audit report

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March 1, 2001
Audit Case Number
2001-FO-0002

TO: Shaun L. Donovan, Acting General Deputy 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 2000 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, 2000. In KPMG's opinion, the financial statements present fairly, in all material respects, FHA's financial position as of September 30, 2000, 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.

This report includes both the Independent Auditors' Report, and FHA's principal financial statements. FHA plans to separately publish an annual report for Fiscal Year 2000 that conforms to Federal Accounting Standards Advisory Board (FASAB) standards. As required by FASAB Statement of Federal Financial Accounting Standards (SFFAS) No. 15, effective for Fiscal Year 2000, a general purpose federal financial report should include as required supplementary information a section devoted to management's discussion and analysis (MD&A). Although the Scope and OMB Requirements section which follows indicates that KPMG has been asked to review FHA's MD&A, the MD&A is not included with this report, but will be a part of FHA's planned annual report to be published in accordance with the CFO Act on or before March 31, 2001.

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. 01-02, *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. 01-02, 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 the Federal Financial Management Improvement Act (FFMIA) of 1996.

To address the first two additional OMB requirements, we engaged KPMG to expand their review of FHA's internal controls and performance measures including those to be reported at the HUD consolidated level. The section discussing internal controls presents the results of this work. 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 KPMG's Independent Auditors' Report, they expressed an unqualified opinion on FHA's financial statements. However, KPMG also reported a potential non-compliance with the Anti-Deficiency Act, 31 U.S.C. 1341 (a), that requires additional analysis, as well as a policy or legal determination by HUD's Office of General Counsel, OMB and/or the Comptroller General. The report identifies a material weakness and three reportable conditions on internal controls in Appendices A and B, discusses each of these conditions in detail, provides an assessment of actions taken by FHA to mitigate them, and makes recommendations for corrective actions. Appendix C briefly describes the resolution of a prior year material weakness and reportable conditions. 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 made 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 Automated Audits Management System (DAAMS), we will continue to track the resolution of these prior years' audit recommendations. KPMG's recommendations from their Fiscal Year 2000 audit cover several 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 DAAMS.

Comments of FHA Officials

On January 29, 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, 2000 and 1999, 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. FHA is a wholly-owned government corporation within the U.S. Department of Housing and Urban Development (HUD). 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, 2000 and 1999, are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America. As discussed in Note 15 to the financial statements, FHA changed its method of recording upward credit subsidy re-estimates in fiscal year 2000.

As a result of our consideration of internal control over financial reporting for fiscal year 2000, we noted reportable conditions in the following four areas, the first one of which we also considered to be a material weakness:

- FHA's information technology systems must be enhanced to more effectively support FHA's business processes,
- FHA/HUD must enhance the design and operation of controls over information systems security and application data integrity,
- FHA must continue to place more emphasis on early warning and loss prevention for Single Family insured mortgages, and
- FHA must sufficiently monitor and account for its Single Family property inventory.

As a result of our tests of FHA's compliance with certain provisions of laws and regulations, we noted one potential instance of noncompliance, further described in the *Compliance with Laws and Regulations* section of this report.

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 fiscal year 2000 and 1999 financial statements present fairly, in all material respects, the financial position of FHA as of September 30, 2000 and 1999, 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 accounting principles generally accepted in the United States of America. As discussed in Note 15 to the financial statements, FHA changed its method of recording upward credit subsidy re-estimates in fiscal year 2000.

The information in the Management's Discussion and Analysis section of FHA's Annual Report is not a required part of the financial statements but is supplementary information required by the Federal Accounting Standards Advisory Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit the information in the Management's Discussion and Analysis section, and, accordingly, we express no opinion on it.

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 or reportable conditions 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, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the 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. Because of the inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected.

We identified one material weakness, described more fully in Appendix A:

- **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.

We also identified the following three reportable conditions that are not considered material weaknesses, described more fully in Appendix B:

- **FHA/HUD must enhance the design and 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 has enhanced the process by which security plans are developed and controlled, and HUD has initiated a data quality improvement program to help address and facilitate improvements in HUD and FHA data elements. However, control weaknesses still exist in system and application access controls, and application data integrity.

- **FHA must continue to place more emphasis on early warning and loss prevention for Single Family insured mortgages.** FHA needs to continue to reduce the frequency and loss severity of defaults on Single Family insured mortgages by continuing its use of loss mitigation tools and improving the effectiveness of monitoring processes for the single family insured portfolio.

- **FHA must sufficiently monitor and account for its Single Family property inventory.** FHA continues to improve single family property acquisition, management, and disposition, however, certain corrective actions remain to be completed.

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 are repeated as findings because they have not been completely resolved as of the date of our report.

Matters that were reported in our prior year report and have been resolved by FHA's management in fiscal year 2000 include:

- Controls over budgetary funds and funds control must be improved (a prior year material weakness);

- FHA must continue to place more emphasis on early warning and loss prevention for Multifamily insured mortgages (a prior year reportable condition);
- FHA must continue actions to safeguard and quickly resolve Secretary-held Single Family mortgage notes (a prior year reportable condition); and
- FHA must improve its review process for estimating reserves for the insured portfolio (a prior year reportable condition).

These matters are described more fully in Appendix C.

We 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 one potential instance of noncompliance required to be reported herein under *Government Auditing Standards* and Office of Management and Budget (OMB) Bulletin 01-02, *Audit Requirements for Federal Financial Statements*.

Allocation of Contract Obligations. Certain contract obligations are allocated between FHA's program and liquidating funds based on the nature of the services to be provided. Limits have been set by appropriation law regarding the amount of administrative costs that may be charged to FHA's program accounts. The allocation methodology that FHA has currently applied for certain contracts may require refinement, to better reflect the relationship of the services to specific programs. Such a re-allocation of obligations between funds would require additional analysis to determine if the re-allocation would result in a matter of noncompliance with the Anti-Deficiency Act, as of September 30, 2000, relating to FHA's Mutual Mortgage Insurance (MMI) program account. We recommend that FHA develop, with consideration of advice from HUD's Office of General Counsel, OMB and/or the U.S. General Accounting Office, as appropriate, a methodology for allocating fiscal year 2000 contracts between the program and liquidating funds, to conclude this matter.

* * * * *

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 or which have been reported by the Office of the Inspector General or the General Accounting Office. Such matters include fraudulent activities, which have been perpetrated against FHA. However, the ultimate resolution of these matters cannot presently be determined.

RESPONSIBILITIES

Management's Responsibility. The Chief Financial Officers Act (CFO) 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.

Management has the responsibility for:

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

Auditors' Responsibility. Our responsibility is to express an opinion on the fiscal year 2000 and 1999 financial statements of FHA based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin No. 01-02. Those standards and OMB Bulletin No. 01-02 require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement. We believe that our audits provide a reasonable basis for our opinion.

In order to fulfill these responsibilities, we:

- examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- assessed the accounting principles used and significant estimates made by management; and
- evaluated the overall financial statement presentation.

In planning and performing our audit, we considered internal control over financial reporting by obtaining an understanding of FHA's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02 and *Government Auditing Standards*. We did not test all internal controls as defined by the Federal Managers' Financial Integrity Act of 1982. The objective of our audit was not to provide assurance on FHA's internal control. Consequently, we do not provide an opinion on internal controls over financial reporting.

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, and certain provisions of other laws and regulations specified in OMB Bulletin No. 01-02. Additionally, our audit procedures were not designed to test the requirements of OMB Bulletin No. 01-02 relating to the Federal Financial Management Improvement Act (FFMIA) of 1996, which were not considered applicable at the FHA level. FFMIA requirements will be reviewed and reported at the HUD consolidated level. We limited our tests of compliance to the provisions described above, and we did not test compliance with all laws and regulations applicable to FHA. Providing an opinion on compliance with laws and regulations was not an objective of our audit, and, accordingly, we do not express such an opinion.

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

KPMG LLP

February 28, 2001

INTRODUCTION

The material weakness and reportable conditions in FHA's internal control, as of and for the year ended September 30, 2000, are summarized in the categories discussed below:

Material Weakness:

1. ***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:

2. ***FHA/HUD must enhance the design and 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 has enhanced the process by which security plans are developed and controlled, and HUD has initiated a data quality improvement program to help address and facilitate improvements in HUD and FHA data elements. However, control weaknesses still exist in system and application access controls, and application data integrity.

3. ***FHA must continue to place more emphasis on early warning and loss prevention for Single Family insured mortgages.*** FHA needs to continue to reduce the frequency and loss severity of defaults on Single Family insured mortgages by continuing it's use of loss mitigation tools and improving the effectiveness of monitoring processes for the single family insured portfolio.

4. ***FHA must sufficiently monitor and account for its Single Family property inventory.*** FHA continues to improve single family property acquisition, management, and disposition, however, certain corrective actions remain to be completed.

All conditions described above have been previously reported. We acknowledge that HUD and FHA have taken actions to address these matters. 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 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 section describes the material weakness as of and for the year ended September 30, 2000; our recommendations; FHA management's response; and our assessment of that response. Appendix B includes a similar discussion of each reportable condition described above. Appendix C presents the material weakness and reportable conditions that were included in the fiscal year 1999 Independent Auditors' Report that were substantially resolved by FHA's management during fiscal year 2000. The full text of management's response is included as Appendix D.

1. 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 with less efficient business processes.

In fiscal year 2000, FHA developed the *FHA Vision of Financial Management*, in which the current state of FHA financial management was modeled and several phases of improvements were documented. Planned improvements include leveraging a new HUD core accounting system that is to provide automated interfaces between HUD, FHA, and other Departmental financial feeder systems. During fiscal year 2000, HUD completed the first phase of this improvement by procuring a commercial software package that will be used, in part, to implement the FHA general ledger. FHA anticipates that the new accounting system will bring FHA into compliance with Federal Financial Management guidelines for the automated posting of transactions to the Standard General Ledger (SGL).

However, because the new accounting system has not been implemented, HUD and FHA are still 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 significant manual analysis. For example, certain subsystems including Strategy (the Single Family Mortgage

Notes System), Single Family Premium Collection System – Periodic (SFPCS-P), and Single Family Acquired Asset Management System (SAMS) of the financial operations and control program areas are currently maintained in local databases that are not interfaced, thus elevating the level of manual processing needed to monitor this process.

Within Multifamily there are various databases used to track properties. These databases are not interfaced, elevating the potential for processing errors. For example, the Multifamily Insurance System (MFIS) and the Multifamily Insurance Claims System (MFCS) are not interfaced which has resulted in active properties remaining in the MFIS after a claim is filed. Delinquency reports are generated manually and therefore are subject to human error. The field office project managers often receive these inaccurate reports and have used them to manage their portfolio. The Multifamily Accounting and Reporting System (MARS) does not have the capability to identify the "unapplied disbursement" portion of a note. A note with an outstanding balance that has both "unapplied collection" and "unapplied disbursement" is a delinquent note, but not identified as such by MARS because the system does not "net" the amounts of both "unapplied" balances. As a result, the reports produced by MARS do not reflect all delinquent notes.

FHA's budgetary and funds control systems consist of non-integrated systems which include the Credit Subsidy Control System, Program Accounting Support/Letter of Credit Collection System and Cash Control Accounting and Reporting System. Lack of interface between these systems requires the use of manual analysis and reconciliation and use of an additional database to collect and summarize funds control information, which subjects the process to control risk. In addition, FHA's manual process for allocating and recording obligations to specific funds led to certain errors in fiscal year 2000. Specifically, certain contracts that serve multiple purposes were not initially allocated between funds properly, requiring year-end adjustments.

Because of the lack of an integrated financial system, key FHA systems, including MFIS, MFCS, SAMS, and the Single Family Mortgage Notes System do not provide the functionality required to sufficiently manage and account for financial transactions in accordance with the Office of Management and Budget's (OMB) Circular No. A-127 (*Financial Management Systems*). OMB No. A-127 weaknesses for several FHA systems can be addressed before the implementation of a new accounting system, including lack of clear system documentation, training and user support, and defined functional requirements.

HUD continues to report material financial management system non-conformances in its *Fiscal Year 2000 Accountability Report*, several of which directly relate to FHA systems. HUD and FHA anticipate that the new accounting system will address these issues by upgrading the departmental subsidiary ledger systems and bringing FHA into substantial compliance with federal financial management guidelines for the automated posting of transactions to the SGL.

Further, FHA is in the process of developing plans to implement a new FHA general ledger, which will be compliant with Joint Financial Management Improvement Project requirements. The first phase of implementation is scheduled to be complete by March 2002 at which time the new general ledger will post SGL transactions and interface automatically with the HUD departmental general ledger. Full implementation of the long-term plan is targeted for December 2005 at which time the new subsidiary ledger is expected to interface directly with FHA operational insurance systems.

Recommendations to address the above include:

1.a. Ensure that the planning and implementation process for the new core accounting system follows relevant OMB guidance, an established Systems Development Life Cycle Methodology and enterprise architecture plan.

1.b. Implement a comprehensive new information technology environment/system to replace the legacy system and manual work around processes to improve systems integration.

1.c. Ensure that the new system will support requirements to comply with the US SGL; Federal budgetary accounting and funds control; and Federal reporting, specifically those related to the Federal Credit Reform Act of 1990.

1.d. Develop and implement a documented process to allocate obligations among FHA funds, based on reasonable and defensible methodology.

Management's Response

Management agreed 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.

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

FHA management relies heavily on computerized information systems to process the large volumes 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 several key applications that support FHA's financial processing environment. We noted that HUD and FHA have taken steps to address prior year control weaknesses in the EDP application control environment. For example, FHA has implemented a process to reconcile data contained in REMS to other multifamily applications, FHA has enhanced the process by which security plans are developed and controlled, and HUD has initiated a data quality improvement program to help address and facilitate improvements in FHA data elements. However, control weaknesses still exist in application security controls and application data integrity. Specifically, we noted the following weaknesses:

Application Security Controls. Certain logical access controls need improvement to provide a more secure EDP environment. This includes enhancing the level of segregation of duties for key data processing functions, limiting contractor access to sensitive application security reports, and ensuring that security risk assessments are performed for key applications. Detailed examples of identified control weaknesses include:

- REMS and MFIS, key FHA Multifamily applications lack sufficient segregation of duties between key operational functions, such as data entry and transaction approval.

- SAMS contractors have the ability to access sensitive security reports that show login information for other contractors.

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

Establishing and maintaining effective information security controls is not only good business practice, but the recently passed Government Information Security Reform Act of 1999 (GISRA) requires that federal agencies develop and implement effective information security policies, procedures, and control techniques. In addition, the HUD and FHA information security control structure needs to be sound because of plans to enhance the Department's Internet technology capabilities, thus significantly increasing the level of information security risk.

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. Detailed examples of identified control weaknesses include:

- SAMS lacks database controls to ensure that data integrity is maintained when the application encounters processing problems.

- Data edit and reasonableness checks in SAMS and Single Family Premium Collection System – Periodic (SFPCS-P) can be enhanced to ensure that data entered into the applications is accurate and complete.

Recommendations to address the above continue to include:

2.a. Controls should be enhanced to provide assurance that segregation of duties are improved for REMS and MFIS, access to sensitive SAMS information is controlled, and a security risk assessment is performed for FHA Connection.

2.b. HUD and FHA should ensure that sufficient information security controls are in place for all applications, and the security controls for the applications are periodically reviewed for appropriateness.

2.c. HUD Security Administrator Working Group (SAWG) meetings should be used as a forum to discuss and elevate important security topics such as segregation of duties, access controls, risk assessments, as well as HUD's and FHA's responsibilities associated with the recently passed GISRA requirements.

In addition, we recommend that:

2.d. HUD's recently initiated data quality improvement program is used to address data integrity issues with SAMS, SFPCS-P, and other applications, as necessary. This will help ensure that HUD and FHA data integrity issues are addressed as a coordinated effort rather than on an application-by-application basis.

2.e. HUD and FHA should develop a coordinated effort to develop a plan for addressing GISRA requirements. Critical components of this effort should include close interaction between the HUD CIO, HUD Inspector General, and HUD and FHA Program Offices.

Management's Response

Management agreed 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.

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

During fiscal year 2000, FHA continued to make progress in improving its ability to monitor its insured portfolio. However, as of September 30, 2000, FHA had not yet fully implemented certain initiatives to identify and manage risks in its Single Family insured portfolio effectively. FHA needs to increase its use and analysis of other data now available to continue improvement in lender monitoring. Timely identification of lenders with above average early default rates are key elements of FHA's efforts to target monitoring and enforcement resources to Single Family insured mortgages and lenders that represent the greatest financial risks to FHA. Potentially problem lenders must be identified before FHA can institute loss mitigation techniques and lender enforcement measures that can reduce eventual claims.

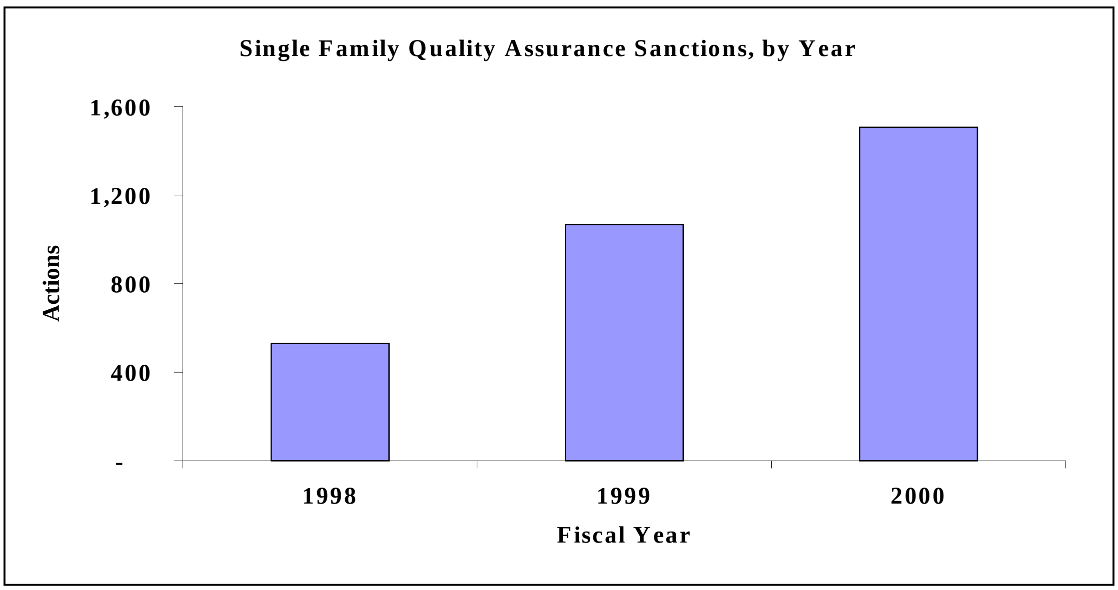
The Office of Single Family Housing continues to improve its early warning and loss prevention processes, although progress remains to be made. These processes include:

- **Appraisal Reform.** In fiscal year 2000, HUD began to implement an appraisal reform program. The Real Estate Assessment Center (REAC) began a pilot of the Single Family Appraisal Subsystem (SASS), which uses specified indicators to statistically identify appraisals for review. Additionally, FHA increased its enforcement authority against poorly performing appraisers through the implementation of Single Family Appraiser Roster Removal Procedures and Appraisal Quality Assessment (AQA) system for field reviews of appraisals.

- **Neighborhood Watch and Credit Watch fully implemented.** Through Neighborhood Watch and Credit Watch, every three months FHA systematically reviews every participating lender branch's early default and claims rates, and suspends the most inferior and advises the marginal to improve. During fiscal year 2000, the Neighborhood Watch system was made public and there are plans to include additional components, such as servicing data, in the system.

- **Single Family Enforcement Actions Increased.** During the past two years, as part of its reorganization plan, FHA has substantially increased the number of persons working in the Quality Assurance Area. As a result, FHA is conducting more on site field reviews. In fact, during fiscal year 2000, the four Homeownership Centers (HOC) performed 925 lender monitoring reviews, nearly three times more lender monitoring reviews than it did two years ago. HUD has a variety of enforcement actions it can take with regard to lender violations. These include "Letters of Reprimand," "Settlement and Indemnification Agreements," and the "Suspension" or "Withdrawal of Mortgage Approval." As shown in Exhibit 1, the total number of quality assurance sanctions has been steadily increasing in the past three years. These quality assurance reviews resulted in approximately 1,500 corrective actions against lenders, including indemnifications and referrals to the Mortgagee Review Board, the Office of Inspector General, and the Departmental Enforcement Center for further investigation or administrative sanctions.

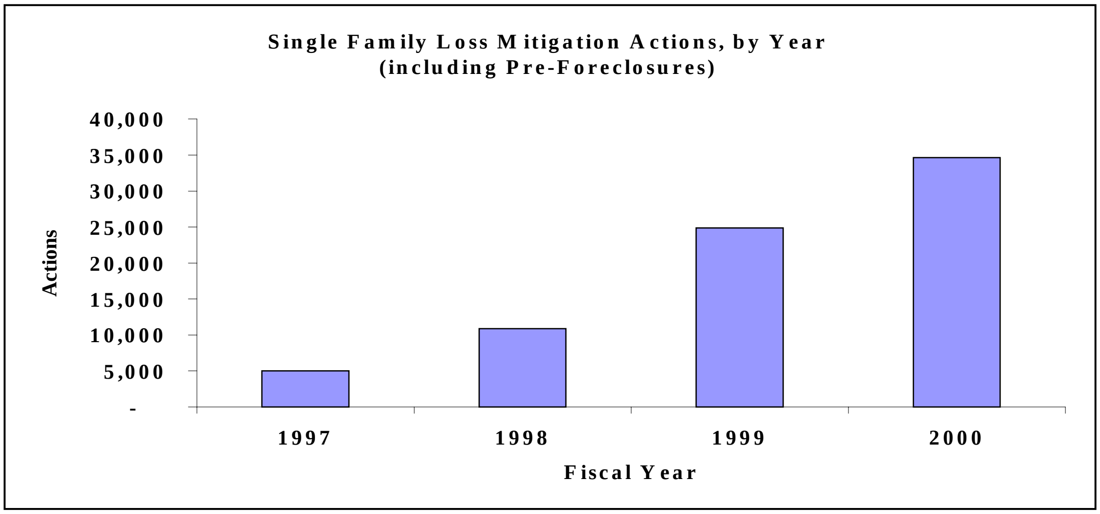
Exhibit 1



Source: Single Family Quality Assurance Fiscal Year 2000 Activity Reported, as of September 30, 2000

- **Use of loss mitigation continues to expand.** As depicted in Exhibit 2, the total number of loss mitigation interventions has increased substantially in the past four fiscal years. In fiscal year 2000, through use of loss mitigation tools available to lenders, FHA has given more than 35,000 borrowers an alternative to foreclosure. A lender training program combined with increased monitoring of lender participation are the key drivers in the program's acceptance.

Exhibit 2



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

- **Post-claim reviews.** The contract for conducting post-claim reviews was awarded April 7, 2000, and the first on-site claim reviews began on May 26, 2000. The contractor is required to examine loss mitigation claims as well as full claims during its on-site reviews of mortgagees. In addition, broad oversight of lenders' compliance with Loss Mitigation requirements is mandatory under the servicing review contract. In fiscal year 2000, a receivable of about $5 million was recorded as a result of the review process.

- **Development of the Lender Assessment Subsystem (LASS) of the REAC began.** During fiscal year 2000, FHA began the development of LASS, a subsystem of the REAC that will automate and improve the process of capturing annual, audited financial and program compliance data for FHA-approved Non-supervised Lenders and Loan Correspondents. Through this analysis, FHA will be able to identify potential problem lenders, and take actions to ensure that these lenders do not cause increased losses to the insurance fund.

- **Triple claim legislation.** To discourage lenders from failing to consider the use of loss mitigation for defaulted loans, a penalty provision, calculated as three times the amount paid on the mortgagee's insurance claim, was enacted as Section 601(f) of the 1999 Appropriations Act. In fiscal year 2000, FHA held a number of meetings with representatives of the lending industry to develop a framework for implementing regulations. In December 2000, HUD issued *Treble Damages for Failure to Engage in Loss Mitigation; Advance Notice of Proposed Rulemaking* to solicit public comment on the implementation of the triple claim legislation.

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

- **Expand the use of post-endorsement technical reviews.** We noted the HOCs have implemented the Underwriting Reports System (URS); an Access-based database used to track post endorsement technical reviews. A standardized Statement of Work, recently drafted and currently being used by all HOCs for the procurement of post endorsement technical reviews, requires the contractor to record and transmit the results electronically through URS. Recently, the results of the post-endorsement review were incorporated into the targeting attributes for Quality Assurance (QA) reviews.

- **Potential geographic concentration of fraud risk.** As reported by HUD Office of Inspector General (OIG) in the "Semiannual Report to the Congress," the Housing Fraud Initiative conducted by HUD OIG has identified, with the assistance and cooperation of FHA's Single Family Housing Program management, concentrations of fraud risk in certain geographic areas. The full impact of these fraudulent activities, which have been perpetrated against FHA, could be recognized as unexpected future claims and defaults against FHA's funds. The HUD OIG has recommended that FHA take certain actions as specified in Chapter 3, Single Family Housing Programs, Loan Origination, of the report referred to above.

Additionally, the General Accounting Office and the HUD OIG issued recent reports citing deficiencies in the Single Family Insurance process.[1] These reports describe fraudulent activities, which have been perpetrated against FHA and make recommendations to be taken by FHA to reduce such losses. The HUD OIG recommended that management consider the loan production process a material weakness under the Federal Managers Financial Integrity Act.

Recommendations to address the above include:

3.a. Continue with plans to implement LASS to automate and improve the process of capturing annual, audited financial and program compliant data for FHA-approved Nonsupervised Lenders and Loan Correspondents.

3.b. Continue with SASS implementation to enhance appraiser monitoring and enforce the quality assurance process.

[1] Major Management Challenges and Program Risks, January 2001(GAO-01-248) and Single-Family Production, Home Ownership Centers, March 30, 2000 (00-SF-121-0001).

3.c. Collect 30- and 60-day delinquency rates on Single Family insured mortgages similar to those used in the industry. This information can be used to identify delinquent loans with the greatest potential for loss mitigation benefits and to provide data that could be used to identify other loss prevention strategies.

3.d. Implement 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. The post-endorsement technical reviews could be used to provide meaningful feedback on a large number of FHA partners.

3.e. Work with FHA's lender partners to develop acceptable implementing regulations to motivate lenders to follow FHA's loss mitigation requirements.

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

3.g. Modify the Post-endorsement technical review process for loans endorsed through an automated underwriting process to focus on data integrity of the application and scorecard factor information.

3.h. Consider implementing automated valuation and fraud detection tools that are beginning to be used in the mortgage industry. Examples include automated tools used prior to endorsement that verify the validity of borrower social security numbers and collect historical data on property sales.

Management's Response

In their response, management does not agree with KPMG's assessment on early warning and loss prevention controls during fiscal year 2000. Management cites substantial improvements in its operations and compliance monitoring in recent years, including appraisal reform, automated underwriting, Credit Watch and resulting terminations, and Neighborhood Watch, that have enhanced FHA's ability to monitor and prevent losses on single family insured mortgages. Additionally, management notes that through the Loss Mitigation program, more than 35,000 homeowners avoided foreclosure, a 134 percent increase in loss mitigation over fiscal year 1999, further discussion is included in management's response in Appendix D.

KPMG's Assessment of Management's Response

We acknowledge that there has been continual improvement in the early warning and loss prevention processes, including the full implementation of Neighborhood Watch and Credit Watch. We also observed that the number of loss mitigation interventions has increased substantially in the past four years.

However, during fiscal year 2000, and as of September 30, 2000, deficiencies still existed in FHA's ability to monitor and prevent losses on single family insured mortgages particularly with the ability to timely detect and prevent fraud including more effective use of the post endorsement review process.

4. FHA MUST SUFFICIENTLY MONITOR AND ACCOUNT FOR SINGLE FAMILY PROPERTY INVENTORY

During fiscal year 2000, 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.

Our audit showed that FHA has realized some success from its Management and Marketing Contracts (M&M). This includes:

- Sales volume increased from 62,000 in fiscal year 1999 to 84,000 in fiscal year 2000, an increase of 35 percent.
- Because sale volume increased, FHA's single family property inventory decreased from 51,000 in fiscal year 1999 to 36,000 properties in fiscal year 2000, a decrease of 32 percent.
- The total net investment value was $3.01 billion, a decrease of $1.23 billion compared to September 30, 1999 as shown in Exhibit 3.
- Aged inventory over 180 days decreased from 20,100 in fiscal year 1999 to 10,300 in fiscal year 2000, a decrease of 49 percent, although the sales of aged inventory resulted in decreasing returns as a percent of appraised value.

Despite these improvements, we found that the monitoring and performance of the Management and Marketing contractors (M&M) tasked with managing and selling properties continues to need improvement.

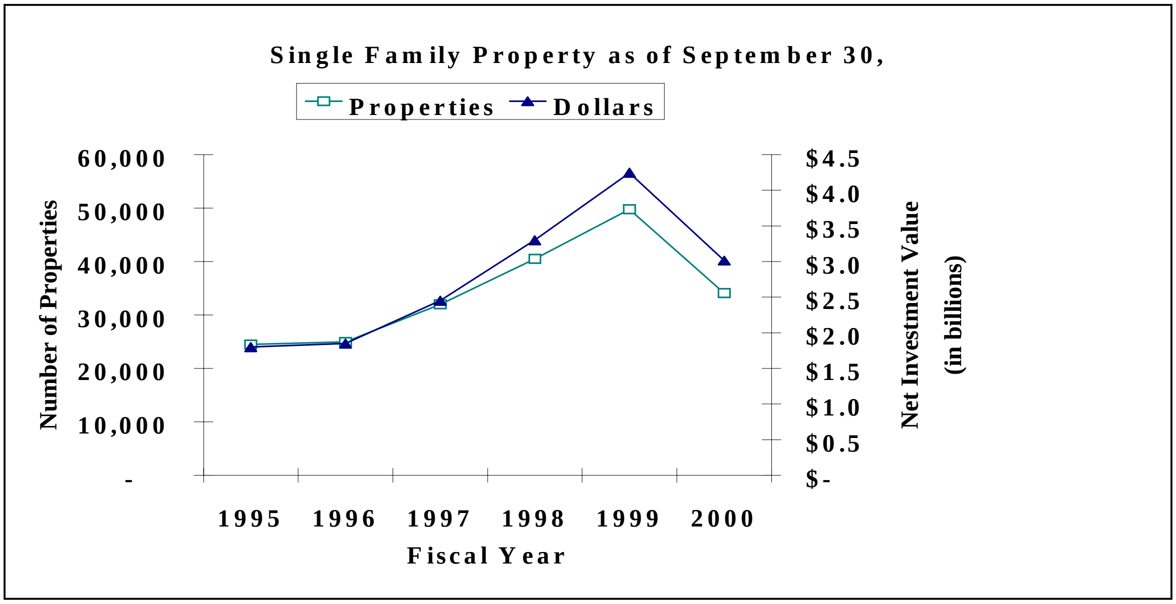


Exhibit 3

Source: Single Family Acquired Asset Management System

Beginning in March 1999, the responsibilities associated with daily Single Family Secretary-owned property operations were shifted to M&M contractors. The M&M contractors are responsible for the management, operations, repairs, maintenance, rental, and sale of single family properties.

Oversight of M&M contractors is performed both at the HOCs and at Headquarters. Each month, the contract Government Technical Representative's (GTR) prepare an assessment report for each M&M contractor in each contract area. This performance assessment is the result of case file reviews by third-party contractors, Special Property Inspector (SPI) physical inspections, and HOC staff on-site observations. Headquarters generates daily reports to track inventory levels, listings, and property sales.

In addition to the work we performed during the course of the fiscal year 2000 financial statement audit, the General Accounting Office and HUD's OIG issued reports during fiscal year 2000 that identified deficiencies in the maintenance of Single Family properties and contractual compliance of the M&M contractors.[2]

We selected a statistically representative, nationwide sample of properties to test property management processes at the contractor level. Additionally, we reviewed a sample of the monthly assessment reports. Deficiencies we noted included:

[2] Major Management Challenges and Program Risks, January 2001(GAO-01-248) and Single-Family Property Disposition Program, September 28, 2000 (Report No. 00-AT-123-0001).

- **Single Family Acquired Asset Management System (SAMS) data integrity issues.** A statistical sample of property case files indicates that 4 percent of active properties recorded in SAMS were not valid Secretary-owned properties. These properties are included in the REO inventory due to initial data entry errors resulting in invalid case numbers or erroneous property addresses.

- **Compilation of M&M contractor monthly assessment report.** The review of a statistical sample of monthly assessment reports indicates that 50 percent of the performance reports issued during fiscal year 2000 did not fully report the results of the case file review and the SPI reports. Additionally, FHA's quality control review of the contractors tasked with reviewing the M&M contractors was inconsistent.

Recommendations to address the above continue to include:

4.a. Proceed with efforts to identify, investigate, and delete bad case numbers from SAMS as part of the data quality improvement initiative.

4.b. Implement and revise, as appropriate, comprehensive oversight tools and management reports to facilitate effective monitoring of the M&M contractors, while providing practical and useful feedback to both the M&M and review contractors. Continue with plans to use risk-based or 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 to provide incentives to the contractors. Such a mechanism will effectively communicate the importance of strictly adhering to HUD guidelines.

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.

In fiscal year 2000, FHA implemented significant corrective actions, which addressed the material weakness on improving controls over budgetary funds and the reportable condition on safeguarding and quickly resolving Secretary-held Single Family mortgage notes. This section documents the significant accomplishments achieved, which lead us to remove these comments from our fiscal year 2000 report.[3]

FHA HAS IMPROVED ITS CONTROLS OVER BUDGETARY FUNDS

During the fiscal year ended September 30, 2000, FHA continued to improve the documentation of processes implemented to conform to accounting principles generally accepted in the United States of America that are applicable for Federal entities, as promulgated by the Federal Accounting Standards Advisory Board (FASAB). Improvement was made in financial systems and processes to ensure accounting and budget information are properly presented and accurate, and timely information is available to management for funds control and decision-making purposes.

In December 1999, FHA developed a *Vision of Financial Management,* which is comprised of a short and long-term plan. The short-range plan consists of an array of activities designed to improve the budgetary and funds control process to address various management deficiencies identified by the audit and to lay the foundation for implementation of the new subsidiary ledger. One of the key components of the short-term plan is to acquire a Commercial Off-the-Shelf (COTS) software package for implementing a new FHA subsidiary ledger that will be fully compliant with Joint Financial Management Improvement Project (JFMIP) requirements.

In the fiscal year 1999 Independent Auditors' Report, we recommended that FHA 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.

To address this issue, FHA organized a work group comprised of staff from the Office of the Chief Financial Officer, Procurement and Contracts, FHA Comptroller, and Budget Office. During fiscal year 2000, FHA performed a reconciliation of F-47 and CSCS, FHA's Multifamily insurance in force system and credit subsidy and related obligations system, respectively. Management determined the status of accounts and balances in all systems and completed reconciliations and reported final balances for both SF-133/Federal Agency Consolidated Trial Balance System (FACTS II) and financial statement reporting.

[3] Building the Public Trust: A Report to Congress on FHA Management Reform, January 2001.

On July 3, 2000, FHA submitted a short-term plan to OMB and implemented the plan to address all major fund control deficiencies identified in the fiscal year 1999 Independent Auditors' Report. FHA developed a process to track in-transit disbursements against apportionment line items, and the sum of all in-transit disbursements against total available resources by appropriation. The database automatically verifies funding at both the apportionment and appropriation level every time a transaction is entered into the database. Furthermore, the database automatically creates an alert message once funding levels have reached designated thresholds. A database user guide, process maps and procedures were drafted to assist with funds control training efforts.

For the preparation of SF-133s, FHA developed a database to import General Ledger (GL) balances each month and produce reports used for budget formulation and apportionment. The process to download the GL balances into the budgetary accounting database is now automated. FHA has also developed a budgetary accounting crosswalk from the FHA GL to the US SGL and other additional procedures to compile budgetary reports in the format required by the FACTS II process.

FHA CONTINUES TO IMPROVE IN IMPLEMENTING EARLY WARNING AND LOSS PREVENTION FOR MULTIFAMILY INSURED MORTGAGES

During fiscal year 2000, FHA continued to implement its early warning and loss prevention initiatives for the Multifamily portfolio. The additional tools implemented by FHA, including the Financial Assessment Subsystem (FASS) financial statement assessment process within the REAC and the electronic collection of delinquency data through the Multifamily Delinquency Data Reporting System, have substantially improved the ability of management to manage its portfolio of Multifamily projects.

FHA HAS RESOLVED SINGLE FAMILY SECRETARY-HELD MORTGAGE NOTES

On September 22, 2000, FHA auctioned 8,053 notes, approximately 72 percent of the then existing portfolio, with an unpaid principal balance of approximately $481 million. The sale generated gross proceeds in excess of $467 million, or 97 percent of the unpaid principal balance of the mortgage loans. The remaining 28 percent of the Single Family Secretary-held mortgage notes portfolio is currently being serviced by the servicing contractor procured during fiscal year 1999.

The servicing contract provides the level of management and oversight required to analyze the portfolio and quickly take actions to address delinquency issues. Because many of the unsold Notes are in the foreclosure process, it is expected that the Single Family portfolio of Secretary-held mortgages will continue to decline in the coming years.

FHA CONTINUES TO 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 Liabilities for Loan Guarantee (LLG). As provided under the Federal accounting requirements and the Federal Credit Reform Act of 1990, this liability is comprised of both liquidating and financing accounts. During fiscal year 2000, FHA continued to make significant progress in developing documentation and refining their processes for estimating and accounting for the LLG. During fiscal year 2000, we noted deficiencies that were not detected through FHA's internal control processes. These resulted in a net increase in the liability of $66 million, an improvement from an adjustment made in fiscal year 1999 that resulted in a net increase in the reserve of $718 million. These errors were ultimately corrected for financial statement purposes.

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U. S. Department of Housing and Urban Development
Washington, D.C. 20410-8000

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

MEMORANDUM FOR: KPMG LLP

FROM: Shaun Donovan, Deputy Assistant Secretary for Multifamily Housing, HT
Commissioner, H

SUBJECT: Response to KPMG's Fiscal Year 2000 FHA Audit Report

This provides FHA's response to the above report. We are very pleased with the report and feel that overall, it accurately captures the progress FHA has made in continuing to address deficiencies. Following are our general comments and those geared toward specific sections of the report.

General Comments

During FY 2000, FHA continued to improve the management and monitoring of its operations through initiatives implemented under HUD 2020 Reform. While in FY 1999, all of the major components of reform were in place, some of the re-engineered processes had not been in place long enough to provide the full beneficial impact envisioned under HUD 2020 Reform. Others that were fully operational in FY 1999 needed further refinement and enhancement to bring them up to peak performance levels. Therefore, this fiscal year FHA focused its efforts on these types of initiatives to continue to address management deficiencies and to improve overall business operations. A number of initiatives were also undertaken to ensure that adequate internal controls are built into all of FHA's program processes to appropriately manage risk so that deficiencies such as those that have been identified in past years do not recur and new deficiencies are not identified.

FHA's continued focus on improvements met with a great deal of success as reflected in the current audit. FHA eliminated the material weakness related to controls over budgetary funds and funds control. It also eliminated two reportable conditions and part of another. These reportable conditions related to the need to: (1) quickly resolve Secretary-held Single Family mortgage notes, (2) improve early warning and loss prevention for multifamily programs, and (3) improve the review process for estimating reserves for the insured portfolio.

While this fiscal year's report continues to cite one material weakness and three reportable conditions from prior years' reports, FHA is far along in addressing these remaining deficiencies. In fact, FHA believes that the progress made to date in addressing the reportable condition "FHA must continue to place more emphasis on early warning and loss prevention for Single Family insured mortgages" is sufficient to have eliminated the condition and, therefore, it should not be included in the report. For the other two remaining reportable conditions, comprehensive project plans with target dates are in place that are expected to eliminate these conditions by the end of FY 2001. In addition, with regards to the systems material weakness, FHA has already completed a number of significant milestone events to begin to bring this finding to resolution.

Specific Comments

Material Weakness:

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.

FHA New General Ledger

We recognized the need for modernization of FHA financial systems and operations in developing the *FHA Vision of Financial Management.* In keeping with the *Vision*, FHA documented the detailed functional requirements for a JFMIP-compliant subsidiary ledger and completed the acquisition of a JFMIP-certified commercial off-the-shelf (COTS) package in FY 2000.

The new subsidiary ledger will enable FHA to meet HUD departmental reporting requirements while maintaining responsibility for its own accounting and financial reporting. As recommended by KPMG, FHA is planning and implementing the subsidiary ledger system using HUD's Systems Development Methodology (SDM) and keeping abreast of HUD's Enterprise Architecture initiative. To this end, FHA has completed the applicable documents for the Initiation Phase of HUD's SDM for the implementation of a new general ledger to replace our legacy general ledger system (Phase II of the *FHA Vision of Financial Management*).

Reportable Condition:

FHA/HUD must enhance the design and operation of controls over information systems security and application data integrity.

FHA agrees with this finding and associated recommendations but has the following concerns.

FHA Connection

FHA Connection is a gateway with its own initial access security. Access to individual systems is handled separately. As a result, there is redundant access control which is a cause for complaint by our business partners. When a partner wishes to execute another function in another system, the log-in process must be repeated. Housing is assessing one previously noted aspect of the Connection relating to repeated failed log-in attempts. Requirements definition is underway to design a means of revoking access rights after a set of sequential failed log-in attempts.

FHA is aware of the need to comply with the OMB Circulars. To that end, FHA is procuring services to ensure preparation of documents under A-127, A-130 and other requirements. The procurement through GSA is nearing selection of a vendor. Initial meetings should begin in early March.

SAMS

Housing initiated action to address the comment that "SAMS lacks database controls to ensure data integrity when the application encounters processing problems" shortly after it was reported. The results of that analysis are expected by the end of February.

The analysis will include:

- Assessment of the frequency of this event
- Number of records that may be affected
- Likelihood of it going undetected
- Cost of correcting any errors
- Potential fiduciary risk
- Scope, cost and length of work that would be required to revise SAMS

The results of this requirements analysis, and the assessment of cost, risk and benefit, will result in a decision as to be the most effective means of dealing with the noted incident.

The report further cites a need for sensitive SAMS information to be better controlled. The source of this concern appears to be Management and Marketing (M&M) contractors potentially viewing what may be commercially protected information or other confidential information. The M&M contractors serve exclusive geographic locales. With the revisions already made to SAMS, the data is grouped or segregated along the same lines. Housing is assessing the potential issues of a local office having jurisdiction over two separate M&M locales to assess the potential for data accessed at that level potentially revealing data on one contractor to another.

FHA must continue to place more emphasis on early warning and loss prevention for Single Family insured mortgages.

FHA does not agree with this finding and associated recommendations. FHA appreciates the recognition of its efforts which resulted in the elimination of last year's reportable condition to continue actions to safeguard and quickly resolve Secretary-held Single Family Mortgage Notes. However, the program officials do believe that the effort and results in this area were surpassed by the achievements in the area of early warning and loss prevention for Single Family insured mortgages and that these efforts and results were sufficient to eliminate this area as a reportable condition. While always motivated to improve and reinvent program design and operations, we judge that progress in this program area has surpassed the point where there are significant deficiencies in the design or operation of internal controls which might adversely impact FHA's ability to provide financial information. Furthermore, the report presents little evidence to support the claim that a reportable condition exists. FHA hopes that KPMG will revise the draft to remove this condition, or provide specific evidence that the condition remains. (See attached summary of Post Technical Review Actions for FY 2000).

In the current year, the Loss Mitigation program continues to grow and gain wider lender acceptance. In FY 2000, FHA helped more than 35,000 homeowners avoid foreclosure, a 134 percent increase in loss mitigation over FY 1999. Moreover, FHA's data indicates that more than 87 percent of loss mitigation actions kept homeowners in their homes while reducing losses to FHA. An aggressive lender training program combined with increased monitoring of lender participation are the key drivers in FHA's strategy.

The Department issued a comprehensive clarification of loss mitigation policies and procedures in Mortgagee Letter 00-05, dated January 19, 2000. Included in this mortgagee letter were changes to address procedural obstacles to using loss mitigation. This guidance and extensive training of mortgagees will increase the use of loss mitigation. In Fiscal Year 2000, FHA's National Servicing and Loss Mitigation Center trained 593 servicing employees from lenders across the country, as well as 664 Housing Counseling employees. Extensive internal training was provided as well, with 377 HUD employees receiving training on loss mitigation, of which 41 were certified to provide loss mitigation training to others. The Department has widely publicized its approval of one loss mitigation analysis tool, Back-in-the-Black, and is in the process of reviewing other commercially available tools. These tools facilitate a thorough analysis of the various loss mitigation options, making it more likely that one will be offered to the home owner.

Considerable effort was expended during FY 2000 to examine the causes of predatory lending and to pilot test measures to reduce its occurrence in the FHA programs and address the problem when detected. The joint Treasury - HUD task force, after public hearings in various cities, reported that predatory lending was principally a phenomena of subprime lending and manifested itself in various guises. These included property flipping (sales at vastly inflated prices); loan flipping (refinancing to terms that are detrimental to the homeowner); unjustifiably high interest rates, points and fees; and basing the credit decision on the homeowner's equity rather than ability to pay. While few FHA insured loans involve predatory lending, those few concern the Department. In parts of Atlanta, Baltimore, Chicago, Los Angeles and New York, FHA is pilot testing methods of detecting and preventing property flipping, assessing loss mitigation efforts, providing restitution to the victims, and penalizing the responsible parties. These tests will continue and expand while FHA attempts to address the problem systemically by changing regulations and integrating flip checking into its systems.

The Department has made substantial improvements in its operations and compliance monitoring in recent years, including the following.

- Appraisal Reform: The appraisal form's addendum, the Valuation Conditions (VC) sheet, was revised to capture more detailed information about readily observable conditions which will help the underwriter judge the sufficiency of the collateral for the loan. A new Consumer Summary Sheet with information about the property and recommendations for inspections must be provided to the homebuyer. This will help the homebuyer make an informed decision about proceeding with the purchase. Guidance on FHA requirements was consolidated and published in a revised handbook, which is available through the Internet's World Wide Web. Making FHA requirements more accessible makes it more likely they will be followed. Roster appraisers were tested on FHA requirements as a condition of continuing to receive assignments. The Real Estate Assessment Center has assumed responsibility for field reviews of single family appraisals, and developed a methodology by which appraisal data are automatically tested to adversely select cases for review. This change improves the targeting of reviews and consistency. HUD's regulations were revised to create a mechanism for suspending poorly performing appraisers from the roster without using the Limited Denial of Participation (LDP) process. This will make disciplining appraisers more efficient and timely.

- Non-profit Reform: Default analysis, monitoring reviews, and audits identified problems in the performance of mortgages to non-profit organizations and inconsistencies in annual recertification reviews. Approval requirements and restrictions on non-profit organizations participating in the mortgage insurance and REO sales programs were revamped and consolidated in Mortgagee Letter 00-08, issued March 3, 2000. The changes are designed to ensure that the non-profit has sufficient experience and capacity to rehabilitate and manage the portfolio it has on hand at any given time. This improves the likelihood of the non-profits' success while reducing FHA's insurance risk. Every non-profits' participation was reviewed and many were not recertified to continue in these programs.

- Automated Underwriting: The proprietary tools approved for use in FHA's programs are being used on an increasing percentage of cases. These tools speed the mortgage approval process and improve the consistency of credit decisions. However, they differ from one another in weighting factors and are largely opaque to all but their makers. Therefore, FHA has been developing its own mortgage scorecard to replace those used in the proprietary tools. Implementation of FHA's mortgage scorecard has progressed to the pilot stage.

- Credit Watch/Termination: This program, launched in June 1999, involves systematically reviewing lenders' early default (90 days or more delinquent) and claim rates, identifying lenders with poorly performing loans, terminating the worst and advising the marginal to improve. Credit Watch/Termination was validated in court as a legitimate means of disciplining originators with high rates of early defaults and claims.

- Neighborhood Watch: This web-based software provides statistics on early 90-day defaults on loans by originating lender, loan characteristics and geographic areas. The system aids HUD staff in detecting patterns of early defaults and gives lenders the ability to police themselves and their business partners. The system was recently made available to the public. Currently, the system focuses on new insurance, but the Department plans to add components to Neighborhood Watch in stages, including servicing data.

- Lender Monitoring: Mortgagee origination, servicing and post claim reviews are continuing in volumes dwarfing those of a few years ago. From 1997 to 1999, the Department increased its lender monitoring staff nearly sevenfold; from 23 in 1997 to more than 140; and increased the number of on-site lender monitoring reviews from 256 in FY 1997 to more than 900. This increased emphasis has led to more referrals to the Mortgagee Review Board, the Office of Inspector General and the Departmental Enforcement Center for further investigation or administrative sanctions.

FHA must sufficiently monitor and account for its Single Family property inventory.

FHA agrees with this finding and associated recommendations and is proceeding to implement both recommendations.

The Single Family Acquired Assets Branch has been working with the Office of the Deputy Assistant Secretary for Single Family Housing since November 2000 in an effort to remove bad cases from SAMS, and has successfully removed all but a few of the cases referred for removal. Efforts are underway to get the system programmer for SAMS to use a special program to remove the cases from SAMS that were recently sold in the Single Family Mortgage Notes asset sale. In addition, the Housing-FHA Comptroller in a January 2001 memo to the Deputy Assistant Secretary for Single Family Housing made a number of recommendations on changes needed in this overall process to prevent or reduce future problems with SAMS bad cases.

Attachment

HOMEOWNERSHIP CENTER
Post Technical Review Actions-FY 2000

Post Endorsement Technical Review		Atlanta	Denver	Philly	Santa Ana		Total
I. Deficiency Letter		**497**	**923**	**77**	**180**		**1677**
(All letters to lenders as a result of post tech reviews - per case)							
Repayment Requests		365	275	65	70		775
This is a subset of deficiency letter total. Includes letters for refunds of excessive and/or unallowable fees and charges and requests for mortgage reductions for over insured loans.							
2. Total Number Quality Assurance Division Actions		**73**	**219**	**12**	**83**		**387**
Number Pending		53	0	6	52		111
Number Indemnifications Received		7	59	3	6		75
Number Cleared/Closed by QAD		13	160	3	25		201
3. Total Number of Referrals		**19**	**18**	**29**	**24**		**92**
QAD (individual case and/or specific lender)		3	8	24	3		38
Program Support (non-profit)		5	0	3	5		13
REO (non profit, realtor, owner occupant)		10	2	2	4		18
IG		1	0	0	0		1
Other		0	10	0	12		22
4. Total Number Lenders Increased Reviews		**11**	**103**	**53**	**576**		**743**
Greater than 5% - Less than 100%		0	0	0	532		532
100% (not including newly released lenders)		11	103	53	44		211
5. Lenders Returned to Pre-closing		**2**	**0**	**10**	**2**		**14**
6. Lenders Removed from DE Processing		**1**	**0**	**0**	**0**		**1**
7.Sanctions (Total from any division within the HOC)		**130**	**87**	**11**	**87**		**315**
LDP Individuals with Lender		74	27	0	9		110
Debarment		11	16	3	31		61
MRB Referrals		45	44	8	47		144
TOTAL ADMINISTRATIVE ACTIONS*		**733**	**1350**	**192**	**952**		**3229**
* Bold items are in totals							
Note: The figures contained in this report are estimates based on reviews of file copies of letters, memos, etc. This data was not consistently being tracked through automated systems.							
Future enhancements to the URS will capture data as it relates to post technical review findings and resolutions.							
In addition to specific referrals, QAD uses the overall output of technical reviews to target lenders for monitoring reviews.							

PRINCIPAL FINANCIAL STATEMENTS

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FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED BALANCE SHEETS
As of September 30, 2000 and 1999
(Dollars in Millions)

	2000	1999
ASSETS		
Intragovernmental		
Fund Balances with the U.S. Treasury (Note 2)	$ 7,915	$ 6,714
Investments in U.S. Government Securities (Note 3)	17,052	14,729
Interest Receivable from U.S. Government Securities	260	202
Other Assets, Net (Note 4)	348	155
Total Intragovernmental	25,575	21,800
Credit Program Receivables and Related Foreclosed Property, Net (Note 5)	2,721	3,889
Other Assets, Net (Note 4)	266	224
TOTAL ASSETS	**$ 28,562**	**$ 25,913**
LIABILITIES		
Intragovernmental		
Claims Payable	$ 1	$ 7
Borrowings from U.S. Treasury (Note 6)	7,155	7,996
Payable to Special Receipt Account for Subsidy Re-estimate	517	338
Other Liabilities (Note 7)	287	116
Total Intragovernmental	7,960	8,457
Accounts Payable	505	396
Unearned Premiums	682	911
Liabilities for Loan Guarantees (Note 5)	7,522	5,803
Debentures Issued to Claimants (Note 6)	218	107
Premium Refunds and Distributive Shares Payable	174	244
Other Liabilities (Note 7)	443	435
TOTAL LIABILITIES	**$ 17,504**	**$ 16,353**
NET POSITION		
Unexpended Appropriations (Note 9)	$ 1,151	$ 314
Cumulative Results of Operations	9,907	9,246
TOTAL NET POSITION	**$ 11,058**	**$ 9,560**
TOTAL LIABILITIES AND NET POSITION	**$ 28,562**	**$ 25,913**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENTS OF NET COST
For the years ended September 30, 2000 and 1999
(Dollars in Millions)

	2000	1999
Unsubsidized Program Costs		
Intragovernmental	$ 477	$ 427
With the Public	2,532	(4,567)
Total Unsubsidized Program Costs	3,009	(4,140)
Less: Earned Revenues (Note 10)	2,886	1,921
Net Unsubsidized Program Costs (Surplus)	$ 123	$ (6,061)
Subsidized Program Costs		
Intragovernmental	$ 111	$ 118
With the Public	391	1,637
Total Subsidized Program Costs	502	1,755
Less: Earned Revenues (Note 10)	579	505
Net Subsidized Program Costs	$ (77)	$ 1,250
NET COST (SURPLUS) OF OPERATIONS	$ 46	$ (4,811)

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENTS OF CHANGES IN NET POSITION
For the years ended September 30, 2000 and 1999
(Dollars in Millions)

	2000	1999
Net Cost (Surplus) of Operations	$ 46	$ (4,811)
Financing Sources:		
Appropriations Used	(1,124)	(664)
Imputed Financing	(11)	-
Transfers-out:		
HUD	233	237
US Treasury	202	1,543
Public	1	1
Total Financing Sources	(699)	1,117
Net Results of Operations	(653)	(3,694)
Prior Period Adjustments	8	-
Net Change in Cumulative Results of Operations	661	3,694
Change in Unexpended Appropriations	837	(127)
Change in Net Position	1,498	3,567
Net Position-Beginning of Period	9,560	5,993
Net Position - End of Period	$ 11,058	$ 9,560

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, 2000
(Dollars in Millions)

	MMI / CMHI FUNDS			GI / SRI FUNDS			
	Program 8600183	Liquidating 86X4070	Financing 86X4587 and 86X4242	Program 86X0200	Liquidating 86X4072	Financing 86X4077 and 86X4105	Total
Budgetary Resources: (Note 13)							
Budget Authority							
Appropriations	$ 491	-	-	$ 262	$ 1,194	-	$ 1,947
Borrowing Authority	-	-	$ 703	-	112	-	815
Unobligated Balances Carried Forward (Note 16)	-	$ 14,531	2,972	266	257	$ 1,927	19,953
Spending Authority from Offsetting Collections	-	3,939	7,809	7	863	1,521	14,139
Adjustments							
Recoveries of Prior Year Obligations	-	109	4	13	38	7	171
Capital Transfers and Redemption of Debt	-	-	(904)	-	-	(641)	(1,545)
NET BUDGETARY RESOURCES	**$ 491**	**$ 18,579**	**$ 10,584**	**$ 548**	**$ 2,464**	**$ 2,814**	**$ 35,480**
Status of Budgetary Resources:							
Obligations Incurred	482	810	7,915	484	1,301	1,012	12,004
Unobligated Balances - Available	9	2,082	1,732	28	677	379	4,907
Unobligated Balances - Not Available	-	15,687	937	36	486	1,423	18,569
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 491**	**$ 18,579**	**$ 10,584**	**$ 548**	**$ 2,464**	**$ 2,814**	**$ 35,480**
Outlays:							
Obligations Incurred	482	810	7,915	484	1,301	1,012	12,004
Less: Spending Authority from Offsetting Collections and Adjustments	-	4,048	7,813	20	901	1,528	14,310
Obligated Balance, Net - Beginning of Period (Note 16)	-	887	(62)	62	636	(55)	1,468
Less: Obligated Balance, Net - End of Period	141	369	315	129	594	(103)	1,445
TOTAL OUTLAYS	**$ 341**	**$ (2,720)**	**$ (275)**	**$ 397**	**$ 442**	**$ (468)**	**$ (2,283)**

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	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)
COMBINED STATEMENTS OF FINANCING
For the years ended September 30, 2000 and 1999
(Dollars in Millions)

	2000	1999
Obligations and Nonbudgetary Resources		
Obligations Incurred	$ 12,004	$ 21,446
Spending Authority from Offsetting Collections and Adjustments	(14,310)	(17,431)
Financing Imputed for Cost Subsidies	11	-
Total Obligations as Adjusted and Nonbudgetary Resources	(2,295)	4,015
Less: Resources That Do Not Fund the Net Cost of Operations		
Costs Capitalized on the Balance Sheet	(1,907)	(1,050)
Financing Sources that Fund Costs of Prior Periods	-	4,727
Transfer Out to HUD without Reimbursement as related to the S&E Expenses	233	237
Other Resources that do not fund the Net Cost of Operations	(289)	507
Total Resources that do not Fund the Net Cost of Operations	(1,963)	4,421
Net Cost of Operations that Do Not Require or Generate Resources		
Gains or Losses on Sales of Credit Program Assets	728	610
Bad Debts Related to Uncollectible Non-Credit Reform Receivables	78	(81)
Reduction of Subsidy Expense from Endorsements and Modifications of Negative Subsidy Cases	(1,926)	(3,620)
Changes in Loan Loss Reserve Expense	(1,127)	850
Reduction of Subsidy Expense due to Fiscal Year Credit Subsidy Downward Re-estimate	(868)	(2,041)
Increase in Interest Income in MMI Liquidating Account due to Fiscal Year Credit Subsidy Downward Re-estimate	(46)	(293)
Other Expenses or Revenue that do not Require or Generate Resources	(405)	94
Total Net Cost of Operations that Do Not Require or Generate Resources	(3,566)	(4,481)
Financing Sources Yet to be Provided		
Fiscal Year Credit Subsidy Upward Re-estimate	3,944	76
Total Financing Sources yet to be Provided (Note 14)	3,944	76
Net Cost (Surplus) of Operations	$ 46	$ (4,811)

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 and to increase the availability of affordable housing to families and individuals, particularly to the nation's poor and disadvantaged. FHA insures private lenders against loss on mortgages which finance Single Family homes, Multifamily projects, health care facilities, property improvements, 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 principal financial statements are presented in conformity with generally accepted accounting principles (GAAP) applicable to Federal agencies, and the financial statement formats presented in Office of Management and Budget (OMB) Bulletin 97-01, "Form and Content of Agency Financial Statements," as amended. The principal financial statements include all Treasury funds under FHA control, which consist of two general fund appropriations, six revolving funds and one special fund receipt account.

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."

Basis of Consolidation

The accompanying principal financial statements include all Treasury account fund symbols for which FHA is responsible. All accounts receivable, accounts payable, transfers in and transfers out within FHA have been eliminated to prepare the consolidated balance sheets, statements of net cost and statements of changes in net position. The statements of budgetary resources and statements of financing are prepared on a combining basis as allowed by OMB Bulletin 97-01.

Use of Estimates

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

Amounts reported for credit program receivables 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 liabilities for loan guarantees, FHA used cash flow model assumptions associated with loans subject to the Federal Credit Reform Act of 1990, 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 program and economic assumptions.

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

The estimates presented in the principal 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 judgement 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 collected and available to fund payments for expenses and for 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 special fund receipt account for loan guarantee commitments and direct loans obligated after September 30, 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 Credit Reform 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 special fund 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 federal entities, the special fund 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), the special fund receipt account of the MMI Fund (miscellaneous receipt account) remains a FHA account. Specifically, 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-estimates from the MMI financing account to the MMI liquidating account, which includes the miscellaneous receipt account, and retains ownership of funds in the miscellaneous receipt account to strengthen the financial position of the MMI fund and meet the Capital Ratio requirement. At the end of fiscal year 1998, FHA met and has since maintained the Capital Ratio requirement. FHA's actuary estimates the Capital Ratio at September 30, 2000 at 3.51 percent.

Prior to fiscal year 2000, as required by FHA's annual appropriation, the MMI financing account transferred a portion of the negative subsidy to the program account to reimburse HUD for Office of Housing salaries and expenses. During fiscal year 2000, all FHA salaries and expenses are funded through appropriations for both the MMI and the GI and SRI program accounts.

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. Unobligated balances of FHA's GI and SRI Fund liquidating accounts at the end of the fiscal year that are not needed for future operations are transferred to the U.S. Treasury's General Fund. 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 2000, FHA continued to take Single Family assignments on those defaulted notes that were in process at the time the assignment program was terminated, April 1996.

Secondly, Multifamily and Title I 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 if guaranteed prior to or after October 1, 1991, in accordance with Credit Reform and SFFAS No. 2, “Accounting for Direct Loans and Loan Guarantees” (see Note 5). Direct loans obligated and loan guarantees 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.

Pre-Credit Reform program receivables 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 pre-Credit Reform 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 October 1, 1991, is valued at net realizable value (see Note 5). The estimate for the allowance for loss related to the net realizable value of pre-Credit Reform 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.

Liabilities for Loan Guarantees

The liabilities for loan guarantees (LLG) related to Credit Reform loan guarantees (committed on or 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 asset 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 mortgage insurance 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-Credit Reform 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 Credit Reform 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 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 Credit Reform 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-Credit Reform 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 LLG when collected.

Full Cost Reporting

SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards*, requires that Federal agencies report the full cost of program outputs in the financial statements. Full cost reporting includes all direct, indirect, and inter-entity costs. For purposes of HUD's consolidated financial statements, HUD 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 is included in FHA's financial statements as an imputed cost for the Consolidated Statement of Net Cost, and an imputed financing for the Consolidated Statement of Changes in Net Position and the Combined Statement of Financing. 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.

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, 2000 and 1999, no distributive shares were declared from the MMI Fund because legislation is not yet enacted. 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.

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	**2000**	**1999**
Intragovernmental Assets:		
Appropriated Funds	$ 344	$ 328
Revolving Funds	7,494	6,250
Fund Balances with the U.S. Treasury	$ 7,838	$ 6,578
Non-Entity Assets		
Intragovernmental Assets:		
Escrow Funds	$ 77	$ 136
Fund Balances with the U.S. Treasury	$ 77	$ 136
Total Fund Balances with the U.S. Treasury	$ 7,915	$ 6,714

Appropriated Funds

Appropriated funds are provided by legislation. Some appropriated funds expire if not obligated by the end of the time period specified in the authorizing 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.

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, 2000 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	5.22%	$ 1,979	$ 1,993	$ 2	$ 1,991	$ 1,987
After one year through five	5.95%	6,700	6,801	57	6,744	6,805
After five year through ten	6.34%	5,828	5,973	89	5,884	6,035
After ten years through fifteen	13.88%	99	82	(6)	88	112
After fifteen years	6.28%	2,332	2,411	67	2,345	2,462
Total		$ 16,938	$ 17,260	$ 209	$ 17,052	$ 17,401

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 year 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

Note 4. Other Assets, Net

Other Entity Assets (dollars in millions)	**Gross 2000**	**Gross 1999**	**Allowance 2000**	**Allowance 1999**	**Net 2000**	**Net 1999**
Intragovernmental Assets:						
HUD Section 312 rehabilitation loan program receivables	$ 5	$ 4	$ -	$ -	$ 5	$ 4
Receivables from unapplied disbursements recorded by Treasury	335	146	-	-	335	146
Total	$ 340	$ 150	$ -	$ -	$ 340	$ 150
Assets with the Public:						
Receivables related to asset sales	$ 41	$ 20	$ -	$ -	$ 41	$ 20
Receivables related to credit program assets	184	163	(88)	(87)	96	76
Equity interest in Multifamily mortgage trust 1996	1	26	-	-	1	26
Premiums receivable	54	35	-	-	54	35
Total	$ 280	$ 244	$ (88)	$ (87)	$ 192	$ 157

Other Non-Entity Assets (dollars in millions)	**2000**	**1999**
Intragovernmental Assets:		
Mortgagor Reserves for Replacement – Investments	$ 8	$ 5
Assets With the Public:		
Mortgagor Reserves for Replacement – Cash	$ 74	$ 67
Total Other Assets		
Intragovernmental	$ 348	$ 155
Assets with the Public	$ 266	$ 224

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 $0.7 million in fiscal year 2000, and was recorded at $26 million in fiscal year 1999. 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 the 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.

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 2000	$ 56	$ 2	$ (32)	-	$ 26
FY 1999	83	12	(66)	-	29

(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 2000	$ 1	-	(2)	-	$ (1)
FY 1999	3	-	(1)	-	2

(dollars in millions)
Defaulted Guaranteed Loans from Pre-Credit Reform 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 2000	$ 2,305	$ 221	$ (1,914)	$ 370	$ 982
FY 1999	2,534	609	(2,135)	626	1,634

(dollars in millions)
Defaulted Guaranteed Loans from Credit Reform 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 2000	$ 647	$ 7	$ (1,218)	$ 2,278	$ 1,714
FY 1999	727	19	(1,688)	3,166	2,224

	2000	1999
Total Credit Program Receivables and Related Foreclosed Property, Net	**$ 2,721**	**$ 3,889**

(dollars in millions)
Guaranteed Loans Outstanding:

	Outstanding Principal, Guaranteed Loans, Face Value	Amount of Outstanding Principal Guaranteed
Total Loan Guarantee Programs:		
FY 2000	$ 589,678	$ 544,601
FY 1999	551,435	508,215

(dollars in millions)
Liabilities for Loan Guarantees:

	Liabilities for Losses on Pre-Credit Reform Guarantees, Estimated Future Default Claims	Liabilities for Loan Guarantees For Credit Reform Guarantees (Present Value)	Total Liabilities For Loan Guarantees
Total Loan Guarantee Programs:			
FY 2000	$ 7,195	$ 327	$ 7,522
FY 1999	8,322	(2,519)	5,803

Foreclosed Property

The average holding period of Single Family properties is approximately 7 months while the average holding period of Multifamily properties is approximately 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-Credit Reform		Credit Reform	
	Single Family	**Multifamily**	**Single Family**	**Multifamily**
Foreclosed Properties:				
FY 2000	9,229	62	24,869	2
FY 1999	14,647	58	35,146	1

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

(dollars in millions)	Pre-Credit Reform		Credit Reform	
	Single Family	**Multifamily**	**Single Family**	**Multifamily**
Outstanding Principal:				
FY 2000	$ 0.2	$ 116	$ 0.1	$ 22
FY 1999	1	187	0.4	40

	Pre-Credit Reform		Credit Reform	
	Single Family	**Multifamily**	**Single Family**	**Multifamily**
Number of Properties:				
FY 2000	4	2	2	3
FY 1999	14	66	4	7

Pre-Credit Reform Valuation Methodology

FHA values its pre-Credit Reform loan guarantee liability and related notes and properties in inventory at net realizable value, determined on the basis of net cash flows. To value these items, FHA uses historical claim rates, collections, and expenses of selling and maintaining property, adjusted for predicted changes in the economy and housing markets.

FHA records loss estimates for Single Family programs to provide for anticipated losses incurred (e.g., claims on insured mortgages where defaults have taken place but claims have not yet been filed). Using the net realizable value method, FHA computes an estimate based on historical claims and loss experience data and adjusts the estimate to incorporate management assumptions about current economic factors.

FHA records a loss estimate for Multifamily programs when defaults are considered probable but have not yet occurred or been reported. The loss estimate is based on a case-by-case analysis of approximately 80 percent of active Multifamily projects. Management further adjusts the estimate based on factors such as administrative expenses, defaulted projects, and potential disasters. The recovery rate assumptions used in the loss estimates are based on historical experience.

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 exceeding fair market value were included. In the analysis, the gross rent for these projects was reduced to bring the rent for assisted units to fair market levels. The effects of this rent reduction on projects' financial health was assessed and the projects were grouped into the following three categories:

- <u>No action:</u> Projects that could continue to pay their operating expenses and mortgage payment from remaining revenues.

- <u>Partial claim:</u> Projects that could pay their operating expenses but could not make a full mortgage payment.

- <u>Default:</u> Projects that could no longer meet their mortgage payment and operating expenses.

Based on this analysis, appropriate adjustments were made to each project's loan loss estimate. No changes were made for projects requiring no action. For those classified as a partial claim, a new sustainable mortgage amount was calculated. For those classified as a partial claim, a new sustainable mortgage amount was calculated. The loss estimated on loans classified as partial claims was based on the amount of the claim payment. For loans classified as default, the loss estimate was set to 100 percent of the project's unpaid principal balance.

Credit Reform Valuation Methodology

FHA values its Credit Reform LLG and related receivables on notes and properties in inventory at the net present value of their estimated future cash flows. The interest rate on U.S. Treasury securities of maturity comparable to the guaranteed loans is the discount factor in the present value calculation. OMB provides these rates to all Federal agencies for use in preparing credit subsidy estimates and requires their use under OMB Circular A-34, "Instructions on Budget Execution."

To apply the present value computations, FHA divides the loans into cohorts. Individual cohorts are defined by year of insurance activity and program type. Multifamily cohorts are defined based on the year in which loan guarantee commitments are made. Single Family mortgages are grouped into cohorts based on loan endorsement dates. A loan can be disbursed in the years after the one in which it was obligated. Within each cohort year, loans are subdivided by risk categories. Each risk category has characteristics that distinguish it from others, including risk profile, premium structure, and the type and quality of collateral underlying the loan.

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

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

- Conditional Termination Rates: The estimated probability of an insurance policy claim or non-claim termination in each year of the policy's term.

- Recovery Rates: The estimated percentage of a claim payment that is recovered through disposition of a mortgage note or underlying property.

- Claim Amount:
  - Single Family – The estimated amount of the claim payment by type of claim.
  - Multifamily – The estimated amount of the claim payment relative to the unpaid principal balance at the time the claim occurs.

Additional information about loan performance assumptions is provided below:

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

- Economic assumptions: 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 2000. The liability for loan guarantee estimate is likely to change depending on the time at which the economic forecasts are collected. Other economic assumptions used, such as discount rates, are provided by OMB.

- Reliance on historical performance: 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 influence loan performance. FHA assumes that similar events may occur during the remaining life of existing mortgage guarantees, which can be as long as 40 years, and affect loan performance accordingly.

- Current legislation and regulatory structure: FHA's future plans allowed under current legislative authority have been taken into account in formulating assumptions when relevant. For example, the Departments of Veterans Affairs and Housing and Urban Development Appropriations Act, 1999, allows mortgage notes to be assigned to FHA and transferred to a third party for servicing. The single-family program office expects to begin a pilot of this program in FY 2001 so FHA projects recoveries on such notes in the MMI model. In contrast, future changes in legislative authority may affect the cash flows associated with FHA insurance programs. These changes cannot be reflected in LLG calculations because of uncertainty over their nature and outcome.

- Single Family loss mitigation program: FHA's estimates relating to 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. Therefore, FHA made these assumptions using the industry expertise of FHA staff.

Because of uncertainties inherent in the loan performance assumptions underlying the LLG and related receivables on notes and properties in inventory, actual cash flows will vary from the estimates over time. A re-estimate process each year allows for estimates to be adjusted.

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 varied. Variance is caused by two factors: (1) additional loan performance data underlying the credit subsidy rate estimates, and (2) revisions to the calculation methodology used to estimate the credit subsidy rates. Loan performance data, which reflect mortgage market performance and FHA policy direction, are added as they become available. Revisions to the estimation methodology result from legislative direction and technical enhancements.

FHA estimated the credit subsidy rates for fiscal year 2000 cohorts in 1998. At the time of budget submission, the rates reflected prevailing policy and loan performance assumptions based on the most up to date information available. These credit subsidy rates can be compared to the credit subsidy rates estimated in 2000. The two rates can be reconciled through credit subsidy re-estimates, which allow FHA to adjust the LLG and subsidy expense to reflect the most current and accurate credit subsidy rate.

Described below are the programs that comprise the majority of FHA's fiscal year 2000 new business. In addition, the Hospital Insurance program is also described. These descriptions highlight the factors that contributed to changing credit subsidy rates and the credit subsidy re-estimate. Overall, FHA's LLG and subsidy expenses increased from the fiscal year 1999 values. The MMI Fund's net increase in LLG, resulting in an upward re-estimate, represents over 94 percent of the total FHA LLG change from fiscal year 1999 to 2000. The GI/SRI Fund is comprised of over 20 Single Family and Multifamily programs, which can generate either positive or negative subsidy. This fund experienced a net decrease in its LLG, resulting in a downward re-estimate. A detailed description for several programs follows.

Mutual Mortgage Insurance (MMI) - The MMI Fund provides insurance for private lenders against losses on Single Family mortgages. The fund protects lenders against loan default on mortgages for properties that meet certain minimum requirements. This allows lenders to provide credit to borrowers who might not meet conventional underwriting requirements.

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 2000, recent data and changing economic conditions of the MMI Fund indicate that the original fiscal year 2000 negative subsidy rate was overstated. The conditional claim and prepayment rates predicted by the *Actuarial Review of the MMI Fund as of Fiscal Year 2000*, significantly influenced this upward re-estimate of the credit subsidy rate. These rates project claim and non-claim termination patterns that increase FHA's expected claim costs. Specifically, the peak of conditional claim rates shifted earlier into the life of the loan compared to last year's estimates and reduced the insurance in force and premium receipts. In addition, the actuarial review raised the fiscal year 2000 prepayment rates since last year's actuarial review underestimated these rates. FHA's liability significantly increased as a result of the changes to the fiscal year 2000 conditional claim and non-claim termination rates

The credit subsidy rate in fiscal year 2000 was also affected by the projected reduction of the sales prices of acquired properties. Beginning this fiscal year, FHA allowed management and marketing (M&M) contractors to lower the selling price of acquired properties over a period of time, within a specified range, to facilitate the property disposition process. FHA also began to allow properties to be sold for $1 after the property has been held on the market for longer than 6 months. As a result of these policy changes, FHA assumes that average property disposition receipts will be lower in the future. In addition, recent data on average claim costs affected the MMI credit subsidy rate. Average claim costs increased from $88,573 in fiscal year 1999 to $90,337 in fiscal year 2000.

The credit subsidy re-estimate process reflects this increase in the MMI fiscal year 2000 credit subsidy rate, which results in an increase 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 with five or more units. Under this program, HUD may 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 in the GI/SRI Fund.

The Section 221(d)(4) credit subsidy rate for the 2000 cohort, estimated in 1998, was higher than the rate calculated at the end of fiscal year 2000. This difference contributes to the downward credit subsidy re-estimate for fiscal year 2000 and decreases the LLG and subsidy expense. There are two reasons for the decrease in subsidy expense.

First, the data underlying the subsidy expense estimate have been updated to reflect an additional year of loan performance information. The updated data reflected numerous loan performance and economic factors, including the continued strength of the housing market and policies affecting the Section 221(d)(4) program. These new data resulted in reduced claim termination rates and lowered the subsidy expense.

Second, the methodology underlying the recovery rate assumptions were revised from those used in the original fiscal year 2000 credit subsidy rate estimate. The new recovery rate assumptions rely more heavily on actual historical experience than on management estimates in predicting the relative prevalence of the methods by which FHA recovers on its claim payments. The new assumptions reflect FHA's experience of realizing a greater portion of recoveries from borrower payoffs and a smaller portion from property sales than was previously assumed. FHA's recoveries are greater when a borrower pays off the loan in full than when FHA forecloses on a property and sells it from inventory. This change in the recovery assumptions contributed to a lower credit subsidy rate.

GI/SRI Section 242 – The Office of Insured Health Care Facilities (OIHCF) operates within FHA. The OIHCF provides loan insurance through the Section 242 mortgage insurance program for the new construction of hospitals or the refinancing 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 approximately 90 percent of the Section 242 portfolio.

Historical data on Section 242 program claim terminations are supplemented based on an OMB-designed defaulting methodology. Under this methodology, currently insured hospital loans are defaulted artificially in the data if they fail to meet three measures of financial strength and are on the Department of Health and Human Services (HHS) Priority Watch List (PWL). A revised HHS PWL and updated financial criteria data led to an increase in the number of hospitals artificially defaulted under this methodology in fiscal year 2000. Due to this, the fiscal year 2000 Section 242 LLG increased.

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 used to generate the 2000 credit subsidy rate overstated the negative subsidy rate. The Section 234(c) program uses the same conditional claim and prepayment rates from the actuarial review to project future performance.

Therefore, the 234(c) program also shows a shift in the peak of the claim rates to an earlier point in the life of the loan, higher prepayment rates, and lower premium inflows as a result of these rates. These factors led to an increased 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)	2000	1999
Agency Debt:		
Debentures Issued to Public – Par Value	$ 218	$ 107
Other Debt:		
Borrowings from U.S. Treasury	7,155	7,996
Total Debt	$ 7,373	$ 8,103
Classification of Debt:		
Intragovernmental Debt	$ 7,155	$ 7,996
Debt with the Public	218	107
Total Debt	$ 7,373	$ 8,103

Debentures Issued to Public

The National Housing Act authorizes FHA, in certain cases, to issue debentures in lieu of cash to settle claims. FHA-issued debentures bear interest at rates established by the U.S. Treasury. Interest rates related to the outstanding debentures ranged from 4.00 percent to 13.38 percent in both fiscal years 2000 and 1999. 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 $218 million in fiscal year 2000 and $107 million in fiscal year 1999. The fair value based on original maturity dates was $296 million in fiscal year 2000, and $151 million in fiscal year 1999.

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 payments 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 years 2000 and 1999, FHA's U.S. Treasury borrowings carried interest rates ranging from 5.36 percent to 7.59 percent. Maturity dates occur from September 2001 – September 2019. 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**	
	2000	**1999**	**2000**	**1999**	**2000**	**1999**
HUD – Section 312 rehabilitation program payable	$ 6	$ 6	$ -	$ -	$ 6	$ 6
Payable to other government agencies	-	1	-	-	-	1
Payable from unapplied receipts recorded by Treasury	281	109	-	-	281	109
Total	$ 287	$ 116	$ -	$ -	$ 287	$ 116

Liabilities with the Public:	**Current**		**Non-Current**		**Total**	
	2000	**1999**	**2000**	**1999**	**2000**	**1999**
Escrow funds related to mortgage notes	$ 159	$ 208	$ -	$ -	$ 159	$ 208
Earnest money held pending completion of property sales	8	73	-	-	8	73
Interest enhancement – Multifamily mortgage auctions	10	12	-	-	10	12
Certificates of claims payable	-	-	12	12	12	12
Amounts withheld from claims paid for foreclosure costs	-	-	14	15	14	15
Interest payable on debentures and outstanding claims	12	16	-	-	12	16
Trust and deposits related to coinsurance program	13	13	-	-	13	13
Miscellaneous undistributed credits and other payables	85	16	10	9	95	25
Payables and undistributed credit for credit program asset	21	2	(2)	(2)	19	-
Unconfirmed cash	101	61	-	-	101	61
Total	$ 409	$ 401	$ 34	$ 34	$ 443	$ 435

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, 2000 and 1999.

Note 9. Unexpended Appropriations

Unexpended Appropriations (dollars in millions)	**2000**	**1999**
Unobligated:		
Available	$ 957	$ -
Unavailable	36	262
Undelivered Orders	158	52
Total	$ 1,151	$ 314

Prior to fiscal year 2000, appropriations were received by FHA's subsidized program funds (GI/SRI) for positive subsidy expenses and administrative expenses. FHA's unsubsidized program funds (MMI/CMHI) received appropriations of negative subsidy generated by the financing funds that were used to cover administrative expenses. In fiscal year 2000, administrative expenses and contract expenses in both subsidized and unsubsidized programs were provided by funds in the annual appropriation. At the end of the fiscal year, the unobligated balances include only unexpended appropriations for positive subsidy expense and contract expenses.

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, and administrative contract expenses committed but not disbursed as of September 30.

Note 10. Earned 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. FHA earned revenue is generated from its loan guarantee operations with the public except for interest income received from Fund Balance deposited at Treasury and Investments in U.S. Government Securities. 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, 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-Credit Reform 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-Credit Reform 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 2000 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 2000 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 2000 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 0.50 percent regardless of the mortgage term. For the Title I program, the maximum insurance premium paid is equal to 0.50 percent of the loan amount multiplied by the number of years of the loan term. The annual insurance premium paid for a Property Improvement loan is 0.50 percent of the loan amount until the maximum insurance charge is paid. Manufactured Housing's annual premium structure is tiered by loan term until the maximum insurance charge is paid.

Pre-Credit Reform insurance premiums earned during fiscal year 2000 totaled $426 million compared to $215 million in 1999. This difference is attributed primarily to an upward adjustment that was made to MMI unearned premiums in fiscal year 2000, which increased pre-Credit Reform insurance premiums earned by $227 million in that same year. Pre-Credit Reform income on sale of mortgage notes during fiscal year 2000 totaled $98 million, compared to $65 million in 1999. In accordance with the Credit Reform Act, all post-Credit Reform premium revenues have been posted to the LLG. Interest income from Investments in U.S. Government Securities and from Fund Balance deposited at Treasury equals $2.862 billion in fiscal year 2000 and $2.097 billion in 1999. Other revenues totaled $56 million for fiscal year 2000, compared to $50 million in 1999.

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 2000:

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

	Endorsement Amount	Default Component	Fees Component	Other Component	Subsidy Amount
MMI	$ 86,227	$ 1,722	$ (4,047)	$ 461	$ (1,864)
GI/SRI					
Single Family	8,285	317	(318)	-	(1)
Title I	268	14	(10)	-	4
Multifamily	4,080	332	(219)	-	113
	12,633	663	(547)	-	116
Total	$ 98,860	$ 2,385	$ (4,594)	$ 461	$ (1,748)

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)

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

All FHA cost and earned revenue reported on the Statement of Net Cost is categorized under the budget functional classification (BFC) for Mortgage Credit (371). 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 Mortgage Credit BFC.

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)	**2000**	**1999**
Unliquidated Obligations, beginning of the year	$ 1,468	$ 1,052
Obligations Incurred during the year	12,004	21,446
Less: Expenditures during the year	12,027	21,208
Unliquidated Obligations, end of year	$ 1,445	$ 1,290

The amount for Unliquidated Obligations, beginning of the fiscal year 2000, reflects adjustments made to the audited Unliquidated Obligations at the end of fiscal year 1999. The $178 million increase of Unliquidated Obligations was the result of adjustments to decrease accounts receivable by $212 million and to decrease accounts payable by $34 million.

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**	
	2000	**1999**	**2000**	**1999**	**2000**	**1999**
Total borrowing, beginning of year	$ 107	$ 166	$ 7,996	$ 6,579	$ 8,103	$ 6,745
New borrowing	111	76	703	1,650	814	1,726
Repayments	-	(135)	(1,544)	(233)	(1,544)	(368)
Total borrowing, end of year	$ 218	$ 107	$ 7,155	$ 7,996	$ 7,373	$ 8,103

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)	**2000**	**1999**
Liabilities not covered by budgetary resources	$ -	$ -
Financing sources yet to be provided:		
Subsidy expense from FY00 upward credit subsidy re-estimates	3,168	58
Interest expense from FY00 upward credit subsidy re-estimates	776	18
Total financing sources yet to be provided	$ 3,944	$ 76

Note 15. Financial Statement Presentation and Policy Changes

In the Balance Sheets, the Unconfirmed Cash balances were reclassified from "Fund Balances with the U.S. Treasury" to "Other Liabilities" to more appropriately reflect the nature of FHA's Unconfirmed Cash as disbursements in transit.

In the Statement of Changes in Net Position, appropriated funds received in the program account of the MMI fund for fiscal year 1997 and 1998 upward credit subsidy re-estimates and fiscal year 1999 administrative expenses were reclassified from Unexpended Appropriations to Transfers In without Reimbursements. These reclassifications were a result of a change in accounting policy provided by the Office of Financial Management Services (FMS) of Treasury. As a result of the reclassification, the audited fiscal year 1999 balances of "Appropriations Used" decreased from $5,487 million to $664 million, "Transfers-out to FHA Program Account" decreased from $3,560 million to $0, and "Change in Unexpended Appropriations" decreased from $1,390 million to $127 million. The Fiscal Year 2000 Statement of Changes in Net Position has also been presented using the new policy guidance from Treasury.

Note 16. Adjustments for Fiscal Year 2000 Unobligated Balances Carried Forward

In the Statement of Budgetary Resources, the fiscal year 2000 "Unobligated Balances Carried Forward" balance of $19,953 million reflects a $169 million decrease in the fiscal year 1999 year-end "Unobligated Balances" of $20,122 million. The fiscal year 1999 year-end "Unobligated Balances" were reduced by $212 million for an adjustment to decrease accounts receivable, and were increased by $34 million for an adjustment to decrease accounts payable. These adjustments were made to comply with OMB Circular A-34 guidance on Budget Execution. Additionally, the fiscal year 1999 year-end "Unobligated Balances" were increased by $9 million to include a fiscal year 1998 audit adjustment related to FHA Debentures Issued to the Public.

Note 17. Subsequent Events

FHA considers certain loan guarantees in the New York City geographic region to have an increased chance to claim in FY 2001, as a result of events occurring subsequent to September 30, 2000. This concentration of risk results from the potential that falsified information may have been provided to FHA when these loans were originated, several years ago. Investigations into these cases are currently being pursued by the HUD Office of Inspector General, through the U.S. Department of Justice. FHA accounted for these potential losses in the accompanying financial statements as of September 30, 2000, by adjusting assumptions in the liabilities for loan guarantee estimates.

Required Supplementary Information

Intragovernmental Assets

FHA's intragovernmental assets, by federal entity, are as follows:

Agency	Fund Balance with U.S. Treasury	Investments in U.S. Gov't Securities	Interest Receivable from U.S. Gov't Securities	Other Assets
U.S. Treasury	$ 7,915	$ 17,052	$ 260	$ 343
HUD	-	-	-	5
Total	$ 7,915	$ 17,052	$ 260	$ 348

Intragovernmental Liabilities

FHA's intragovernmental liabilities, by federal entity, are as follows:

Agency	Borrowings from U.S. Treasury	Payable to Special Receipt Acct for Subsidy Re-estimate	Other Liabilities
U.S. Treasury	$ 7,155	$ 517	$ 281
HUD	-	-	6
Total	$ 7,155	$ 517	$ 287

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