47,000 homes at present.

FHA Must Improve Its Review Process for Estimating Reserves for the Insured Portfolio.

During fiscal year 1999, FHA accumulated additional data to support the liability for loan guarantee estimates for its credit programs. To improve the cash flow estimates, FHA updated all assumptions used to calculate the FY 1999 LLGs with data through the end of the fiscal year. Additional data was collected to improve the calculation of the multifamily recovery rates by including the income and expense activity during the period that the mortgage notes are held. A review of recent loss mitigation data was conducted to better predict the success and costs associated with the single family loss mitigation program.

Each of the cash flow models used to calculate the LLGs were reviewed and modeling improvements were implemented. Sensitivity analyses and decomposition analyses were performed to identify modeling improvements and explain differences. In addition, the MMI models were streamlined and automated to avoid calculation errors. The MMI model was tested and a cell-by-cell review was performed to ensure consistent and accurate results. A master input sheet was created for each multifamily risk category allowing each cohort's models to receive inputs from a single source and thereby reduce the chance of data entry error.

FHA developed and updated model documentation for all of the LLG cash flow models to reflect modeling changes and current assumptions. This documentation includes a model user's guide, review of the source systems of actual data, cash flow calculations, and implementation of modeling and policy changes in the models.

FHA established formal policies and procedures and is in the process of implementing them at all levels of the cash flow modeling process. These procedures include both formal and informal supervisory reviews to ensure that data collection, assumption calculations, model changes, and program changes are all approved by the appropriate parties and implemented correctly.

FHA agrees with the finding and associated recommendations. We have improved the review processes for the LLG calculation and ensured that the appropriate management personnel are involved in the preparation, review and submission of the data. Our plans include performance of a detailed data integrity validation on the data used to calculate the LLG. In addition, we plan to apply credit reform accounting to the liquidating account. This will ensure that pre- and post-credit reform liabilities are estimated with the same assumptions and prevent any unintentional inconsistencies between the estimates.

FHA/HUD Must Enhance the Design/Operation of Controls Over Information Systems Security and Application Data Integrity.

System and Application Access Control

<u>REMS</u>

The Office of Multifamily Housing agrees that better controls should be in place to operate REMS in accordance with established federal security requirements. Steps will be taken in FY 2000 to develop and implement a formal, documented user access request process; require users to change system passwords on a periodic basis; and develop and implement formal, documented procedures that enhance segregation of duties between REMS Security Administrators and data entry personnel.

<u>FHA Connection</u>

The Department has made great strides in the area of Security on the FHA Connection. Procedures for lending institutions exist in Mortgagee Letters 97-14 and 98-13, the letter issued to the CEO when an application for an Application Coordinator is processed, and the Quick Start Guide.

Training has been developed and will be given to the Home Ownership Center trainers. The two day session will cover periodical review and termination of IDs that need to be performed by the Application Coordinator (the security officer for the FHA Connection currently periodically checks all user IDs).

FHA Connection contingency plans were developed for Y2K which include the recovery of software and alternative processing procedures. We have also developed a security plan for the FHA Connection that is currently under review.

Application Data Integrity

Multifamily Housing

During FY 2000, the Office of Multifamily Housing Programs will develop and implement an annual reconciliation process to ensure data fed to REMS from the following systems are complete and correct: TRACS, ARAMS, F47, LAS, PAS, LOCCS. This will address KPMG's recommendation that "controls be enhanced to ensure that REMS data being relied upon by FHA management is complete and accurate".

SAMS

Housing has noted the auditor's concerns about instances where incomplete processing of direct disbursement transactions has occurred. Housing agrees that the posting of partially completed transactions to system tables would be a data quality problem that should be addressed. Housing has asked the system contractors for an estimate of the level of effort to fix this problem. Assuming that the cost is not disproportionate with the benefit, Housing agrees to fund the repair of this item in FY 2001 (the activities eligible for funding in FY 2000 have already been allocated).

PRINCIPAL FINANCIAL STATEMENTS

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FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED BALANCE SHEET
As of September 30, 1999 and 1998
(Dollars in Millions)

	1999	1998
ASSETS		
Intragovernmental		
Fund Balances with the U.S. Treasury (Note 2)	$ 6,653	$ 6,608
Investments in U.S. Government Securities (Note 3)	14,729	14,108
Interest Receivable from U.S. Government Securities	202	174
Other Assets, Net (Note 4)	155	223
Total Intragovernmental	21,739	21,113
Credit Program Receivables and Related Foreclosed Property, Net (Note 5)	3,889	3,135
Other Assets, Net (Note 4)	224	256
TOTAL ASSETS	**$ 25,852**	**$ 24,504**
LIABILITIES		
Intragovernmental		
Accounts Payable	$ 7	$ 15
Borrowings from U.S. Treasury (Note 6)	7,996	6,579
Payable to Special Receipt Account for Subsidy Re-estimate	338	154
Other Liabilities (Note 7)	116	210
Total Intragovernmental	8,457	6,958
Accounts Payable	396	569
Unearned Premiums	911	891
Liabilities for Loan Guarantees (Note 5)	5,803	9,404
Debentures Issued to Claimants (Note 6)	107	166
Premium Refunds and Distributive Shares Payable	244	205
Other Liabilities (Note 7)	374	318
TOTAL LIABILITIES	**$ 16,292**	**$ 18,511**
NET POSITION		
Unexpended Appropriations (Note 9)	$ 314	$ 1,704
Cumulative Results of Operations	9,246	4,289
TOTAL NET POSITION	**$ 9,560**	**$ 5,993**
TOTAL LIABILITIES AND NET POSITION	**$ 25,852**	**$ 24,504**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENT OF NET COST
For the years ended September 30, 1999 and 1998
(Dollars in Millions)

	1999	1998
Unsubsidized Program Costs		
Intragovernmental	$ 427	$ 387
With the Public	(4,567)	1,973
Total Unsubsidized Program Costs	(4,140)	2,360
Less: Earned Revenues (Note 10)	1,921	2,777
Net Unsubsidized Program Costs (Surplus)	$ (6,061)	$ (417)
Subsidized Program Costs		
Intragovernmental	$ 118	$ 83
With the Public	1,637	763
Total Subsidized Program Costs	1,755	846
Less: Earned Revenues (Note 10)	505	548
Net Subsidized Program Costs	$ 1,250	$ 298
NET COST (SURPLUS) OF OPERATIONS	$ (4,811)	$ (119)

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION
For the years ended September 30, 1999 and 1998
(Dollars in Millions)

	1999	1998
Net Cost (Surplus) of Operations	$ (4,811)	$ (119)
Financing Sources:		
Appropriations Used	(5,487)	(1,838)
Imputed Financing	-	(5)
Transfers-out:		
HUD	237	237
US Treasury	1,543	830
FHA Program Account	3,560	1,601
Public	1	-
Total Financing Sources	(146)	825
Net Results of Operations	(4,957)	706
Net Change in Cumulative Results of Operations	(4,957)	706
Change in Unexpended Appropriations	1,390	(1,143)
Change in Net Position	(3,567)	(437)
Net Position-Beginning of Period	(5,993)	(5,556)
Net Position - End of Period	$ (9,560)	$ (5,993)

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
COMBINING STATEMENT OF BUDGETARY RESOURCES
For the year ended September 30, 1999
(Dollars in Millions)

	MMI / CMHI FUNDS			GI / SRI FUNDS			
	Program 8690183	Liquidating 86X4070	Financing 86X4587 and 86X4242	Program 86X0200	Liquidating 86X4072	Financing 86X4077 and 86X4105	Combined Total
Budgetary Resources: (Note 13)							
Budget Authority							
Appropriations	$ 4,823			$ 542			$ 5,365
Borrowing Authority			$ 900		$ 76	$ 750	1,726
Unobligated Balances Carried Forward	1,264	$ 14,406	548	456	2,024	1,097	19,795
Spending Authority from Offsetting Collections		4,939	10,374		559	1,551	17,423
Adjustments							
Recoveries of Prior Year Obligations				3	1	4	8
Enacted Rescissions of Prior Year Balances					(7)		(7)
Capital Transfers and Redemption of Debt					(1,229)	(233)	(1,462)
Permanently not Available Pursuant to Public Law	(1,264)			(16)			(1,280)
NET BUDGETARY RESOURCES	$ 4,823	$ 19,345	$ 11,822	$ 985	$ 1,424	$ 3,169	$ 41,568
Status of Budgetary Resources:							
Obligations Incurred	4,823	4,752	8,850	719	1,060	1,242	21,446
Unobligated Balances - Available		466	1,087	19	364	74	2,010
Unobligated Balances - Not Available		14,127	1,885	247		1,853	18,112
TOTAL STATUS OF BUDGETARY RESOURCES	$ 4,823	$ 19,345	$ 11,822	$ 985	$ 1,424	$ 3,169	$ 41,568
Outlays:							
Obligations Incurred	4,823	4,752	8,850	719	1,060	1,242	21,446
Less: Spending Authority from Offsetting Collections and Adjustments		4,939	10,374	3	560	1,555	17,431
Obligated Balance, Net - Beginning of Period		693	(128)	(15)	519	(17)	1,052
Less: Obligated Balance, Net - End of Period		825	(62)	62	520	(55)	1,290
TOTAL OUTLAYS	$ 4,823	$ (319)	$ (1,590)	$ 639	$ 499	$ (275)	$ 3,777

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
COMBINING STATEMENT OF BUDGETARY RESOURCES
For the year ended September 30, 1998
(Dollars in Millions)

	MMI / CMHI FUNDS			GI / SRI FUNDS			
	Program 8680183	Liquidating 86X4070	Financing 86X4587 and 86X4242	Program 86X0200	Liquidating 86X4072	Financing 86X4077 and 86X4105	Combined Total
Budgetary Resources: (Note 13)							
Budget Authority							
Appropriations	$ 1,602			$ 1,395			$ 2,997
Borrowing Authority			$ 2,628		$ 126	$ 737	3,491
Unobligated Balances Carried Forward		$ 13,072	331	506	2,428	414	16,751
Spending Authority from Offsetting Collections		4,425	4,950		733	2,115	12,223
Adjustments							
Recoveries of Prior Year Obligations		13	5	18	9	2	47
Permanently not Available Pursuant to Public Law				(16)			(16)
Payment on Debt			(205)		(28)	(220)	(453)
NET BUDGETARY RESOURCES	$ 1,602	$ 17,510	$ 7,709	$ 1,903	$ 3,268	$ 3,048	$ 35,040
Status of Budgetary Resources:							
Obligations Incurred	338	3,105	7,161	1,448	1,244	1,951	15,247
Unobligated Balances - Available		1,177	544	83	298	357	2,459
Unobligated Balances - Not Available	1,264	13,228	4	372	1,726	740	17,334
TOTAL STATUS OF BUDGETARY RESOURCES	$ 1,602	$ 17,510	$ 7,709	$ 1,903	$ 3,268	$ 3,048	$ 35,040
Outlays:							
Obligations Incurred	338	3,105	7,161	1,448	1,244	1,951	15,247
Less: Spending Authority from Offsetting Collections and Adjustments		4,438	4,955	18	742	2,117	12,270
Obligated Balance, Net - Beginning of Period		474	(169)	55	422	(82)	700
Less: Obligated Balance, Net - End of Period		693	(128)	(15)	519	(17)	1,052
TOTAL OUTLAYS	$ 338	$ (1,552)	$ 2,166	$ 1,500	$ 405	$ (231)	$ 2,625

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 FINANCING
For the years ended September 30, 1999 and 1998
(Dollars in Millions)

	1999	1998
Obligations and Nonbudgetary Resources		
Obligations Incurred	$ 21,446	$ 15,247
Spending Authority from Offsetting Collections and Adjustments	(17,431)	(12,270)
Financing Imputed for Cost Subsidies	-	5
Total Obligations as Adjusted, and NonBudgetary Resources	4,015	2,982
Resources That Do Not Fund Net Cost of Operations		
Costs Capitalized on the Balance Sheet	(1,050)	2,114
Financing Sources that Fund Costs of Prior Periods	4,727	1,075
Changes in Unfilled Customer Orders	461	(163)
Transfer Out to HUD without Reimbursement related to S&E	237	237
Other	46	(107)
Total Resources that do not Fund Net Cost of Operations	4,421	3,156
Net Cost of Operations that Do Not Require or Generate Resources		
Gains or Losses on Sales of Credit Program Assets	610	142
Bad Debts Related to Uncollectible Non-Credit Reform Receivables	(81)	(68)
Reduction of Subsidy Expense from Endorsements and Modifications of Negative Subsidy Cases	(3,620)	(2,842)
Changes in Loan Loss Reserve Expense	850	(663)
Reduction of Subsidy Expense due to FY 99 Credit Subsidy Downward Re-estimate	(2,041)	(129)
Increase in Interest Income in MMI Liquidating Account due to FY 99 Credit Subsidy Downward Re-estimate	(293)	(12)
Other	94	135
Total Net Cost of Operations that Do Not Require or Generate Resources	(4,481)	(3,437)
Financing Sources Yet to be Provided		
Fiscal Year 1999 Credit Subsidy Upward Re-estimate (Note 14)	76	3,492
Total Financing Sources yet to be Provided	76	3,492
Net Cost (Surplus) of Operations	$ (4,811)	$ (119)

The accompanying notes are an integral part of these statements.

Notes to Principal Financial Statements

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. FHA insures private lenders against loss on mortgages which finance single family homes, multifamily projects, health care facilities, property improvements, and manufactured homes. The objectives of the activities carried out by FHA relate directly to developing affordable housing.

FHA categorizes its activities as either single family, multifamily, or Title I. Single family activities support basic home ownership, multifamily activities support high density housing and medical facilities, and Title I activities support manufactured housing and home improvement.

FHA’s major programs are classified as unsubsidized and subsidized. These programs are composed of four major Funds. The unsubsidized program is comprised of (1) the Mutual Mortgage Insurance Fund (MMI), FHA's largest Fund, which 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; and (2) the Cooperative Management Housing Insurance Fund (CMHI), which also is a mutual fund, that provides mortgage insurance for management-type cooperatives. The subsidized program is comprised of (3) the General Insurance Fund (GI) which provides for 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 and nonprofit hospitals; and (4) the Special Risk Insurance Fund (SRI) which provides mortgage insurance on behalf of mortgagors eligible for interest reduction payments who otherwise would not be eligible for mortgage insurance.

The MMI and CMHI Funds are required to charge borrowers a premium that is designed to cover default losses and administrative expenses, and to provide equity. These Funds are designed to not be dependent upon appropriations to sustain operations. The GI and SRI Funds, however, are not designed to be self-sustaining, and as a result, are dependent on appropriations from Congress.

Basis of Accounting

The financial statements are presented in conformity with generally accepted accounting principles (GAAP), as illustrated in Office of Management and Budget (OMB) Bulletin 97-01, “Form and Content of Agency Financial Statements,” as amended, and in accordance with the Federal Accounting Standards Advisory

Board's (FASAB) Statements of Federal Financial Accounting Standards (SFFAS). On October 19, 1999, the American Institute of Certified Public Accountants' (AICPA) Council designated FASAB as the accounting standard setting body for Federal government entities under Rule 203, "Accounting Principles" of the AICPA's Code of Professional Conduct. Prior to the AICPA Council's action, the AICPA considered federal accounting standards as representing a comprehensive basis of accounting other than GAAP.

The financial statements include the accounts of all funds under FHA control, consisting of two general fund appropriations and six revolving funds. Recognition and measurement of budgetary resources, for purposes of preparing the Combining Statement of Budgetary Resources, is based on budget concepts and definitions provided by OMB Circular A-11, section "Federal Credit Data" and by Circular A-34, "Instructions on Budget Execution."

Use of Estimates

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported.

Amounts reported for credit program receivable and related foreclosed property, unearned premiums, the liabilities for loan guarantees, and the payable to the U.S. Treasury receipt account for subsidy re-estimates, represents FHA's best estimates based on pertinent information available.

To estimate the liability for loan guarantees, FHA used cash flow model assumptions associated with loans subject to the Federal Credit Reform Act of 1990 (Credit Reform), as described in Note 5, to estimate the cash flows associated with future loan performance. To make reasonable projections of future loan performance, FHA developed assumptions, as described in Note 5, based on historical data and current and forecasted economic assumptions.

The estimates presented in the consolidated financial statements are not subject to precise quantification or verification and may change as economic and market factors, and management's evaluation of those factors, change. Although management used its best judgment in developing those estimates, actual results could differ from those estimates.

Fund Balances with the U.S. Treasury

Fund balances with the U.S. Treasury consist of amounts available to fund payments for expenses and to fund escrow payments for mortgages, and of amounts collected but unavailable until authorizing legislation is enacted (see Note 2). Fund balance with the U.S. Treasury is received and paid through accounts defined by law and included in the Federal budget.

Credit Reform Accounting

Credit Reform establishes the use of the program, financing, and negative subsidy receipt account for loan guarantee commitments and direct loans obligated after September 30, 1991 (post-1991). It also establishes the liquidating account for activity relating to any loan guarantee commitments and direct loans obligated before October 1, 1991 (pre-Credit Reform). The program account is a budget account that 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. Also, the program accounts usually receive a separate appropriation for administrative expenses. The financing account is a non-budgetary account that records all of the cash flows resulting from post-1991 direct loans or loan guarantees. It disburses loans, collects repayments and fees, makes claim payments, holds balances, borrows from U.S. Treasury, earns or pays interest, and receives the subsidy cost payment from the credit program account.

The negative subsidy receipt account is a budget account used for the receipt of amounts paid from the financing account when there is a negative subsidy from the original estimate or a downward re-estimate. In most cases, a receipt account is a General Fund account, that belongs to the U.S. Treasury. However, per an agreement with OMB, in order to resolve the different requirements between Credit Reform and the National Affordable Housing Act of 1990 (NAHA), this negative subsidy receipt account (miscellaneous receipt account) remains an FHA account. The NAHA requires that FHA's MMI Fund achieve a Capital Ratio of 2.0 percent by fiscal year 2000. The Capital Ratio is defined as the ratio of economic net worth (current cash plus the present value of all future net cash flows) of the MMI Fund to unamortized insurance in force (the unpaid balance of insured mortgages). Therefore, FHA transfers negative subsidy and downward subsidy re-estimate to the MMI Liquidating account and retains ownership of funds in the miscellaneous receipt account to strengthen the financial position and meet the Capital Ratio requirement.

The financing account of the MMI Fund is also required to transfer a portion of negative subsidies to FHA's miscellaneous receipt account, to satisfy the legislated transfer of funds to HUD covering Office of Housing salaries and expenses.

The liquidating account is a budget account that records all cash flows to and from FHA resulting from pre-Credit Reform direct loan obligations or loan guarantee commitments. Liquidating account collections in any year are available only for obligations incurred during that year or to repay debt. Any remaining unobligated balances at the end of the fiscal year are unavailable for obligation in subsequent fiscal years and must be transferred to U.S. Treasury's General Fund at the end of the fiscal year. This rule is applicable to FHA's GI and SRI Fund liquidating accounts. Credit Reform also provides permanent indefinite authority to cover obligations and commitments in the event that funds in the liquidating accounts are otherwise insufficient.

Investments in U.S. Government Securities

Under current legislation, FHA may invest available funds in excess of current needs in non-marketable market-based U.S. Treasury securities for the MMI/CMHI liquidating account. 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. The valuation of these investments is at acquisition cost net of unamortized premium or discount. Amortization of the premium or discount is recognized on a straight-line basis (see Note 3).

Credit Program Receivables and Related Foreclosed Property

Credit program receivables arise from two sources. Prior to April 1996, under certain conditions prescribed by law, FHA would take assignment of insured single family loans that were in default for direct collection rather than acquire the related properties through foreclosure. Single family loans were assigned to FHA when the mortgagor defaulted due to certain "temporary hardship" conditions beyond the control of the mortgagor and when, in FHA management's judgment, the loan could be brought current in the future. During fiscal year 1999, FHA continued to take single family assignments on those defaulted notes that were in process at the time the assignment program was terminated.

Secondly, multifamily loans are assigned when lenders file mortgage insurance claims to FHA for defaulted notes. 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.

Credit program receivables for direct loan programs and defaulted guaranteed loans assigned for direct collection are valued differently based on the direct loan obligation or loan guarantee commitment date. These valuations are in accordance with Credit Reform and SFFAS No. 2, “Accounting for Direct Loans and Loan Guarantees” (see Note 5). Those obligated or committed on or after October 1, 1991 (post-Credit Reform) are valued at the net present value of expected cash flows from the related receivables.

Credit program receivables resulting from obligations or commitments prior to October 1, 1991, (pre-Credit Reform) are recorded at the lower of cost or fair value (net realizable value). Fair value is estimated based on the prevailing market interest rates at the date of mortgage assignment. When fair value is less than cost, discounts are recorded and amortized to interest income over the remaining terms of the mortgage or upon sale of the mortgages. Interest is recognized as income when earned. However, when full collection of principal is considered doubtful, the accrual of interest income is suspended, and receipts (both interest and principal) are recorded as collections of principal. Pre-Credit Reform loans are reported net of the allowance for loss and any unamortized discount. The estimate for the allowance on credit program receivables is based on historical loss rates and recovery rates resulting from asset sales and property recovery rates, net of the cost of sales.

Foreclosed property acquired as a result of defaults of loans obligated or loan guarantees committed on or after October 1, 1991, is valued at the net present value of the projected cash flows associated with the property. Foreclosed property acquired as a result of defaults of loans obligated or loan guarantees committed prior to 1992, is valued at net realizable value (see Note 5). The estimate for the allowance for loss related to the net realizable value of foreclosed property, is based on historical loss rates and recovery rates resulting from property sales, net of the cost of sales.

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.

Liability for Loan Guarantees

The liability for loan guarantees (LLG) related to Credit Reform loans (made after October 1, 1991) is comprised of the present value of anticipated cash outflows for defaults, such as claim payments, premium refunds, property expense for on-hand properties and sale expense for sold properties, less anticipated cash inflows such as premium receipts, proceeds from property sales and principal and interest on Secretary-held notes.

The pre-Credit Reform LLG is computed using the net realizable value method. The LLG for pre-Credit Reform single family insured mortgages includes estimates for defaults that have taken place, but where claims have not yet been filed with FHA. In addition, the LLG for pre-Credit Reform multifamily insured mortgages includes estimates for defaults which are considered probable but have not been reported to FHA (see Note 5).

Unearned Premiums

Unearned premiums are recognized for pre-1992 loan guarantee premiums collected but not yet earned in the liquidating account. Premiums charged by FHA for single family mortgage insurance provided by its MMI/CMHI 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 activities charge periodic insurance premiums over the mortgage insurance term. Premiums on annual installment policies are recognized for the liquidating accounts on a straight-line basis throughout the year.

Premiums associated with post-1991 loan guarantees are included in the calculation of the LLG and are not included in the unearned premium amount reported on the Consolidated Balance Sheet, since the LLG represents the net present value of all on-hand and future cash flows associated with those insurance portfolios.

Appropriations and Monies Received from Other HUD Programs

The GI and SRI Funds were not designed to be self-sustaining. As a result, the National Housing Act of 1990, as amended, provides for appropriations from Congress to finance the operations of these Funds. For post-1991 loan guarantees, appropriations to the GI and SRI Funds are made at the beginning of each fiscal year to cover estimated losses on loans to be insured during that year. For pre-1992 loan guarantees, the FHA has permanent indefinite appropriation authority to finance the cash requirements of 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 an addition to the liability for loan guarantees when collected.

Full Cost Reporting

SFFAS No. 4 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 identified 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 included in FHA’s fiscal year 1998 consolidated financial statements last year and were treated as imputed cost for the Consolidated Statement of Net Cost, and imputed financing for the Consolidated Statement of Changes in Net Position and the Combined Statement of Financing. The amount of imputed costs for the entire department in fiscal year 1999 was approximately $2.4 million, and FHA’s portion was determined to be less than $1 million, an immaterial amount to FHA’s consolidated financial statements. According to FASAB’s SFFAS No. 4, recognition of inter-entity costs that are not fully reimbursed is limited to material items that are significant to the receiving entity. Therefore, the imputed cost and imputed financing adjustment does not appear on FHA’s fiscal year 1999 consolidated financial statements.

In a separate effort, FHA conducted a mid-year and end-of-year time allocation survey of all Office of Housing operational managers throughout the field and headquarters, to determine FHA’s direct personnel cost associated with the Housing Salaries and Expenses (S&E) transfer to HUD and to allocate these costs between the unsubsidized and subsidized programs. The HUD CFO’s office also conducted a survey 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 funds, 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, the MMI and CMHI Funds distribute excess revenues to mortgagors at the discretion of the Secretary of HUD. Such distributions are determined based on the MMI and CMHI Funds' financial positions and their projected revenues and costs. In November 1990, Congress passed the National Affordable Housing Act (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 capitalization requirements. Although the capitalization requirements were met at September 30, 1999 and 1998, no distributive shares were declared from the MMI Fund. The NAHA does not affect distributions from the CMHI Fund.

Liabilities Covered by Budgetary Resources

Liabilities are to be classified as those covered and not covered by budgetary resources, as defined by OMB, 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 or to draw on permanent indefinite appropriations to satisfy the liabilities. Thus, all of FHA's liabilities are considered covered by budgetary resources.

Reclassifications

Certain fiscal year 1998 balances have been reclassified to conform with the fiscal year 1999 financial statement presentations, the effect of which is not considered material.

Note 2. Fund Balances with the U.S. Treasury

Substantially all of FHA's cash transactions are processed by the U.S. Treasury. Fund balances with the U.S. Treasury at September 30, were composed of the following:

(dollars in millions)

Entity Assets	**1999**	**1998**
Intragovernmental Assets:		
Appropriated Funds	$ 328	$ 1,704
Revolving Funds	6,189	4,770
Fund Balances with the U.S. Treasury	$ 6,517	$ 6,474
Non-Entity Assets		
Intragovernmental Assets:		
Escrow Funds	$ 136	$ 134
Fund Balances with the U.S. Treasury	$ 136	$ 134
Total Fund Balances with the U.S. Treasury	$ 6,653	$ 6,608

Appropriated Funds

Appropriated funds represent activities undertaken by law with monies that expire if not obligated by time periods specified in the legislation.

Revolving Funds

FHA's revolving funds are authorized by specific provisions of law to finance a continuing cycle of operations in which expenditures generate receipts and the receipts are available for expenditure without further action by the Congress.

Escrow Funds

FHA's escrow funds represent deposits made by mortgagees to pay for property taxes and insurance related to defaulted guaranteed mortgage notes assigned for direct collection and notes received under the direct loan program.

Timing Differences with U.S. Treasury

A difference exists between FHA's recorded fund balances with the U.S. Treasury and the U.S. Treasury's records. As of September 30, U.S. Treasury's records show more fund balances than FHA's general ledger due to differences related to processing time of the various accounting systems.

(dollars in millions)

	1999	1998
Timing Difference with U.S. Treasury as of September 30, attributable to:		
Single Family claims	$ (52)	$ (122)
Multifamily property	(7)	(10)
Single Family property	(4)	(9)
Single Family premiums	-	(18)
Other	2	3
Disbursement schedules prepared, but not disbursed by U.S. Treasury	$ (61)	$ (156)
U.S. Treasury SF 6653	$ 6,714	$ 6,764
FHA Fund Balances with the U.S. Treasury	$ 6,653	$ 6,608

Note 3. Investments in U.S. Government Securities

As discussed in Note 1, all investments are in non-marketable securities issued by the U.S. Treasury and, are therefore considered intragovernmental. These securities carry market-based interest rates. The cost, par value, net unamortized discount, net investment, and market values as of September 30, 1999 were as follows:

(dollars in millions)

Maturity	Weighted Average Interest Rate	Cost	Par Value	Unamortized Discount (Premium), Net	Investment, Net	Market Value
One year or less	5.34%	$ 508	$ 510	$ 1	$ 509	$ 510
After one year through five	5.66%	6,400	6,487	53	6,434	6,487
After five years through ten	6.36%	5,292	5,425	97	5,328	5,461
After ten years through fifteen	13.01%	126	109	(7)	116	147
After fifteen years	6.28%	2,332	2,411	69	2,342	2,377
Total		$ 14,658	$ 14,942	$ 213	$ 14,729	$ 14,982

The cost, par value, net unamortized discount, net investment, and market values as of September 30, 1998 were as follows:

(dollars in millions)

Maturity	Weighted Average Interest Rate	Cost	Par Value	Unamortized Discount (Premium), Net	Investment, Net	Market Value
One year or less	5.24%	$ 1,868	$ 1,910	$ 19	$ 1,891	$ 1,900
After one year through five	5.80%	3,654	3,695	28	3,667	3,851
After five years through ten	6.32%	5,914	6,069	125	5,944	6,680
After ten years through fifteen	10.63%	276	259	(8)	267	346
After fifteen years	6.28%	2,332	2,411	72	2,339	2,771
Total		$ 14,044	$ 14,344	$ 236	$ 14,108	$ 15,548

Note 4. Other Assets, Net

Other Entity Assets (dollars in millions)	**Gross 1999**	**Gross 1998**	**Allowance 1999**	**Allowance 1998**	**Net 1999**	**Net 1998**
Intragovernmental Assets:						
HUD Section 312 rehabilitation loan program receivables	$ 4	$ 4	$ -	$ -	$ 4	$ 4
Receivables from unapplied disbursements recorded by Treasury	146	213	-	-	146	213
Total	$ 150	$ 217	$ -	$ -	$ 150	$ 217
Assets with the Public:						
Receivables related to asset sales	$ 20	$ 32	$ -	$ -	$ 20	$ 32
Receivables related to credit program assets	163	164	(87)	(89)	76	75
Equity interest in Multifamily mortgage trust 1996	26	60	-	-	26	60
Premiums receivable	35	25	-	-	35	25
Total	$ 244	$ 281	$ (87)	$ (89)	$ 157	$ 192

Receivables from Unapplied Disbursements Recorded by U.S. Treasury

The initial allocations among the U.S. Treasury accounts that make up FHA are based on estimates. These receivables reflect the difference between the estimates and the actual figures for two of FHA's U.S. Treasury accounts. Each such estimate is reversed at the beginning of every year, and the corrected figure flows into the proper FHA accounts through routine processing.

Receivables Related to Asset Sales

FHA conducts sales of its foreclosed single family and multifamily properties and mortgage notes. Receivables have been recorded to reflect amounts due from purchasers.

Receivables Related to Credit Program Assets

These receivables include amounts due from the public for miscellaneous administrative charges such as late fees, services charges and interest on administrative charges associated with loans receivables. They also include overpayment of claims to lenders and rent due on foreclosed properties.

Equity Interest in Multifamily Mortgage Trust 1996

A 1996 multifamily mortgage notes sale was accomplished through the use of an asset securitization structure. Mortgages were pooled and sold to a Grantor Trust resulting in sales proceeds of $645 million and a 30 percent equity interest in subordinate Class B Trust Certificates which has been recorded at $26 million in fiscal year 1999, and was recorded at $60 million in fiscal year 1998. FHA has no guarantees resulting from this transaction and the risk of loss is limited to the trust certificate held. The fair value of this equity interest at September 30 approximates the recorded amounts.

Premiums Receivable

As discussed in Note 1, FHA collects premiums related to its various insurance programs. This amount only reflects the receivable for premiums associated with pre-Credit Reform loan guarantees, as premiums associated with post-Credit Reform loan guarantees are used in the determination of their LLG.

Allowance for Loss

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

Other Non-Entity Assets (dollars in millions)	**1999**	**1998**
Intragovernmental Assets:		
Mortgagor Reserves for Replacement – Investments	$ 5	$ 6
Assets With the Public:		
Mortgagor Reserves for Replacement – Cash	$ 67	$ 64

Mortgagor Reserves for Replacement

FHA holds in trust amounts to cover repairs and renovations to properties associated with multifamily mortgages held in its portfolio. These amounts have either been invested in U.S. Government securities or are deposited in minority-owned banks.

Note 5. Credit Program Assets and Liability for Loan Guarantees

An analysis of credit program assets, loan guarantees, and the liability for loan guarantees are provided in the following tables as of September 30:

(dollars in millions)

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

	Loans Receivable, Gross	Interest Receivable	Allowance For Loan & Interest Losses	Foreclosed Property	Value of Assets Related to Direct Loans
Total Direct Loan Programs:					
FY 1999	$ 83	$ 12	$ (66)	-	$ 29
FY 1998	88	13	(76)	-	25

(dollars in millions)

Direct Loans Obligated After Fiscal Year 1991:

	Loans Receivable, Gross	Interest Receivable	Allowance For Subsidy Cost (Present Value)	Foreclosed Property	Value of Assets Related to Direct Loans
Total Direct Loan Programs:					
FY 1999	$ 3	-	(1)	-	$ 2
FY 1998	6	-	-	-	6

(dollars in millions)

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

	Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Allowance For Loan & Interest Losses	Foreclosed Property, Net	Defaulted Guaranteed Loans Receivable, Net
Total Loan Guarantee Programs:					
FY 1999	$ 2,534	$ 609	$ (2,135)	$ 626	$ 1,634
FY 1998	2,690	642	(2,460)	560	1,432

(dollars in millions)

Defaulted Guaranteed Loans from Post-1991 Guarantees:

	Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Allowance For Subsidy Cost (Present Value)	Foreclosed Property, Gross	Value of Assets Related to Defaulted Guaranteed Loans Receivable
Total Loan Guarantee Programs:					
FY 1999	$ 727	$ 19	$ (1,688)	$ 3,166	$ 2,224
FY 1998	614	21	(1,315)	2,352	1,672

	1999	1998
Total Credit Program Receivables and Related Foreclosed Property, Net	**$ 3,889**	**$ 3,135**

(dollars in millions)

Guaranteed Loans Outstanding:

	Outstanding Principal, Guaranteed Loans, Face Value	Amount of Outstanding Principal Guaranteed
Total Loan Guarantee Programs:		
FY 1999	$ 551,435	$ 508,215
FY 1998	518,069	475,236

	Liabilities for Losses on Pre-1992 Guarantees, Estimated Future Default Claims	Liabilities for Loan Guarantees For Post-1991 Guarantees (Present Value)	Total Liabilities For Loan Guarantees
Total Loan Guarantee Programs:			
FY 1999	$ 8,322	$ (2,519)	$ 5,803
FY 1998	7,473	1,931	9,404

Foreclosed Property

The average holding period of single family properties is approximately 6 months while the average holding period of multifamily properties is 8 years. Additional requirements are usually attached to FHA's foreclosed property to restrict future use or disposal of those assets. The following table is a summary of FHA's foreclosed properties resulting from loans and loan guarantees at September 30:

(number of properties)	Pre-1992		Post-1991	
	Single Family	**Multifamily**	**Single Family**	**Multifamily**
Foreclosed Properties:				
FY 1999	14,647	58	35,146	1
FY 1998	13,828	50	25,542	-

The following tables summarize the dollar amount and number of FHA's foreclosure proceedings in process at September 30:

(dollars in millions)	Pre-1992		Post-1991	
	Single Family	**Multifamily**	**Single Family**	**Multifamily**
Outstanding Principal:				
FY 1999	$ 1	$ 187	$ .4	$ 40
FY 1998	2	111	1	13

	Pre-1992		Post-1991	
	Single Family	**Multifamily**	**Single Family**	**Multifamily**
Number of Properties:				
FY 1999	14	66	4	7
FY 1998	40	45	8	5

Pre-Credit Reform Valuation Methodology

FHA values its pre-Credit Reform loan guarantee liability and related notes receivable and foreclosed properties acquired from defaults on guaranteed loans, on the basis of cash expected to be paid for the liability or received from the assets, net of any related costs of collection or sale. In valuing these items, FHA uses historical rates of defaults, collections, and expenses of selling and maintaining property, adjusted for any predicted changes in the economy and housing markets.

Loss estimates are recorded in Single Family to provide for anticipated losses incurred by FHA (e.g., claims on insured mortgages where defaults have taken place but claims have not yet been filed). The estimate is computed using the net realizable value method and is based on historical claims and loss experience data, adjusted for management judgments concerning current economic factors.

FHA records the loss estimates for the Multifamily program when defaults are considered probable but have not yet been reported as such to FHA. The loss estimate is based on case-by-case analysis of approximately 79 percent of all the multifamily insured mortgages and is further adjusted by management for factors such as administrative expenses, projects already in default, and potential disaster. The recovery rate is based on actual notes sales and property dispositions over the most recent three years.

A separate analysis was conducted to adjust the loan loss estimate for planned reductions in project-based Section 8 rental assistance subsidies. All projects that submitted annual financial statements, received Section 8 assistance, and had rents in excess of the fair market value were included in the analysis. The gross rent for these projects was reduced to bring the rent for assisted units to their fair market value. The projects were then grouped into the following three categories:

- No action: Those that could continue to pay their operating expenses and mortgage payment from remaining revenues.

- Partial claim: Those that could pay their operating expenses but could not make a full mortgage payment.

- Default: Those that could no longer meet their mortgage payment and operating expenses.

On the basis of this analysis, appropriate adjustments were made to each project's loan loss estimate. No changes were made for projects requiring no action. For those qualified for a partial claim, a new mortgage amount was calculated. For those facing default, the loss estimate was increased to 100 percent of the unpaid principal balance for the project.

Credit Reform Valuation Methodology

The post-Credit Reform LLG and related notes receivable and foreclosed properties are valued at the net present value of their estimated cash flows. Present value calculations are based on the interest rate of U.S. Treasury securities of comparable maturity to the loans guaranteed. These rates are provided to all Federal agencies for use in preparing credit subsidy estimates and are used as required under OMB Circular A-34, "Instructions on Budget Execution."

To apply the present value computations, loans are divided first into cohorts; each program in each given year is a separate cohort. Cohorts are determined for the multifamily insured mortgages by the year in which the loan guarantee commitment is made; for the single family cohorts the endorsement date is used to determine the cohort year. In some cases, loans are disbursed in the year following that in which obligations are incurred. Within the cohort, loans are further subdivided by risk categories, each with different characteristics including risk profile, premium structures, and recoveries from the sale of properties and mortgage notes. The present value of future cash flows are determined using the significant assumptions detailed below.

Significant Assumptions - In order to estimate the present value of the future cash flows, FHA has developed sophisticated financial models. The models incorporate information on the expected timing of cash flows as well as the dollar amounts. These models rely on the following rates or ratios of loan performance:

- <u>Conditional Termination Rates:</u> The estimated probability of mortgage claims or non-claim terminations that can be expected in each year of the cohort's term.

- <u>Recovery Rates:</u> The estimated percentage of a claim payment that is recovered through the sale of a mortgage note or property.

- <u>Claim Amount Ratios:</u> The estimated size of the claim relative to the unpaid principal payment at the time the claim occurs.

Furthermore, these loan performance assumptions rely on the following fundamental modeling assumptions:

- <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 claim and prepayment rates were obtained from McGraw-Hill/DRI forecasts of U.S. annual economic figures from June 1999. Had FHA used more recent economic forecasts, its estimate of the net present value of loan guarantee liabilities would likely change. Other economic assumptions used, such as discount rates, are provided by OMB.

- <u>Reliance on historical performance</u>: FHA relies on the average historical performance of its insured multifamily portfolio to forecast future performance of that portfolio. Changes in legislation, subsidy programs, tax treatment and economic factors all have impacts on 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, and affect loan performance accordingly. A smoothing methodology is used to dampen the effects of extreme events.

- <u>Current legislation and regulatory structure</u>: Although future changes in legislative authority and regulatory structure may affect the claims, premiums, and recoveries associated with FHA's insurance, no changes are reflected in LLG calculations because of the uncertainty of the outcome of such legislation. FHA's future plans allowed under current legislative authority, however, have been taken into account in formulating assumptions when relevant.

- <u>Single family loss mitigation program</u>: FHA's estimations regarding claim payments and recovery amounts are affected by assumptions made about the MMI loss mitigation program, which became effective in April 1996. Because this program was introduced recently, there is limited data available on which to base assumptions. Assumptions are made using the historical experience that is available in addition to the industry expertise of FHA staff.

Because of uncertainties inherent in the assumptions for projected default rates, monies received from the sale of notes or properties, and costs of maintaining and selling those assets, the actual net present value of the loan guarantee liabilities and related properties will undoubtedly vary from the estimates over time. A re-estimation process each year allows for the adjustment of those estimates.

Discussion of Change in the Liability for Loan Guarantee - To comply with Credit Reform, 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 displayed periods of both variance and stability. Periods of variance can be explained by two factors; (1) changes to the data underlying the credit subsidy rates and/or (2) revisions to the calculation methodology used to estimate the credit subsidy rates. Economic forces and policy shifts drive the changes in the data while legislative direction and technical enhancements produce the methodological revisions.

The fiscal year 1999 credit subsidy rates were established in 1997. At the time of budget submission, the credit subsidy rates reflected the policy and assumptions prevailing at that time and were based on the most up to date credit data available. A comparison can be made between the established rates used throughout fiscal year 1999 to recognize subsidy expense related to new loan guarantee disbursements versus rates established with updated credit data at the end of fiscal year 1999. The credit subsidy re-estimate process allows FHA to reconcile the two rates, thereby adjusting the LLG and subsidy expense to reflect the more accurate credit subsidy rate.

Described below are the programs that contain the majority of FHA's fiscal year 1999 new business. In addition, given changes in the healthcare environment, the Hospital Insurance program is also included. These descriptions highlight the factors that contributed to the credit subsidy re-estimate. Overall, there were reductions in LLG and subsidy expense over that which was experienced in fiscal year 1998. Changes in the MMI Fund LLG represent over 90 percent of the total FHA LLG decrease from fiscal year 1998 to 1999. The GI/SRI Fund is comprised of over 20 single family and multifamily programs, which can generate either positive or negative subsidy. This Fund's net decrease in LLG accounts for less than 10 percent of the total FHA LLG change. A more detailed description of changes to specific programs follows.

Mutual Mortgage Insurance (MMI) - The MMI Fund provides insurance for private lenders against losses on single family mortgages. By protecting the lender against loan default on mortgages for properties that meet certain minimum requirements, the Fund allows borrowers who might not meet conventional underwriting requirements to obtain credit.

Due to the magnitude of the MMI Fund, program changes to the Fund can significantly affect the overall LLG and subsidy expense recorded in the financial statements. During 1999, the MMI policy changes and current data and economic conditions have indicated that the original fiscal year 1999 negative subsidy rate for the MMI Fund was understated. Specifically, two policy changes have significantly affected the subsidy expense in 1999. First, the use of management and marketing (M&M) contractors in the property disposition process has increased the proceeds received from the sale of acquired properties. Second, the *Departments of Veterans Affairs and Housing and Urban Development Appropriations Act, 1999* allows mortgage notes to be assigned to FHA and either serviced by FHA or transferred to a third party for servicing. This policy is expected to increase FHA's recoveries through cash collections and interest savings.

The credit subsidy rate in 1999 was also affected by lower expected claim costs based on recent data and changing economic conditions. Fiscal year 1999 loss mitigation data indicate a substantive increase in the use of loss mitigation by lenders. Loss mitigation decreases FHA's claim costs by providing lenders an alternative to foreclosure. In addition, recent data and changing economic conditions also affect two of the most significant determinants of the MMI credit subsidy rate, the claim and non-claim termination rates. The claim and non-claim termination rates generated by the most recent MMI actuarial review project claim and non-claim termination patterns that lower FHA's expected claim costs.

The credit subsidy re-estimate process reflects this reduction in the MMI fiscal year 1999 credit subsidy rate which results in a decrease of the LLG and subsidy expense.

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 consisting of five or more units. Under this program, HUD may only insure up to 90 percent of the total project cost, and may not insure loans with HUD-subsidized interest rates. The Section 221(d)(4) program is the largest multifamily program within the GI/SRI Fund.

The original Section 221(d)(4) fiscal year 1999 credit subsidy rate (as estimated in 1997) was higher than the rate recalculated at the end of fiscal year 1999. This variance contributes to the fiscal year 1999 downward credit subsidy re-estimate which decreases the LLG and subsidy expense. The reason for this decrease in subsidy expense is two-fold.

First, the data underlying the estimation of the subsidy expense has been updated. The updated data was affected by numerous economic factors, including the strength of the housing market, the easing of interest rates, and policies affecting the Section 221(d)(4) program. This new data produced claim and non-claim termination rates that significantly lowered the subsidy expense.

Second, the model used to estimate the original fiscal year 1999 credit subsidy rate was revised to include the income and expense incurred during the recovery holding periods. In general, properties held as notes generate more income than properties held after foreclosure. The inclusion of the notes holding period income also contributed to a lower credit subsidy rate.

GI/SRI Section 242 - Operating within FHA is the Office of Insured Health Care Facilities (OIHCF). The OIHCF provides loan insurance through the Section 242 mortgage insurance program for the new construction of hospitals or the refinance of existing FHA-insured hospitals. Many of the hospitals insured through the Section 242 program serve as community anchors that provide jobs and health care services to populations in need. Hospitals in New York State constitute 89 percent of the Section 242 insurance in force portfolio.

The Section 242 program claims data is supplemented with claims data of OMB-defaulted hospitals. A hospital is OMB-defaulted if the hospital fails to meet three financial criteria and is on the Department of Health and Human Services (HHS) Priority Watch List (PWL). A revised HHS PWL and updated financial criteria data drove this reduction in OMB-defaulted hospitals. Due to a reduction in the number of OMB-defaulted hospitals, the fiscal year 1999 Section 242 subsidy rate has decreased significantly.

GI/SRI Section 234(c) **-** The Section 234(c) program insures a loan for as many as 30 years to purchase a unit in a condominium building. 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. The Section 234(c) program is FHA's largest single family program in the GI/SRI Fund. Historically, the program generates a negative subsidy expense.

As with the MMI Fund, current data and economic conditions indicate that the initial assumptions to generate the 1999 credit subsidy rate understated negative subsidy. Fiscal year 1999 credit data for the single family GI/SRI programs indicate an increase in the percentage of non-conveyance claims such as pre-foreclosure sales and loss mitigation. The higher use of non-conveyance claims lowers the expected claim costs associated with the 234(c) program.

The reduction of the loss rates, based on historical data, resulted in an increase in the recoveries on defaults. In addition, the claim and non-claim termination rates generated by the MMI actuarial review are also used to project the future performance of the Section 234(c) program. The claim and non-claim termination rates generated by the most recent MMI actuarial review project claim and non-claim termination patterns that lower FHA's expected claim costs.

As a result, the current re-estimated subsidy rate for the 234(c) program reflects the lower claim costs and higher premium inflows projected by the current claim and non-claim termination rate patterns. These factors have led to a reduced LLG and subsidy expense reflected in the financial statements.

Note 6. Debt

Debentures Issued to Claimants and Borrowings from U.S. Treasury

(dollars in millions)	1999	1998
Agency Debt:		
Debentures Issued to Public – Par Value	$ 107	$ 166
Other Debt:		
Borrowings from U.S. Treasury	7,996	6,579
Total Debt	$ 8,103	$ 6,745
Classification of Debt:		
Intragovernmental Debt	$ 7,996	$ 6,579
Debt with the Public	107	166
Total Debt	$ 8,103	$ 6,745

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 range from 4 percent to 13.38 percent in fiscal year 1999, and from 4 percent to 12.88 percent in fiscal year 1998. They may be redeemed by lenders prior to maturity 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 $107 million in fiscal year 1999 and $166 million in fiscal year 1998. The fair value based on original maturity dates was $151 million in fiscal year 1999, and $211 million in fiscal year 1998.

Borrowings from U.S. Treasury

In accordance with Credit Reform, FHA borrowed from the U.S. Treasury when cash was needed. Usually, a need for cash was recognized when FHA initially determined negative credit subsidy amounts related to new loan disbursements or to existing loan modifications. In some instances, borrowings were needed where available cash was less than claim payment due or downward subsidy re-estimates. All borrowings were made by FHA's financing accounts. Negative subsidies are generated primarily by the MMI/CMHI Fund financing account; downward re-estimates have occurred from activity of the FHA's loan guarantee financing accounts.

During fiscal year 1999, FHA's U.S. Treasury borrowings carried interest ranging from 5.36 percent to 7.59 percent, compared to a 5.57 percent to 7.59 percent range in fiscal year 1998. Maturity dates occur from September 2000 – September 2018. Loans may be repaid in whole or in part without penalty at any time prior to maturity.

Note 7. Other Liabilities

Other Liabilities Covered by Budgetary Resources

(dollars in millions)

Intragovernmental Liabilities:	**Current**		**Non-Current**		**Total**	
	1999	**1998**	**1999**	**1998**	**1999**	**1998**
HUD – Section 312 rehabilitation program payable	$ 6	$ 4	$ -	$ -	$ 6	$ 4
Payable to other government agencies	1	23	-	-	1	23
Payable from unapplied receipts recorded by Treasury	109	183	-	-	109	183
Total	$ 116	$ 210	$ -	$ -	$ 116	$ 210

Liabilities with the Public:	**Current**		**Non-Current**		**Total**	
	1999	**1998**	**1999**	**1998**	**1999**	**1998**
Escrow funds related to mortgage notes	$ 208	$ 204	$ -	$ -	$ 208	$ 204
Earnest money held pending completion of property sales	73	25	-	-	73	25
Interest enhancement – Multifamily mortgage auctions	12	13	-	-	12	13
Certificates of claims payable	-	12	12	-	12	12
Amounts withheld from claims paid for foreclosure costs	-	-	15	14	15	14
Interest payable on debentures and outstanding claims	16	19	-	-	16	19
Trust and deposits related to coinsurance program	13	13	-	-	13	13
Miscellaneous undistributed credits and other payables	16	18	9	-	25	18
Payables and undistributed credit for credit program asset	2	-	(2)	-	-	-
Total	$ 340	$ 304	$ 34	$ 14	$ 374	$ 318

Note 8. 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 these legal actions and claims will not materially affect FHA's financial statements as of, and for, the fiscal year ended September 30, 1999. This was the case for fiscal year 1998 as well.

Note 9. Unexpended Appropriations

Unexpended Appropriations (dollars in millions)	**1999**	**1998**
Unobligated:		
Available	$ -	$ 43
Unavailable	262	1,636
Undelivered Orders	52	25
Total	$ 314	$ 1,704

Appropriations were received by FHA's subsidized program funds (GI/SRI) for subsidy expenses and administrative expenses. FHA's unsubsidized program funds (MMI/CMHI) received appropriations of negative subsidy generated by the financing funds to cover their administrative expenses. Unobligated balances include only unexpended appropriations for subsidy expense, since all appropriations for administrative expenses have been expended.

FHA's undelivered orders represent obligations for goods and services ordered but not yet received, obligations for credit subsidy of guaranteed loans committed but not yet disbursed by lenders, and direct loans obligated but not yet disbursed by FHA as of September 30.

Note 10. Exchange Revenue

FHA insures private lenders against loss on mortgages financing the purchase of single family homes, multifamily projects, health care facilities, property improvements, and manufactured homes. The insurance premium is the primary revenue source for the MMI and CMHI Fund. Insurance premiums and other financing sources (congressional appropriations) support the GI and SRI Funds. The premium structure, set by the National Affordable Housing Act and published in the Code of Federal Regulations (CFR), which became effective July of fiscal year 1991, includes both an up-front premium for single family MMI, multifamily GI and SRI, and a periodic premium for all Funds, both single family and multifamily. The premium rates generally remain constant from year to year.

Up-front Premiums

The up-front premium rate is used to calculate the up-front premium paid by borrowers. Rates, which are set by legislation, vary according to the mortgage type and the year of origination. Single family up-front premiums for pre-1992 cases 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. The multifamily up-front premium for pre-1992 cases is treated much like a periodic premium, and is amortized 1/12 per month for the first full year. The up-front premium rates in fiscal year 1998 and 1999 were:

Up-front Premium Rates

	Mortgage Term 15 Years or Less	Mortgage Term More Than 15 Years
Single Family	2.00%	2.25%
Multifamily	.50%	.50%

In accordance with Section 203(c)(1) of the National Housing Act, reductions to premium charges are at the discretion of the Secretary of Housing. In accordance with Mortgagee Letter 97-37, during fiscal year 1998 and 1999 in cases where the single family first-time homebuyer received housing counseling, the borrower was subject to a discounted up-front premium rate of 1.75 percent, regardless of the mortgage term.

Periodic Premiums

The periodic premium rate is used to calculate monthly or annual premium receipts. These rates, which are legislated, vary by mortgage type and program. Periodic premiums can be calculated on an amortized or unamortized basis, depending on the Fund. The periodic premium rate in fiscal year 1998 and 1999 for single family and multifamily were:

Periodic Premium Rates

	Mortgage Term 15 Years or Less	Mortgage Term More Than 15 Years
Single Family	.25%	.50%
Multifamily	.50%	.50%

Although the up-front and periodic premium rates can vary slightly by multifamily risk category, generally both rates remain .50 percent regardless of the mortgage term.

Pre-Credit Reform insurance premiums earned during fiscal year 1999 totaled $215 million compared to $776 million in 1998. This difference is attributed primarily to a downward adjustment that was made to MMI unearned premiums in fiscal year 1998, which increased pre-Credit Reform insurance premiums earned by $471 million in that same year. Pre-Credit Reform income on sale of mortgage notes during fiscal year 1999 totaled $65 million, compared to $130 million in 1998. In accordance with the Credit Reform Act, all post-Credit Reform revenues have been posted to the LLG. All pre-Credit Reform interest income and the post-Credit Reform interest income on uninvested funds equals $2.097 billion in fiscal year 1999 and $2.348 billion in 1998. Other revenues totaled $50 million for fiscal year 1999, compared to $71 million in 1998.

Note 11. Subsidy Expense Generated by New Endorsements

The following table identifies the components of subsidy expense generated by new insurance endorsements in fiscal year 1999:

Components of Subsidy Expense Generated by New Endorsements
(dollars in millions)

	Endorsement Amount	Default Component	Fees Component	Other Component	Subsidy Amount
MMI	$ 113,170	$ 1,911	$ (5,754)	$ 786	$ (3,057)
GI/SRI					
Single Family	10,767	281	(423)	-	(142)
Title I	496	8	(14)	-	(6)
Multifamily	4,623	441	(244)	-	197
	15,886	730	(681)	-	49
Total	$ 129,056	$ 2,641	$ (6,435)	$ 786	$ (3,008)

The following table identifies the components of subsidy expense generated by new insurance endorsements in fiscal year 1998:

Components of Subsidy Expense Generated by New Endorsements
(dollars in millions)

	Endorsement Amount	Default Component	Fees Component	Other Component	Subsidy Amount
MMI	$ 90,509	$ 1,170	$ (4,517)	$ 665	$ (2,682)
GI/SRI					
Single Family	9,663	265	(398)	-	(133)
Title I	1,034	16	(31)	-	(15)
Multifamily	3,606	419	(223)	-	196
	14,303	700	(652)	-	48
Total	$ 104,812	$ 1,870	$ (5,169)	$ 665	$ (2,634)

Note 12. Gross Cost and Earned Revenue by Budget Functional Classification

As was the case in fiscal year 1998, all cost and earned revenue reported on the Statement of Net Cost is categorized under the budget functional classification (BFC) for Commerce and Housing Credit (370). All of the FHA U.S. Treasury account symbols found under the department code “86” for Department of Housing and Urban Development appear with the Commerce and Housing Credit BFC, therefore no breakout is necessary.

Note 13. Status of Budgetary Resources

FHA has two program, two liquidating, and four financing appropriations. For presentation purposes, the four financing accounts have been collapsed into two due to small dollar amounts for appropriation 86X4242 and 86X4105.

The Statement of Budgetary Resources has been prepared as a combining 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.

Pursuant to Public Law 101-510, 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.

The amount of budgetary resources obligated for unliquidated obligations at the end of the period were:

(dollars in millions)	1999	1998
Unliquidated Obligations, beginning of the year	$ 1,052	$ 700
Obligations Incurred during the year	21,446	15,247
Less: Expenditures during the year	21,208	14,895
Unliquidated Obligations, end of year	$ 1,290	$ 1,052

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

Financing sources for repayments are from premiums earned, and the maturity dates on these borrowings are generally 20 years or more. Funded borrowings and repayments at September 30 were:

(dollars in millions)	From the Public		From U.S. Treasury		Total	
	1999	**1998**	**1999**	**1998**	**1999**	**1998**
Total borrowing, beginning of year	$ 166	$ 68	$ 6,579	$ 3,639	$ 6,745	$ 3,707
New borrowing	76	126	1,650	3,365	1,726	3,491
Repayments	(135)	(28)	(233)	(425)	(368)	(453)
Total borrowing, end of year	$ 107	$ 166	$ 7,996	$ 6,579	$ 8,103	$ 6,745

Note 14. Financing Sources yet to be Provided, Footnote Disclosure related to the Statement of Financing

FHA financing sources yet to be provided will be paid from resources realized in the future. All liabilities are considered covered by budgetary resources because FHA has permanent indefinite appropriation authority, as discussed in Note 1.

(dollars in millions)	**1999**	**1998**
Liabilities not covered by budgetary resources	$ -	$ -
Financing sources yet to be provided:		
Subsidy expense from FY99 upward credit subsidy re-estimates	58	2,745
Interest expense from FY99 upward credit subsidy re-estimates	18	747
Total financing sources yet to be provided	$ 76	$ 3,492

Appendix A

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