Audit Report

Financial Audits Division
Office of Audit

Federal Housing Administration Audit of Fiscal Year 1997 Financial Statements

98-FO-131-0003
March 9, 1998

U.S. Department of Housing and Urban Development
Office of Inspector General
Office of Audit, Room 8284
451 7th Street SW
Washington, D.C. 20410-4500

Audit Report

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Report: 98-FO-131-0003 *Issued: March 9, 1998*

TO: Art H. Agnos, Acting General Deputy Assistant Secretary for Housing, H

James A. Heist

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

SUBJECT: Audit of the Federal Housing Administration's Fiscal Year 1997 Financial Statements

This report presents the results of KPMG Peat Marwick LLP's (KPMG) audit of the Federal Housing Administration's (FHA) financial statements for the year ended September 30, 1997. We concur with KPMG's opinion, that the financial statements present fairly, in all material respects, FHA's financial position and results of its operations, and cash flows for the year then ended, in conformity with generally accepted accounting principles.

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

Audit Scope and OMB Audit Requirements

This audit was conducted in accordance with *Government Auditing Standards* and was performed according to the requirements of the Chief Financial Officers Act and Office of Management and Budget (OMB) Bulletin No. 93-06, *Audit Requirements for Federal Financial Statements*. 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. 93-06, as amended, exceed *Government Auditing Standards*, primarily in three areas. These relate to:

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

To address the first additional OMB requirement, we engaged KPMG to expand their review of FHA's internal controls. The section discussing internal controls presents the results of this work. To address the second additional requirement, we are performing procedures required by OMB Bulletin No. 93-06. Because FHA's annual report is not yet complete, our review is ongoing and the results of our review will be reported at a later date. With respect to FFMIA, the reporting requirements do not apply to the FHA audit, but will be reported at the HUD consolidated level.

Results of KPMG's Audit

In addition to KPMG's unqualified opinion on FHA's financial statements, the audit results were similar to those reported in prior years. KPMG reported three material weaknesses and three reportable conditions on internal controls and one issue of non-compliance with laws and regulations. KPMG's report discusses each of these conditions in detail, provides an assessment of actions taken by FHA to mitigate them and makes recommendations for corrective actions. During the course of the audit, KPMG also identified several matters which, although not material to the financial statements, are being communicated to us and FHA management separately.

Recommendations and Follow-up on Prior Audits

In audit reports on FHA's prior years' financial statements, various recommendations were presented to address FHA's internal control weaknesses and non-compliance with laws and regulations. While FHA has taken certain actions to address these recommendations, corrective actions were incomplete. In accordance with the Department's Audits Management System, we will continue to track the resolution of these prior years' audit recommendations. KPMG's recommendations from their Fiscal Year 1997 audit cover many of the same issues described in prior audits. FHA's management should review all outstanding recommendations and determine a correct course of action which responds to the current status of all open findings.

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

Comments of FHA Officials

On February 2, 1998 we provided a draft of KPMG's internal control report to FHA officials for their review and comment. The remaining draft report sections were provided during the week of March 2, 1998. FHA officials largely agreed with the findings and recommendations.

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

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INDEPENDENT AUDITORS' REPORT

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

We have audited the 1997 and 1996 consolidated financial statements of the Federal Housing Administration (FHA). The objective of our audits was to express an opinion on the fair presentation of FHA's consolidated financial statements. In connection with our audits we also considered FHA's internal controls 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 consolidated financial statements.

In our opinion, FHA's 1997 and 1996 consolidated financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles.

During our consideration of internal control over financial reporting and our tests of compliance with certain laws and regulations, we noted:

- material weaknesses in internal control over financial reporting related to:
  - addressing staff and administrative resource issues,
  - placing more emphasis on early warning and loss prevention regarding the insured portfolio, and
  - continuing emphasis on improving accounting and financial management systems;
- reportable conditions related to:
  - resolving Secretary-held multifamily mortgage notes and minimizing additional mortgage note assignments and note servicing responsibilities,
  - monitoring and accounting for single family property inventory, and
  - reviewing processing controls for all computer systems and placing more emphasis on computer security; and
- non-compliance with data and accounting requirements of the Credit Reform Act of 1990.

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

OPINION ON CONSOLIDATED FINANCIAL STATEMENTS

We have audited the accompanying consolidated statements of financial position of FHA, as of September 30, 1997 and 1996, and the related consolidated statements of operations, changes in government equity (deficiency), and cash flows for the years then ended. These consolidated financial statements are the responsibility of FHA's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

In our opinion, the accompanying 1997 and 1996 consolidated financial statements present fairly, in all material respects, the financial position of FHA as of September 30, 1997 and 1996, and the results of its operations, and its cash flows for the years then ended, in conformity with generally accepted accounting principles.

Our audits were made for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information is presented for purposes of additional analysis rather than to present the financial position, results of operations, and cash flows of the individual funds. The consolidating information is not a required part of the consolidated financial statements. The consolidating information has been subjected to the auditing procedures applied in the audits of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

INTERNAL CONTROLS

We noted certain matters involving internal control over financial reporting and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants and OMB Bulletin 93-06, as amended. Reportable conditions are matters coming to our attention that, in our judgment, relate to significant deficiencies in the design or operation of internal control over financial reporting and could adversely affect FHA's ability to record, process, summarize, and report financial data consistent with the assertions of management in the consolidated financial statements.

A material weakness is a condition in which the design or operation of specific 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 consolidated financial statements of FHA may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of internal control would not necessarily disclose all internal control matters that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we noted matters involving internal control that we consider to be material weaknesses as described above.

These material weaknesses, which apply to the single family and multifamily programs in varying degrees as addressed by program area in Appendix A, exist in three major interrelated areas. Material weaknesses are:

- ***FHA must address staff and administrative resource issues***. FHA must review the staffing levels, personnel skills versus skill needs, and training resources required under the current initiatives to streamline work into the single family Home Ownership Centers (HOCs) and to reengineer multifamily operations. These resource issues are complicated by national initiatives towards a smaller Federal government and prevent FHA from: (1) placing adequate resources on multifamily loss mitigation functions; (2) properly managing troubled multifamily assets; and (3) quickly implementing new automated systems. FHA must also address the impact on resources resulting from consolidating its nationwide single family operations into four HOCs in fiscal year 1998.

- ***FHA must place more emphasis on early warning and loss prevention for insured mortgages***. FHA must focus more attention on reducing the frequency and loss severity of defaults on insured mortgages by improving its efforts to identify and cure troubled multifamily mortgages before they become seriously delinquent and by utilizing loss mitigation tools for the single family insured portfolio before properties are foreclosed.

- ***Continued emphasis must be placed on improving accounting and financial management systems***. Some of FHA's automated systems either do not provide needed management information or do not produce reliable information. Better information systems for strategic decision-making would make monitoring loans more productive and staff more efficient. Improvements to the information systems are hindered because of budgetary constraints and the existence of other critical system priorities at HUD.

Appendix A shows these weaknesses by program area and discusses them further.

Three reportable conditions that are not considered material weaknesses are addressed in Appendix B. These reportable conditions are repeated from our prior year report, as they have not been completely resolved since the date of our last report. These reportable conditions are summarized as follows:

- ***FHA must continue actions to quickly resolve multifamily Secretary-held mortgage notes and minimize additional mortgage note assignments and note servicing responsibilities***. Servicing and managing defaulted mortgage notes assigned to FHA requires significant resources. The diversion of resources to service the Secretary-held note portfolio reduces resources available to monitor insured mortgages resulting in additional claim payments.

- ***FHA must sufficiently monitor and account for single family property inventory.*** FHA has control weaknesses in its single family property acquisition, management, and disposition functions. These and other control weaknesses have: (1) decreased FHA's ability to effectively monitor, control, and report accurately on the Single Family Property Division's activities; (2) increased the risk of loss to FHA on the sales of its single family properties as resources may not be safeguarded against waste, loss, or misuse; (3) raised concerns about system reliability as a result of data input errors, data inconsistencies, and incomplete data fields; (4) caused inefficiencies due to the need for expansive clean-up efforts to address data integrity problems; and (5) hindered FHA's objective to reduce inventory in a manner that maximizes the return to the mortgage insurance funds while preserving and protecting residential properties and communities.

- ***FHA must perform a review of processing controls for all computer systems and place more emphasis on computer security.*** Control weaknesses exist in overall and application level security in FHA's electronic data processing environment.

These conditions were considered in determining the nature, timing, and extent of audit tests applied in our audit of the 1997 consolidated financial statements. We have not considered internal control subsequent to the date of this report.

Although not considered reportable conditions, we also noted other matters during our audit, which will be reported to FHA's management in a separate letter.

COMPLIANCE WITH LAWS AND REGULATIONS

The results of our tests, performed as part of obtaining reasonable assurance about whether the consolidated financial statements are free of material misstatement, disclosed the following instances of noncompliance that are required to be reported herein under *Government Auditing Standards* and the Office of Management and Budget (OMB) Bulletin No. 93-06, as amended.

FHA is not in compliance with data and accounting requirements of the Credit Reform Act of 1990. The Credit Reform Act (Credit Reform) requires that FHA track the cash flows related to its insurance portfolio cohorts (books of business) and risk categories (projects with similar risk characteristics) at the case level. FHA's single family periodic premiums system does not generate the required case-specific cash flow data required to reestimate its subsidies properly. This data is allocated to cohorts and risk categories using cash flow estimates, rather than actual cash flows. FHA maintains all other data used to calculate Credit Reform subsidies at the required case-specific level.

Also, FHA has not been accounting for contractor expenses related to post-1991 insured mortgages in accordance with Credit Reform. Under Credit Reform accounting, this discrepancy has resulted in the under-funding of the financing account for the GI/SRI fund. Further, a question exists as to whether FHA's payment of some contractor expenses was eligible under the National Housing Act.

These matters are discussed further in Appendix C.

The data requirements matter was also noted in our report on the 1996 consolidated financial statements dated March 4, 1997. We considered both instances of non-compliance in forming our opinion on whether FHA's 1997 consolidated financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles.

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

RESPONSIBILITIES

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

Management has the responsibility for:

- preparing the consolidated financial statements in conformity with generally accepted accounting principles;

- establishing and maintaining adequate internal controls over financial reporting; and

- complying with applicable laws and regulations.

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

(1) transactions are executed in accordance with management's authorization and are properly recorded and accounted for to permit the preparation of reliable financial statements in accordance with generally accepted accounting principles, and to maintain accountability over assets;

(2) funds, property, and other assets are safeguarded from unauthorized use or disposition; and

(3) transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the consolidated financial statements.

Auditors' Responsibility. Our responsibility is to express an opinion on the 1997 and 1996 consolidated financial statements of FHA based on our audits. We conducted our audits in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin No. 93-06, as amended, except for those portions of the Bulletin that relate to the review of performance measures. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement and presented fairly in accordance with generally accepted accounting principles. We believe that our audits provide a reasonable basis for our opinion. Our audits were not designed to test the requirements of OMB Bulletin No. 93-06, as amended, relating to the Federal Financial Management Improvement Act of 1996 (FFMIA), as FFMIA is not considered applicable at the FHA level. FFMIA requirements will be reviewed and reported on at the HUD consolidated level.

In planning and performing our audit of the consolidated financial statements of FHA, we considered internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements and not to provide an opinion on internal control over financial reporting. Accordingly, we do not express such an opinion.

As part of obtaining reasonable assurance about whether the consolidated financial statements are free of material misstatement, we performed tests of FHA's compliance with certain provisions of laws and regulations. However, the objective of our audit of the consolidated financial statements, including our tests of compliance with certain provisions of applicable laws and regulations, was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

In order to fulfill these responsibilities, we:

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

With respect to internal control over financial reporting, we obtained an understanding of the design of relevant policies and procedures, determined if they had been placed in operation, assessed control risk, and performed tests of internal controls.

Because of inherent limitations in internal control, fraud may nevertheless occur and not be detected. Also, projection of an evaluation of internal controls to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate. We have not considered internal control over financial reporting subsequent to September 30, 1997.

Distribution. This report is intended solely for the use of the HUD Office of the Inspector General, the management of HUD and FHA, and Congress. However, this report is a matter of public record and its distribution is not limited.

KPMG Peat Marwick LLP

March 6, 1998
Washington, D.C.

INTRODUCTION

Material weaknesses in FHA's internal control are summarized in the three categories discussed below:

- ***FHA must address staff and administrative resource issues***. FHA must review the staffing levels, personnel skills versus skill needs, and training resources required under the current initiatives to streamline work into the single family Home Ownership Centers (HOCs) and to reengineer multifamily operations. These resource issues are complicated by national initiatives towards a smaller Federal government and prevent FHA from: (1) placing adequate resources on multifamily loss mitigation functions; (2) properly managing troubled multifamily assets; and (3) quickly implementing new automated systems. FHA must also address the impact on resources resulting from consolidating its nationwide single family operations into four HOCs in fiscal year 1998.

- ***FHA must place more emphasis on early warning and loss prevention for insured mortgages***. FHA must focus more attention on reducing the frequency and loss severity of defaults on insured mortgages by improving its efforts to identify and cure troubled multifamily mortgages before they become seriously delinquent and by utilizing loss mitigation tools for the single family insured portfolio before properties are foreclosed.

- ***Continued emphasis must be placed on improving accounting and financial management systems***. Some of FHA's automated systems either do not provide needed management information or do not produce reliable information. Better information systems for strategic decision-making would make monitoring more productive and staff more efficient. Improvements to the information systems are hindered because of budgetary constraints and the existence of other critical system priorities at HUD.

These three material weaknesses, all repeat conditions from our prior year audit, in addition to the three reportable conditions noted in Appendix B, are interrelated in that none can be effectively addressed without addressing the others. Additionally, these weaknesses apply to the single family and multifamily programs in varying degrees.

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 (1) how legislative and budgetary changes will impact FHA, and (2) what effect such changes may have on FHA's ability to implement existing or future corrective action plans.

FHA continued to make progress in addressing material weaknesses during 1997 as noted in each of the material weaknesses in the following text.

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. Notwithstanding external impediments beyond its control, FHA must continue to address its internal impediments to achieving necessary change with a "sense of urgency."

The following sections describe each material weakness; FHA's action plans and significant actions to correct the deficiency; our assessment of planned and completed actions undertaken by FHA as of the date of this report; and our recommendations.

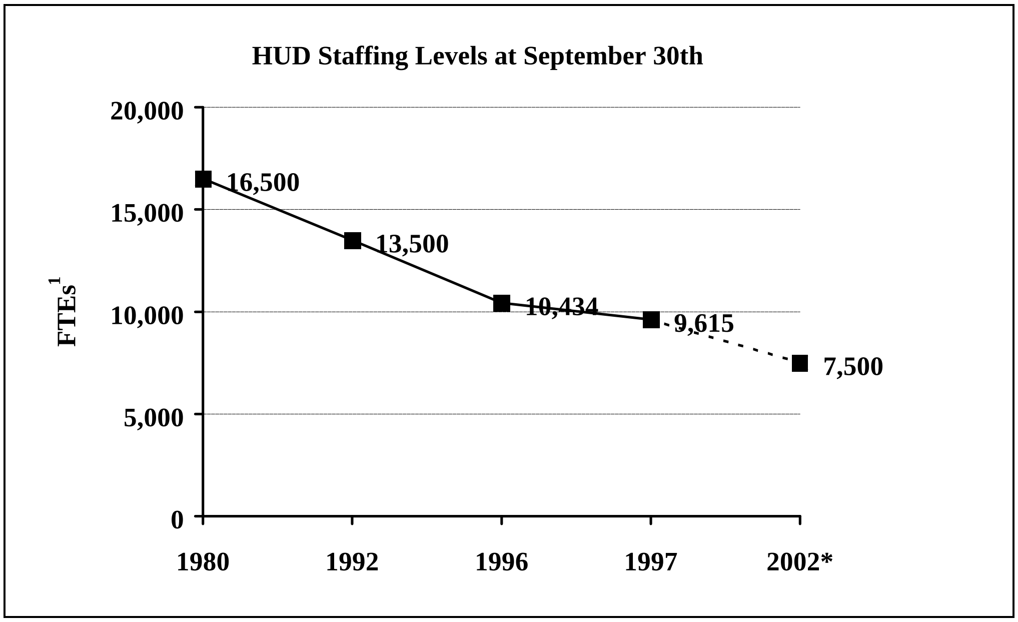
FHA has made progress over the year in addressing the weaknesses and developing plans to correct them. Our concluding comments to Appendix A of the report acknowledge this progress.

FHA MUST ADDRESS STAFF AND ADMINISTRATIVE RESOURCE ISSUES

Unlike private institutions or government-sponsored enterprises involved in housing credit, FHA does not have the authority to hire staff or the ability to quickly invest more resources in automated tools or staff training when transaction volume increases. Nor can FHA quickly or easily change the structure of its mortgage insurance programs to reduce staff-intensive functions and promote efficiency. In such an environment, critical credit and asset management functions suffer. Resource restrictions that increase the risk of borrower default or the cost of servicing and disposing of assets are fundamentally at odds with cost effective credit management.

FHA's staffing issues are multifaceted and include: (1) mismatches between workload, staff resources, and efficient performance; (2) mismatches between skill sets and skill needs; (3) barriers to effective staff redeployment; and (4) collective bargaining agreements. These staff and administrative resource issues have been and will continue to be compounded by workforce reductions. As depicted in Exhibit 1, HUD's workforce has shrunk from 13,500 employees in 1992 to 9,615 at September 30, 1997. Anticipated budget restrictions will lead to further reductions in HUD staff to an anticipated 7,500 by the end of fiscal year 2002.

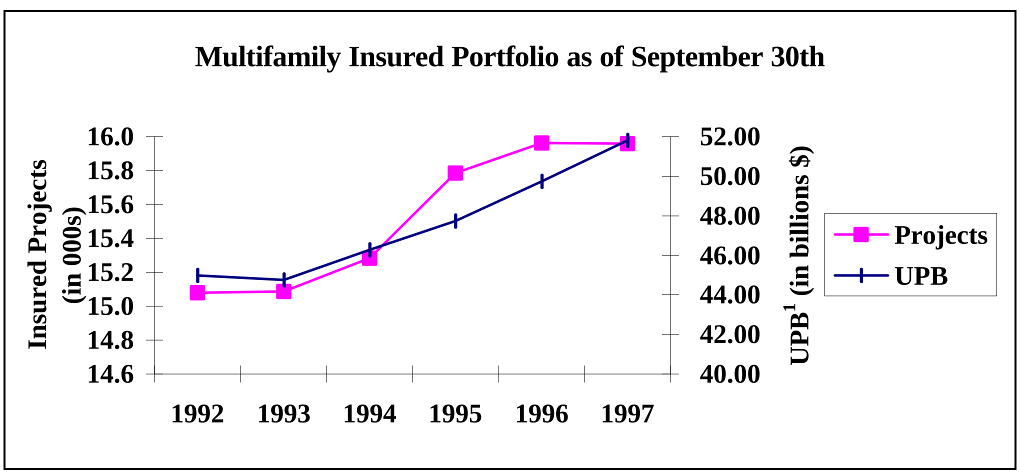
Exhibit 1



Source: OIG's Semi-annual Report to Congress, dated March 31, 1997; Office of Human Resources, Department of HUD
1) Full Time Equivalent
* projected

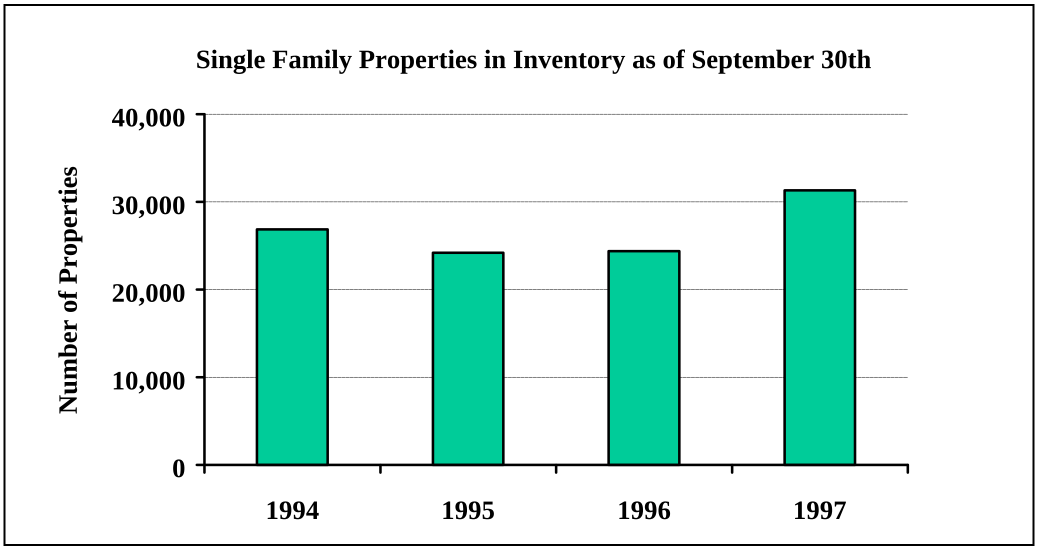
At the same time that this workforce reduction is occurring, FHA's: (1) long-term housing program budget is expected to rise; (2) multifamily insured portfolio continues to increase as depicted in Exhibit 2; (3) single family insured portfolio continues to increase and has risen over $63 billion since fiscal year end 1994; and (4) single family property inventory continues to increase as depicted in Exhibit 3. Because these staffing reductions are occurring at a period of time when FHA's portfolios continue to grow these resources issues need to be addressed urgently.

Exhibit 2



Source: FHA's 1995 Management Report; fiscal year 1997 Multifamily Baseline Report.
1) Unpaid Principal Balance

Exhibit 3



Source: Single Family Acquired Asset Management System

FHA's staffing needs continue to be most critical in the Multifamily insured portfolio monitoring area and, to a lesser degree as a result of the loan sales program, in the multifamily Secretary-held note servicing area. The Single Family issues center primarily around property management and disposition, staff utilization and redeployments.

A significant barrier impeding FHA's progress, as broadly recognized in the HUD 2020 Management Reform Plan (HUD 2020) and FHA's business plan, is the challenge to change the culture, work environment, and work ethic within the organization to that which clearly focuses on and rewards, performance and product.

Multifamily

Multifamily Action Plans and Significant Actions to Address Resource Issues

FHA's Office of Multifamily Housing (Multifamily) is responsible for developing new business and programs, monitoring current insured mortgages, planning for Section 8 contract expirations, and managing the Secretary-held note and property inventories. FHA's ongoing plans to address staff and administrative resource issues are incorporated within HUD 2020. These plans include: (1) establishing independent centers to centralize back office functions previously performed in the Field Offices; (2) improving technology; (3) consolidating and restructuring functions to streamline processes and achieve economies of scale; (4) privatizing and outsourcing functions and increasing accountability of various partners; and (5) increasing accountability of internal managers and providing employees with relevant training.

The establishment of independent centers is designed to centralize certain back office functions currently performed by the Field Offices. Centralization will allow the Field

Offices to focus on their primary responsibilities of oversight and management of properties insured by or assigned to FHA with fewer staff. HUD intends to establish the following independent centers:

- *Real Estate Assessment Center (Assessment Center)*. In 1997, HUD began the development of a department-wide Assessment Center for approximately 30,000 FHA insured, direct loan, HUD-held, and Section 8 project based subsidized properties. The Assessment Center will consolidate, into a single database, the assessment of the physical and financial condition of HUD's real estate -- functions that currently are performed in Field Offices. HUD expects that the Assessment Center, which will be external to Multifamily, will be fully operational during 1998. By implementing a centralized, computerized process, the Assessment Center should allow HUD to assess its portfolio with less staff.

- *Financial Management Center*. The Financial Management Center (or Section 8 Center) will be responsible for the financial management of Section 8 rental subsidy programs. This will include reviewing and approving budgets and payments for Section 8 rental subsidies, data maintenance, processing year-end statements, calculating renewal needs, and maintaining funding controls. Centralization of these responsibilities in the Financial Management Center will allow project managers to focus on managing their properties instead of performing labor-intensive paperwork. The Financial Management Center will be located in Kansas City, and HUD projects that it will become operational in 1998.

- *Enforcement Center*. The Enforcement Center will centralize enforcement activities previously performed by Field Office personnel. External to the Office of Housing and FHA, the Enforcement Center will become involved with those projects that receive a "fail" grade from the Assessment Center. For all projects referred, the Enforcement Center will contract with outside investigators, auditors, engineers, or attorneys to perform a due diligence review of the project, and make recommendations on a strategy to be followed. The day-to-day asset management of projects referred to the Enforcement Center will still be handled by the Multifamily Hubs or program centers. The Enforcement Center is expected to be in place and operational by the end of 1998.

HUD and FHA need improved technology to allow reduced staff to meet the continued demands of a growing insurance in force portfolio. In addition to the Assessment Center System, Multifamily's technology initiatives include:

- *Development Application Processing (DAP)*. The DAP system is being designed for use by potential mortgagors and mortgagees to generate and submit application packages electronically. Currently, the DAP system is being tested, and is expected to be fully operational by the end of 1998. This system will reduce the existing labor intensive paper-based application process.

- *Real Estate Management System (REMS)*. Multifamily is developing a comprehensive database of project-related information to support management and staff in the field and at Headquarters. REMS is an enhancement of the Housing Professional system used currently by the Special Workout Analysis Team (SWAT) to manage troubled properties. The system will replace the Field Office Multifamily National System (FOMNS), eliminating the duplication of effort that often takes place in the field when multiple systems (FOMNS and local systems) are used to perform asset management. REMS is scheduled to be fully implemented at all Multifamily Hubs and program centers during 1998.

The consolidation and restructuring of functions to streamline processes is meant to achieve economies of scale required in an environment with fewer workers. Multifamily consolidation and reengineering efforts include:

- *Consolidation of Field Offices*. FHA's Multifamily Field Offices are currently in the last phases of a restructuring that will move the current 51 Field Offices into 18 Multifamily Hubs with 33 program centers. This will consolidate the reporting structure, and allow for each individual Hub to achieve efficiencies by consolidating routine functions. Decisions will be made at the Hub level, with Hub Directors responsible to the Multifamily Deputy Assistant Secretary for both the Hub and the program centers that report to it. Headquarters will act as support to the Hubs and program centers. Location of Hubs was based on where the portfolio currently is located, and where Multifamily Housing anticipates future development. Within each Hub, the Director will have the ability to allocate resources between program centers, improving the efficiency and flexibility of the organization. The Hub structure is scheduled to be implemented in 1998.

- *Consolidation of Routine Operations*. Multifamily has identified processing functions that can be consolidated into a few centralized Field Offices to capitalize on economies of scale and reduce inefficient and redundant uses of Field Office personnel. For example, Voucher Processing Hub's (VPH) transition into a permanent organization was approved by the Office of Housing during fiscal year 1997. The VPH now handles the voucher processing for all 51 Field Offices, and is responsible for payment review and approval functions as well. HUD has also established two Property Disposition (PD) Hubs, located in Atlanta and Fort Worth, to manage and dispose of multifamily properties. The PD Hubs became operational in the beginning of fiscal year 1998, and now handle all Secretary-owned multifamily property for FHA.

- *Reengineer and Streamline Processes*. During fiscal year 1997, Multifamily commissioned a reengineering team to streamline processes and procedures to gain efficiencies while maintaining adequate controls. Its objective is to identify inefficient processes performed by personnel in the Field Offices and improve them. The reengineering team expects to complete its project in 1998.

- *Project Managers in the Field.* With the implementation of the Multifamily Hubs and program centers, Multifamily has also changed the roles of individuals located in the Field Offices. The Field Offices will no longer be divided between development and asset management staff. The position of project manager was created to reflect the multidisciplinary role of personnel within the new field organization. Each project manager will have their own portfolio to manage from application submission through endorsement with ongoing monitoring. Project managers will also be the initial HUD contact for lenders, developers, property managers and tenants. Personnel will assume the project manager role when the Field Office reorganization takes place in the Spring of 1998.

FHA is moving towards privatizing and outsourcing functions and increasing accountability of various FHA partners to relieve asset managers of non-asset manager work. Delegation of certain underwriting responsibilities to mortgagees or contractors will assist in this process. Multifamily outsourcing and delegation initiatives include:

- *Shifting Service Delivery from Retail Operations to a Wholesale Operation by Delegating Certain Underwriting Responsibilities to Mortgagees or Contractors.* FastTrack and Ultra FastTrack are local Field Office tailored processing options that use handbook waiver authority delegated by the FHA Commissioner to trim HUD multifamily mortgage insurance processing requirements. It results in reductions in the amount of time required by HUD staff to process the mortgage applications and the level of effort required. HUD also saves staff time and eliminates delays in processing because it no longer has to order and contract for appraisal and inspection reports (and possibly architectural reviews). Those reports will be the responsibility of the lenders. As a part of FastTrack and Ultra FastTrack, FHA anticipates assessing an underwriting surcharge. The surcharge would be imposed on mortgagees for any claims incurred during the first three years after final endorsement. FastTrack and Ultra FastTrack are expected to be implemented at all of the Field Offices in 1998.

- *Physical Inspections.* As a part of the Assessment Center project, a new physical inspection protocol is being developed by Multifamily. Annual physical inspections will be performed by contractors, and the results included along with financial factors in an integrated scoring model to develop an overall risk ranking for the project. Previously, these inspections were performed by HUD personnel, mortgagees, and regional contractors. The use of contractors allows HUD personnel to change to an oversight function rather than performing the task. Physical inspections using the new inspection protocol are expected to begin in the Spring of 1998.

- *Continue the Asset Sales Strategy.* As discussed in Appendix B of this report, Multifamily will continue to sell its inventory of notes, thus freeing note servicing staff for other critical functions.

FHA must shift the way the remaining employees work and think for the multifamily reform program to be successful. Changing the systems, organizations, and work processes alone will not position FHA to manage its business if the employees do not adapt as well. Multifamily initiatives to assist employees include:

- *Project Manager Training.* Multifamily is in the process of conducting training sessions at the Multifamily Hubs to educate current asset managers and development personnel on their new duties as project managers. The training program emphasizes the customer focus of HUD as outlined in HUD 2020, and includes segments on the Assessment Center, the Enforcement Center, and the Section 8 Center. The initial project manager training sessions began in December 1997, and are scheduled to continue through March 1998.

- *Communication.* The Office of Housing is proactively addressing internal cultural and work ethic issues that have been recognized in the HUD reinvention plan. In a memo to all Housing employees, the Assistant Secretary for Housing indicated that performance levels and measurement must be strengthened in order for the "new" Office of Housing to be an organization where the ethic is one of competence and excellence; performance and product; and responsibility and accountability.

KPMG's Assessment of Planned and Completed Multifamily Actions

HUD and Housing made significant progress during fiscal year 1997. Development of the major initiatives outlined in HUD 2020 has begun. New processes and training of staff commenced during 1997. These are interim steps, designed to effectively manage the current inventory of notes and properties and to continue to serve the ongoing needs of the housing markets. Introduction of the Assessment Center, the Section 8 Financial Management Center and the Enforcement Center in late fiscal year 1998 or early 1999 will complete the transformation.

The implementation of the Assessment Center, consolidating functions through the use of Hubs, and HUD's commitment to selling Secretary-held notes will allow staff in Field Offices to focus on managing assets, rather than enforcing actions and performing numerous other non asset manager tasks. Credit and asset management functions remained strained throughout fiscal year 1997 because many of these plans are in their early stages of implementation. Recent litigation involving the prior financial advisor for the note sales has the potential to delay future sales, resulting in increased losses to the insurance fund.

The Office of Housing is: (1) proactively addressing internal cultural and work ethic issues that have been recognized in HUD 2020; (2) taking steps to change the perception of its external partners and customers; and (3) communicating, via letters, satellite communications, and working groups, with its partners and customers to inform them of the changes occurring within HUD and their role in helping the Office of Housing to meet the challenges of the 21st century.

KPMG's Multifamily Recommendations

We continue to recommend that FHA:

- Invite information systems technology experts and key user groups to participate in reengineering plans and initiatives. Multifamily process reengineering teams should also solicit input from the Inspector General's office on the sufficiency of internal controls over the new streamlined procedures; and

- Proceed with the implementation of the replacement systems for the MARS and PMS systems with diligence to ensure that the transition of data from the old systems to the new ones is successful.

Additionally, we recommend that FHA:

- Benchmark the performance of the new Hubs and programs centers, using productivity and cost measures, to assess the reallocation of staffing resources;

- Develop a formal plan geared towards transitioning the institutional knowledge of employees that accept "buyout" offers to employees who will assume their responsibilities;

- Monitor the effectiveness of project manager training on an ongoing basis - specifically for personnel who have assumed positions with significant, new responsibilities;

- Develop a set of comprehensive criteria for mortgagees under the FastTrack and Ultra FastTrack development programs that reflects the increased responsibility assigned to the lenders; and

- Create effective criteria to quantify progress of Hubs and program centers towards fulfilling the goals of HUD 2020.

Single Family

Single Family Action Plans and Significant Actions to Address Resource Issues

FHA's Office of Single Family Housing has taken several critical steps toward addressing its operational resource issues. A reorganization plan was developed to consolidate most functions involving loan processing, quality assurance, marketing and outreach, and real estate owned management into four HOCs. In addition, during fiscal year 1998, all note servicing and loss mitigation efforts will be consolidated into the Oklahoma City Field Office. The reorganization will centralize and streamline operations to gain efficiencies of scale and as, a result, reduce Single Family Housing personnel by more than 60 percent from 1995 levels. To manage risk effectively while rapidly downsizing, FHA must continue its current progressive initiatives and identify and incorporate other opportunities for operational efficiencies.

In August 1997, the Balanced Budget Act of 1997 extended the legislation to eliminate, indefinitely, eligibility for the assignment program for insured loans. The elimination of the mortgage assignment program supports FHA's reallocation of resources from note servicing to property disposition, as FHA will no longer be receiving significant numbers of notes into its portfolio. This will allow FHA to focus on single family property disposition and more effective and cost beneficial loss mitigation efforts. FHA also plans to:

- *Implement the Consolidation Plan*. FHA developed a plan that will consolidate the loan processing, quality assurance, marketing and outreach, and real estate owned management from 81 Field Offices, into four HOCs. The evolutionary structure of the HOCs is designed to consolidate and augment the current headquarters and Field Office structure with efficient customer service operations. In 1995, the single family consolidation process began when the Denver HOC was opened and operated on a limited basis, to address problems and questions in the streamlining process as they arose. The office consolidated routine, location-neutral single family origination functions from 23 Field Offices in the Southwest and Rocky Mountain regions, and demonstrated the efficiencies achievable through consolidation and specialization. HUD expects complete transition to the HOC structure by the end of fiscal year 1998, with transition of the individual functions to begin as depicted in Exhibit 4.

- *Revise FHA's Property Disposition Function*. FHA is evaluating two alternatives to revise its process for managing the disposition of single family properties acquired through conveyances and foreclosures. The alternatives are to: (1) outsource the entire single family property disposition function; or (2) sell the properties to the private sector through either bulk sales or by selling the rights to a stream of future properties. The procurement process to identify an organization that will provide financial advisory services with respect to the sale of the single family properties on behalf of HUD is in progress. A financial advisor is expected to be selected by the end of the second quarter of fiscal year 1998.

Exhibit 4

TRANSITION TO SINGLE FAMILY HOC STRUCTURE

	Denver	Philadelphia	Atlanta	Santa Ana
Loan processing	Complete	Complete	Complete	2nd Q 1998
Quality assurance	Complete	2nd Q 1998	2nd Q 1998	2nd Q 1998
Marketing and outreach	2nd Q 1998	2nd Q 1998	2nd Q 1998	2nd Q 1998
Real estate owned management	2nd Q 1998	2nd Q 1998	2nd Q 1998	2nd Q 1998
Note servicing and loss mitigation	3rd Q 1998	Not Applicable	Not Applicable	Not Applicable
Number of Field Offices Consolidated	23	24	18	16

Source: Office of Single Family Housing

The objective of hiring the financial advisor is to assist in determining the best course of action and to assist in implementing that plan. FHA's goals for single family property dispositions are to: (1) increase the return on the disposition of properties; (2) reduce the time between foreclosure and resale; (3) allow for anticipated personnel reductions in the asset management and disposition areas; and (4) improve the disposition process.

FHA is also considering revising the long-term management and disposition of single family real estate owned properties. Legislation under the National Housing Act was proposed during fiscal year 1998 and, if enacted, would provide FHA with additional flexibility to chose the most cost effective methods of paying insurance claims and disposing of acquired notes or homes. FHA would have the authority to take assignment of single family mortgages upon default, rather than initiating foreclosure and taking the property into inventory. FHA would then either sell the note or transfer the note to a third party for servicing, loss mitigation, or foreclosure and property disposition, depending on the circumstances. This strategy, if enacted, would not be implemented by FHA before fiscal year 2000.

- *Contract with the Private Sector*. In fiscal year 1997, FHA contracted out the asset management and property disposition functions of three Field Offices to assess the feasibility of this alternative. An audit of the single family real estate owned pilot contracts conducted by the Office of the Inspector General noted some weaknesses in the contracts between HUD and the contractors. However, none of the weaknesses were considered significant enough to affect the contractors' performing their duties and promoting HUD's best interests. However, the report identified significant deficiencies in the Single Family Asset Management System, as discussed in Appendix B.

- *Continue Single Family Secretary-held Mortgage Note Sales*. During fiscal year 1997, FHA completed two single family mortgage note sales, and plans one additional sale for fiscal year 1998 (further details are provided in Appendix D). The disposition of mortgage notes lessens the workload and responsibilities of loan servicers and leads to the realignment of resources to other areas of FHA's operations.

- *Expand the Reach and Breadth of The FHA Connection*. During fiscal year 1997, FHA established access to its databases for FHA business partners via the World Wide Web through an initiative called The FHA Connection. The FHA Connection is an interactive system on the Internet that gives approved FHA lenders real-time access to several FHA systems for the purpose of originating and servicing loans. This has reduced the time intensive process of FHA staff entering information and researching cases for lenders and allowed FHA to redirect these resources. Lenders can electronically query FHA cases and process case number assignments, insurance applications, appraisal information, lender transfers, and mortgage record changes.

- *Continue Electronic Data Interchange (EDI) Implementation*. FHA uses EDI to accept single family claims for insurance benefits, receive monthly mortgage loan default status reports, mortgage change records, and mortgage insurance termination. The use of EDI in lieu of paper or magnetic formats results in fewer errors, enhances data integrity, and reduces labor-intensive processing for FHA staff. EDI submission of single family claims was mandated in August 1997 and lenders who do not comply incur a processing fee for submitting paper claims. The submission of monthly mortgage loan default status reports, mortgage change records, and mortgage insurance termination using EDI was mandated for large lenders by September 1996 and phased in for medium and small lenders through December 1997. In addition to the transactions currently processed by EDI, FHA is supporting the Mortgage Electronic Registration System (MERS) by working with their industry partners to explore the feasibility of creating universally accepted transactions for the mortgage industry.

KPMG's Assessment of Planned and Completed Single Family Actions

The transfer of workloads from the Field Offices to the HOCs is still in its early stages and FHA faces significant logistical and staffing challenges before it can realize many of the benefits derived from the centralization of repetitive tasks. Once fully implemented and expanded, EDI initiatives will create operating efficiencies for both FHA and its mortgagees. However, the phasing in of mandates for EDI initiatives during 1997 and some implementation issues continue to offset the efficiencies gained.

As discussed in detail in Appendix D, FHA continued to reduce the single family note portfolio through two note sales in fiscal year 1997. The benefits of a reduced volume of notes to service will allow for the consolidation of all note servicing into a satellite office of the Denver HOC, by the end of fiscal year 1998. The termination of the assignment program indefinitely will prevent further significant additions to the Secretary-held mortgage note portfolio and will allow for a significant reduction of note servicing staff.

KPMG's Single Family Recommendations

We continue to recommend that FHA:

- Implement the transition plan to shift workload and staff from Field Offices to HOCs to streamline operations, better serve FHA's customers, and provide quality services and information to FHA's internal and external customers. A significant challenge in the implementation process will be to manage the change effectively to ensure critical processes are functioning as designed during the transition phase. Also, management should actively keep staff focused on their work during this time of significant change.

- Continue implementation of the human resource strategy that:

  - plans for resource redeployment;
  - identifies candidates to fill job opportunities at the HOCs and marketing and outreach offices based on skills sets needed versus existing skill sets;
  - contains a comprehensive training program for personnel performing single family functions once operations have been consolidated significantly; and
  - identifies specific performance measures for single family personnel that are linked to their roles and responsibilities under the new structure and FHA's overall objectives of increasing home ownership;

- Finalize its strategy to revise the single family asset management and property disposition process and develop an implementation plan with specific goals and timelines. Any strategy to contract services to the private sector must include controls to monitor contractor performance.

- Determine if improvements and standardization of the servicing on the single family notes remaining in inventory would be cost beneficial based on the number of notes remaining in inventory. The benefits of improved note servicing and collection activities should improve the payment histories of notes in inventory, thereby increasing the value to FHA in future note sales. Regardless, communication from management emphasizing the importance of servicing activities may be needed, given the number of organizational changes occurring at FHA, including the consolidation of all single family note servicing into the Oklahoma City Field Office.

- Continue to conduct working group sessions with lenders to identify areas of FHA operations that can be further streamlined (e.g., claims processing and property disposition processes).

- Analyze all transactions and communications between FHA, lenders, the Mortgage Electronic Registration Systems, Inc., and other partners, to identify additional opportunities to expand the use of EDI (e.g., data used for delegated underwriting) and transmitting business correspondence.

- Coordinate with Ginnie Mae as it develops its EDI initiatives and evaluate opportunities for mutual efficiencies.

- Review the transaction processes that have been automated using EDI to determine the feasibility of re-engineering the processes to reduce staff time and eliminate unneeded steps (e.g., even though claim forms for insurance benefits were mandated to be submitted using EDI after August 1997, mortgagees are still required to send paper claims to Field Offices).

Additionally, we recommend that FHA:

- Review the consolidation of the single family processes into HOCs. Reviewing strengths and weaknesses resulting from consolidating single family operations into the HOCs should be performed after these functions have been in operation for at least twelve months. This review should highlight practices that are working well and should be performed at the other HOCs, if they are not being performed already. The review should also highlight the problems encountered and solutions reached that may be helpful in any consolidation of the multifamily process. A "Best Practices" manual should be created from this review and distributed to all HOCs for reference.

- Review access to the FHA Connection to ensure that both large and small lenders have access to the databases. In addition, as additional database records become electronically accessible, the information should be considered for access through The FHA Connection.

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

FHA does not have adequate systems, processes, or resources to identify and manage risks in its insured portfolios effectively. Timely identification of troubled insured mortgages is a key element of FHA's efforts to target resources to insured mortgages that represent the greatest financial risks to FHA. Troubled insured mortgages must be identified before FHA can institute loss mitigation techniques that can reduce eventual claims.

Multifamily

Multifamily Action Plans and Significant Actions to Improve Monitoring and Early Warning Loss Prevention

Within FHA's current structure, the monitoring of the multifamily insured and Secretary-held mortgage note portfolios relies heavily on personnel in the Field Offices. In a variety of ways and to varying degrees, depending upon the program and the region, FHA currently performs assessments of the financial and physical condition of its properties. However, the current process is decentralized, inconsistent, sometimes untimely, and resource intensive.

Risk management and loss mitigation activities are performed by asset managers in the individual Field Offices. Based on their knowledge of the Field Office's portfolio, projects are assigned to "troubled and potentially troubled" listings on a field office by field office basis. Although guidance on classifying projects as "troubled or potentially troubled" exists, it is not applied uniformly across all Field Offices. Additionally, Field Offices do not have a standard process for placing projects on the "troubled and potentially troubled" listing, or a standard, documented methodology for removing them. These factors are compounded by problems with the Field Office Multifamily National System (FOMNS) that forces Field Offices to use local management systems for day-to-day risk assessment and management.

When done timely, risk-ranking the multifamily insured portfolio allows FHA to target its resources more efficiently to higher risk properties. This process, supplemented with additional training and detailed physical, financial, and operational information, can improve decision making for mitigating losses. Timely reviews of mortgagees with poor underwriting and claim statistics can also enhance quality control, decrease risk, and minimize losses.

Multifamily plans to improve early warning and loss prevention efforts focus on three broad categories: (1) improve technology; (2) strengthen oversight and monitoring capabilities; and (3) improve asset management tools and techniques.

HUD has embarked on a series of systems initiatives that, once developed and implemented, should improve Multifamily's ability to conduct risk management and loss mitigation through the use of technology. These initiatives include:

- *The Real Estate Assessment Center (Assessment Center)*. As discussed earlier, the Assessment Center will consolidate the assessment of physical and financial condition of HUD's real estate projects into a single database and assessment system. Once implemented, the Assessment Center will give HUD a comprehensive oversight tool that will enable centralized and consistent analysis that can be used to identify troubled and potentially troubled housing projects where HUD should focus its limited resources. The Assessment Center should greatly improve HUD's risk management and mitigation capabilities.

- *The Real Estate Management System (REMS).* As discussed earlier, Multifamily is developing a comprehensive database of project-related information to support management and staff in the field and at Headquarters. The ability of project managers in the field to access all pertinent project information from one centralized database is intended to provide the project managers with reliable and timely data, including information that currently does not exist anywhere within Multifamily, to manage the risk within their portfolio. REMS will be implemented at all Multifamily Hubs and program centers in 1998.

- *The Annual Financial Statements (AFS) System.* The AFS System is a process being developed by Multifamily to collect annual audited project financial statements for insured projects electronically. Once the statements are submitted, the system will perform an initial check for completeness, and then allow other systems to access the financial statement data for analysis or review. With the audited financial statements already in an electronic format, the timeliness and quality of risk assessments should improve, and better FHA's ability to manage its portfolio. Multifamily anticipates deploying AFS nationwide in 1998.

In addition to the systems being developed to improve FHA's risk management processes, FHA is strengthening its oversight and monitoring capabilities to identify and manage risk in the insured portfolio. These initiatives include:

- *The Enforcement Center.* As discussed earlier, HUD is in the process of consolidating its enforcement activities across the Department into one Enforcement Center that will centralize enforcement activities previously performed in the Field Offices. An attempt will be made to cure troubled projects; however sanctions may be required. Sanctions administered by the Enforcement Center will range from civil money penalties and abatement of Section 8 payments to referral to the Department of Justice for criminal prosecution. The Enforcement Center is expected to be in place and operational by November 1998.

- *The Quality Assurance Center (QAC).* As a part of the FastTrack and Ultra FastTrack initiatives to place more responsibility on the lenders in the field, Multifamily Housing has created the QAC to review the Hubs and program centers' originating and servicing functions. The QAC will concentrate on reviewing lender's underwriting and development procedures, servicing activities, and the management activities of individual Multifamily Hubs and program centers. Discrepancies found in lender activities could result in sanctions that include suspension or elimination of FastTrack and Ultra FastTrack origination authority. The QAC is planned to be in place and operational in 1998.

- *Coordination of Oversight and Monitoring of the Hospital Portfolio.* Based on contractor recommendations, FHA has reached an agreement with the Department of Health and Human Services to develop projects jointly, using a loan committee that includes personnel from both agencies, and eliminating any previous disconnect. This should increase FHA's ability to manage individual hospitals in the portfolio, reduce overall risk, and increase the efficiency of the organization.

To further improve the ability of Multifamily to manage risk and mitigate loss within its portfolio, it has developed a series of programs and asset management tools to both identify and reduce the overall risk of loss. These initiatives include:

- *Continuation of the Portfolio Reengineering Program.* In September 1997, Congress extended FHA's authority to proceed with the Portfolio Reengineering Demonstration Program with expiring Section 8 contracts. The demonstration program uses a variety of tools and authorities to restructure the financing of assisted FHA-insured projects to prevent or reduce claims upon Section 8 contract expiration. The project lessens the burden placed on asset managers in the field by taking high-risk projects (projects with excessive Section 8 subsidy and excessive debt service), and decreasing their risk of default by lowering their debt service. In October 1997, the Multifamily Assisted Housing Reform and Affordability Act (MAHRA) gave FHA the authority to proceed with the Portfolio Reengineering Program on a permanent basis. MAHRA created the Office of Multifamily Assisted Housing Restructuring (OMAHR) to perform all of the duties of the original demonstration program. (See Appendix B for additional details).

- *Senior Asset Managers.* Multifamily has recently created the position of a senior asset manager to monitor the most troubled projects. The senior asset managers' specialization will directly improve Multifamily's ability to mitigate losses from troubled assets, and allow project managers to concentrate on servicing the remaining, previously ignored portion of the portfolio, improving their ability to detect any increases in risk. They are scheduled to be in place when the reorganization becomes effective in the Spring of 1998.

- *Section 221(g)(4) Portfolio Analysis*. Mortgagees may assign Section 221(g)(4) mortgages to FHA at the end of 20 years if the loan is then current. During 1997, FHA contracted with a financial advisor to assess viable alternatives for this portion of the portfolio. Options considered included: (1) taking assignment; (2) performing third party reflector sales on a mark to market basis; and (3) selling the mortgages with private insurance without retaining FHA's insurance obligation. Legislation authorizing third party reflector sales is currently pending in Congress. Without authorization from Congress, FHA anticipates taking the assignment of these mortgages as claims are filed, and selling them in auctions as soon as possible.

- *Dissemination of Risk Ranking Data Used for Loss Reserve Estimation.* Risk ranking information prepared at FHA headquarters for calculating loss reserves can be valuable in identifying troubled and potentially troubled projects. In 1998, this information will be provided to Field Offices for analysis in hard copy and electronic versions.

KPMG's Assessment of Planned and Completed Multifamily Actions

Although progress has been made to identify and service troubled and potentially troubled projects, the inventory of these projects remains high. Additionally, deficiencies identified during property management and financial statement reviews and physical inspections are not followed up conscientiously. The placement of senior asset managers at the Multifamily Hubs and program centers in 1998 should cure some projects, and the implementation of the Assessment Center and Enforcement Center should enable Multifamily to assess risk and mitigate losses proactively. Multifamily anticipates that the QAC will reduce the overall risk of the portfolio by improving the quality of the data obtained from mortgagees. However, these centers are currently in development, and are not scheduled to be operational until fiscal year 1999.

Until the centers become operational, several of the other initiatives are intended to assist with loss mitigation and risk assessment. Both REMS and AFS should alleviate some of the current systems problems at the Field Offices; HUD expects that both of these initiatives will be operating prior to the end of fiscal year 1998.

However, both decreasing staffing levels, and the significant organizational changes that are taking place, will have a direct effect on the ability of FHA to manage its portfolio in the short term and long term. FHA's current strategy to sell Section 221(g)(4) notes as they are assigned instead of using reflector sales increases FHA's risk, and could result in greater losses to the insurance fund.

KPMG's Multifamily Recommendations

We continue to recommend that FHA provide more specific and structured training to its Field Office staff. Specific training and guidance should be developed to show how data warehouse and risk ranking information can be used for loss mitigation and the identification and ultimate resolution of troubled or potentially troubled projects.

Additionally, we recommend that FHA:

- Strengthen requirements to obtain payment history information for insured multifamily projects, including delinquency and default information, from mortgagees. This information should be obtained in electronic form on a monthly basis. Monetary penalties, for mortgagees who fail to report, should be considered to promote reporting compliance.

- Consult with others in the multifamily housing industry developing state of the art technology and monitoring systems to prepare a comprehensive work program for the QAC to use in conducting on-site reviews of mortgagees, and reviews of closed development packages at the Multifamily Hubs and programs centers.

- Involve personnel from the QAC with reengineering and asset management streamlining efforts currently in place within Multifamily to increase their knowledge of new procedures at the Field Offices.

- Perform parallel testing of new systems (e.g., REMS) against replaced or local systems to ensure data integrity prior to shutting off the local unsupported systems.

- Continue with its development and implementation of the Real Estate Assessment Center, Enforcement Center, and Section 8 Center to improve risk assessment, management, and enforcement capabilities.

- Obtain authority from Congress to continue reflector sales for the Section 221(g)(4) portfolio to reduce future note assignments and claim payments from the insurance fund.

Single Family

Single Family Action Plans and Significant Actions to Improve Monitoring and Early Warning and Loss Prevention

The single family area continues to experience some of the same problems as the multifamily area, but to a lesser degree. To address many of these problems, the Office of Single Family Housing has created a quality control mechanism at Headquarters and each of the four HOCs - a Quality Assurance Division (QAD). Although the single family insured mortgagee portfolio is large, automated monitoring using statistical and trend analysis can be used effectively.

To achieve lower claims and losses to FHA and monitor the insured portfolio of single family mortgages more effectively, FHA has planned or taken steps to:

- *Increase the QAD staff who perform on-site reviews of FHA-approved mortgagees*. During the past two years, FHA has increased the QAD staff. The current staff of 43 monitors is expected to grow by an additional 33 monitors by the end of fiscal year 1998. FHA expects that all monitors will be trained and assigned to a HOC before the end of fiscal year 1998. The monitors' training will focus on reviewing lender performance and target lenders with deficient underwriting practices. The scope and depth of QAD's reviews are expected to be tailored to each situation.

  A majority of a monitor's time will be spent performing targeted reviews that are determined by a review of various information such as lender default rates, claim rates, delinquency reporting, late payment of mortgage insurance premiums, borrower complaints, tips from other lenders, and portfolio volume.

- *Utilize existing loss mitigation tools as alternatives to mortgage foreclosure*. Congress authorized FHA to implement new loss mitigation tools, including partial claims and mortgage modifications, and revised requirements for existing tools to provide lenders with greater flexibility and financial incentives to use them where appropriate. FHA seeks to accomplish the following objectives in its loss mitigation program:

  - Maximize the opportunity for borrowers to retain home ownership and cure delinquencies on their mortgages.
  - Mitigate losses resulting from foreclosure by using alternatives to foreclosure.
  - Minimize paperwork and empower lenders to work directly with homeowners to determine the most appropriate loss mitigation tool.
  - Provide lenders with performance-based incentives.

  FHA estimates that a significant number of seriously delinquent loans could be cured through borrower self-help and others would avoid foreclosure through relief measures provided by loss mitigation tools.

- *Develop a lender scoring system to analyze loss mitigation tool usage, performance, and effectiveness in comparing lenders*. In conjunction with its emphasis on using loss mitigation tools as alternatives to foreclosure, FHA developed a scoring system to rank comparable lenders' success in minimizing their default rate and their actual costs compared to their potential costs to FHA relative to other lenders in a state. This system was developed using technology form Ginnie Mae's Issuer Portfolio Analysis Database (IPADs) and Correspondent Portfolio Analysis Database (CPADs). The results of the first ranking period (1996) were released in May of 1997 and provide the top 25th percentile with additional authority to use loss mitigation tools and financial incentives during fiscal year 1998. The rankings will be recomputed each year and lenders with the best performances will receive the financial incentives in the following year.

- *Initiate a pilot program in which automated underwriting was offered to a limited set of FHA mortgagees for a test period.* FHA's objectives were to:

  – Use technology to identify and better evaluate underserved borrowers;
  – Use technology to measure and manage risk;
  – Enhance FHA's research and analytical capabilities; and
  – Make FHA programs more attractive for lenders and make it easier for lenders to implement and participate in FHA programs.

  FHA anticipates that automated underwriting for FHA loans will predict future borrower performance problems in a statistically sound manner. The pilot program with Freddie Mac was completed during 1997. In March 1998, FHA approved Freddie Mac's automated underwriting system for use by lenders originating FHA loans. FHA expects to conduct a similar automated underwriting pilot with Fannie Mae and PMI (a private mortgage insurance company) during fiscal year 1998. In addition, FHA plans to develop its own mortgage scorecard that ultimately will be required for use in an approved underwriting system for FHA loans.

- *Improve the Single Family Default Monitoring System (SFDMS).* The SFDMS is a key monitoring system in the single family area. This system tracks and monitors delinquency and default information at the mortgagee/servicer level. FHA has identified data integrity problems with the delinquency information in SFDMS; some lenders did not report on the default status of borrowers and others reported inaccurate information. To address data integrity concerns, FHA is assessing penalties against lenders who are negligent in reporting defaulted loan information. Also, the post-claim review contractor and the QAD have increased their focus on SFDMS reporting during on-site and post-claim reviews.

  When SFDMS identifies a mortgagee or servicer with excessive default rates, FHA performs an on-site review to ensure they meet FHA standards. FHA also reviews mortgagees that have below-average "cure" rates for the mortgages they service. In addition, HUD is testing on-line reporting capabilities with direct links to mortgagees to increase the timeliness of default reporting.

- *Use Mortgage Portfolio Analysis System (MPAS) information to conduct quarterly analyses of lender claims and default rates.* During fiscal year 1996, FHA developed the MPAS system to monitor mortgagees' claim and default rates. MPAS measures the performance of FHA-insured single family portfolios, by originating mortgagee, based on data from SFDMS. MPAS analyzes a mortgagee's national claim and default rates, within the jurisdiction of a HUD Field Office, by branch office of the mortgagee, by zip code, and by census tract. If a mortgagee's default and claim rates are deemed excessive (greater than 150 percent of average rates), the mortgagee is placed on credit watch status and monitored closely for a period of at least six months. FHA plans to terminate the approved status of mortgagees whose claim and default rates exceed 200 percent of the normal (average) rate for the corresponding geographic area. During 1997, FHA began identifying lenders subject to review and will begin these reviews in 1998.

- *Utilize a database to track and review financial stability of lenders*. FHA developed a system to summarize and track key financial ratios, adjusted net worth, and other indicators of mortgagee performance. The system will be used to identify mortgagees experiencing financial difficulties and highlight negative financial trends as an early warning indicator for troubled mortgagees. FHA initially input mortgagee financial data into the database during fiscal year 1997, and expects to have good trend information by fiscal year 1999. In addition, FHA is in the initial stages of developing a process whereby lenders would be required to electronically submit financial statement information for annual recertification. Financial information from these databases will eventually be used by the QAD to assist in targeting their lender reviews. FHA anticipates that this project will pilot during fiscal year 1999.

- *Develop and Implement the Single Family Data Warehouse*. During 1997, FHA developed and launched a data warehouse that allows users easy access to data from eleven different systems.

KPMG's Assessment of Planned and Completed Single Family Actions

FHA's single family monitoring focuses on risk identification and actual lender and borrower performance. We believe that the plans for more effective monitoring and early warning detection capabilities will ultimately reduce claims and losses to FHA.

FHA has developed the foundation for an effective single family monitoring and early warning system. The reallocation of resources from the Field Office structure to the HOCs should assist in the early identification of lenders and borrower groups that adversely impact FHA's overall loss mitigation objectives. However, much remains to be done to fully implement these plans and reap their benefits. Currently, FHA cannot conduct all of the monitoring efforts discussed above to effectively enforce program compliance and mitigate claims and losses to FHA.

The benefits of the QAD duties should become evident as the program expands and monitors are deployed, but not without the appropriate commitments to training and sufficient resource dedication to develop and implement the QAD's monitoring tools.

Automated underwriting has been used successfully by lenders for non-FHA loans and should prove successful for FHA insured loans. A statistically derived default prediction model will provide FHA with better information about the risks inherent in each book of business. However, automated underwriting for FHA loans is still in the development stages.

The full benefit of the MPAS initiative will not be realized until FHA resumes terminating origination authority for lenders whose claim and default rates exceed 200 percent of the average rates for the area.

The database of financial indicators for mortgagees will take several years to provide meaningful trend information that correlates indicators of weakening financial condition to appropriate follow-up and/or enforcement requirements.

Finally, the uses of the Single Family Data Warehouse and benefits derived have not been completely realized at FHA due to the limited time that the system has been in operation. As users begin to understand and use the warehouse more often, employees should begin managing the portfolio more effectively as they will be able to identify and focus on high-risk lenders more easily.

KPMG's Single Family Recommendations

We continue to recommend that FHA:

- Increase the QAD's profile with FHA approved lenders and make FHA's enforcement priorities consistent and highly publicized. This can be accomplished in a number of ways including mortgagee letters, correspondence with lenders, meetings with top management during on-site reviews, and articles in industry publications. Creating awareness of these issues with mortgagees may lend to self-policing of FHA's enforcement concerns.

- Focus the QAD's enforcement actions on the accuracy of delinquency and default data submitted to FHA via EDI and the SFDMS. FHA is not confident about the quality of SFDMS data. Increased QAD attention to this matter should improve the accuracy of lender submissions.

- Compare each lender's claim and default rate information, provided by MPAS, to lender's loss mitigation performance indicators. This analysis should reveal whether a mortgagee's high claim and default rates result from poor underwriting or poor application of loss mitigation efforts. This information can be used to assist in directing the efforts of the QAD.

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

- Accelerate plans with private sector entities to evaluate the feasibility of developing an artificial intelligence tool to help mortgagees select the most promising loss mitigation tool (or foreclosure) for delinquent FHA-insured loans, given a borrower's current circumstances. These organizations are developing such tools for conventional lenders.

Additionally, we recommend that FHA:

- Utilize the loss mitigation scoring model to understand and predict the full impact of the different loss mitigation tools as effective alternatives to mortgage foreclosure and as a beneficial financial alternative to the mortgage assignment program. FHA should also use the loss mitigation scoring model to not only reward lenders with satisfactory scores but also identify lenders with unacceptable scores. Training and awareness programs should be developed to rectify deficient servicing practices identified and eliminate non-compliant lenders from the FHA insurance programs.

- Monitor actual use of loss mitigation tools by lenders and evaluate whether the loss mitigation program should be modified to encourage wider use.

CONTINUED EMPHASIS MUST BE PLACED ON IMPROVING ACCOUNTING AND FINANCIAL MANAGEMENT SYSTEMS

For a number of years, weaknesses have been reported in FHA's financial management systems. Systems are not linked and integrated, or configured to meet all financial reporting requirements. Additionally, many of FHA's financial management systems do not share a common data architecture, and not all systems provide the appropriate case level detail required for credit reform compliance. Recommendations included: (1) enhancing the general ledger and subsidiary systems to facilitate better case level reporting for compliance with Credit Reform; (2) developing an integrated multifamily system that allows Field Offices to more effectively and efficiently monitor insured and Secretary-held portfolios (including early warning and credit risk modules); (3) fully implementing an "umbrella" system at FHA that will integrate all financial management systems; and (4) enhancing systems for reporting by program, geographical area, or other relevant components.

It has been noted that resources needed to develop state-of-the-art systems are lacking because of department-wide budgetary constraints or the existence of other critical system priorities at HUD. As a result, FHA's past systems plans centered on enhancing existing systems, and actual implementation of the plans was often a long, tedious process that did not produce timely results.

The Office of Management and Budget (OMB) has mandated that all critical systems be Year 2000 compliant by March 1999 to allow for the identification of problems and corrections. FHA's accounting and financial management systems will be affected by the

Year 2000 and are required to be compliant with the OMB mandate. HUD is addressing the issue on a Department-wide level, however it is appropriate to address the issue here briefly. According to a recent review of HUD's Financial Management Systems, FHA has 19 critical systems that were in operation at the end of fiscal year 1997. Of these 19 systems, only two of the critical systems have been programmed to address the Year 2000, but neither system has been certified as Year 2000 compliant. As the Year 2000 issue applies to all systems, regardless of mandates, the cost of reprogramming systems continues to increase.

HUD Action Plan and Significant Activities to Address System Weaknesses

During fiscal years 1993 and 1994, FHA developed an overall integration strategy that management believes can be implemented within current budgetary restrictions. This umbrella plan, known as the Information Strategy Plan (ISP), is based on a total integration strategy along program lines (Single Family, Multifamily, and Title I). The plan is designed to eliminate outdated systems and save the systems that provide current, reliable data. Management believes it is more cost beneficial to retain systems that require minor modifications before integration than to develop an entire new module through the ISP. In addition, FHA will be able to modify these systems on a yearly basis as implementation of the ISP unfolds. As FHA progresses in the reengineering of their business processes, their technology plans will be further refined. The ISP will implement state-of-the-art technology, including electronic commerce, such as electronic data interchange, the Internet, and, data warehousing, to improve system operations and provide access to business and portfolio information.

The goals of the ISP are to: (1) modify, eliminate, or replace single family insurance systems and other existing systems to eliminate redundancies, improve data integrity, facilitate integration, and maintain common or relational databases, where possible; (2) utilize data warehousing technology to provide access to accurate and complete business and portfolio information to facilitate analysis, reporting, and management decision making; (3) bring outsourced systems in house to reduce cost, facilitate integration, and enhance security; (4) implement electronic commerce to eliminate manual efforts, reduce cycle times, and reduce errors; (5) enhance the general ledger system; and (6) develop or enhance management information systems for both multifamily and single family.

During fiscal year 1997, FHA continued its efforts to define the requirements for integrating existing processing systems and implementing a new accounting system to comply with Credit Reform, and provide efficient and centralized access to financial information for reporting and analysis. The new system is an integrated financial and program database designed to capture and account for insurance transactions at the case level as required by Credit Reform. This is in response to HUD's determination that aggressive actions needed to be taken to implement an integrated financial system for the entire Department, including FHA, to resolve a number of long-term financial deficiencies reported by OIG, GAO and independent financial auditors. FHA has aligned its financial integration plan and timetable with HUD's Financial Systems Integration

(FSI) initiative. Under the ISP, FHA has established a process reengineering team dedicated to the Department's FSI initiative.

Specific accomplishments during fiscal year 1997 include:

- HUD revised the plan and timetable for enhancing the budgeting and accounting systems to be in compliance with Credit Reform by the end of fiscal year 1998. Parallel testing will occur during the first and second quarters of fiscal year 1999. These enhancements include budgetary controls, and improve periodic reconciliations and outlay estimates that FHA provides to OMB and Treasury. Selection of a standard general ledger was completed in early 1998 with implementation effective by fiscal year end 1998. HUD plans to have a fully integrated financial management system installed and operational in the 1999 fiscal year.

- FHA began developing an integrated multifamily system that will better monitor the insured and Secretary-held portfolio (including early warning and risk modules). The Multifamily Data Warehouse was implemented in fiscal year 1997 with the deployment of a visual basic application that provides all multifamily users with a user-friendly interface to the warehouse together with a basic query facility. Version 1.1 (an enhancement of v1.0) of the Risk Assessment Management System (RAMS) was released to all of the Multifamily field offices in July 1997, which allows asset managers to manage their respective portfolios and identify troubled or potentially troubled projects. Phase II of RAMS was initiated in June 1997, with completion scheduled for Fiscal Year 1998. Additionally, multifamily is developing the Real Estate Management System to be implemented in 1998. This system will function as comprehensive database of project related information to support management and staff in the field and at Headquarters.

- FHA implemented the upfront module of the Single Family Premium Collection System. Once the periodic module of this system is implemented in fiscal year 1998, FHA will have a unified single family insurance premium billing system and reconciliation module that will replace a number of old and disjointed premium systems, and provide the case level detail required for Credit Reform.

- FHA implemented the Single Family Data Warehouse and expanded the use of electronic commerce activities. The data warehouse allows users to access single family data from eleven different systems and provides information to facilitate analysis and reporting.

- Electronic Data Interchange (EDI) was expanded and is operational for several of FHA's transactions, including the submission of single family claims for insurance benefits, monthly mortgage loan default status reports, and mortgage record changes.

- FHA Connection was implemented during FY 1997, allowing FHA's business partners to transact on-line with FHA via the World Wide Web for the purpose of originating and servicing loans.

HUD also has a number of technology initiatives in process in 1998. These include:

- the Real Estate Assessment Center System (REACS);
- the Development Application Processing system (DAP);
- the Real Estate Management System (REMS); and
- the Annual Financial Statements (AFS) System

Each of these has been discussed in earlier sections of this report.

KPMG's Assessment of Planned and Completed Actions

The goal of FHA's plan is to gradually provide and use more comprehensive and modern financial management systems. It includes consolidated and long-term direction and, when implemented, should provide an integrated database to support financial management and accounting functions. Although some progress has been made, much work needs to be done to implement the plan. While progress continues to be made in adding functionality, future phases of the implementation schedule must be completed to address identified deficiencies and needs.

FHA's inability to quickly develop or acquire more modern information technology will continue to deter its efforts to be a more efficient and effective housing credit provider. Until new information technology is implemented and available throughout the agency, FHA must collect data and develop information in less efficient ways. FHA must aggressively pursue system development, modernization, and improvement.

KPMG's Recommendations

We continue to recommend that FHA:

- Further improve its financial management systems by aggressively monitoring and adhering to the timelines established in its action plans.

- Continue efforts to purify data in its multifamily data warehouse to ensure that users have complete, accurate, and reliable information.

- Ensure users participate fully in systems design and development. Systems integration and development must be a fundamental component of all re-engineering efforts.

Additionally, we recommend that FHA assist HUD in implementing the "Approach to Year 2000" detailed action plan, and continue to assess the impact on FHA specific systems to prioritize their compliance.

KPMG'S CONCLUDING COMMENTS

Many of the issues discussed in this report are not new to FHA or to federal agencies in general. They are "legacy" issues that have compounded in their effects over many years. Significant management efforts are being directed to improvements in these areas. However, progress toward correcting these weaknesses is slow because the issues are multifaceted, interrelated, and require diligent multiyear efforts to resolve. FHA management has responded to the challenge and has developed and implemented action plans that address each of the issues identified in this report.

FHA is changing for the better. We applaud management for its consistency in its efforts to make FHA relevant in, and responsive to, the marketplace. However, with the recent changes in senior management within FHA, the organization must remain focused on the tasks at hand. Although the process is challenging, the steady and diligent actions of past years are beginning to produce results.

FHA MUST CONTINUE ACTIONS TO QUICKLY RESOLVE MULTIFAMILY SECRETARY-HELD MORTGAGE NOTES AND MINIMIZE ADDITIONAL MORTGAGE NOTE ASSIGNMENTS AND NOTE SERVICING RESPONSIBILITIES

Until 1994, the Multifamily and Single Family Secretary-held mortgage note portfolio was growing rapidly. At that time, FHA owned almost 2,400 multifamily mortgage notes with an outstanding principal balance of more than $7 billion, and over 95,000 single family notes with an unpaid principal balance of $4.6 billion. This mortgage note inventory was so large that it compromised FHA's capacity to perform its principal loss prevention functions.

In March 1994, FHA began addressing the Secretary-held inventory by initiating an aggressive program to sell its Secretary-held multifamily and single family mortgages. Under this program, subsidized and unsubsidized multifamily mortgage notes and single family notes were sold to the private sector in a series of asset sales.

During 1996, FHA made progress in reducing the Secretary-held note inventory and as a result, this comment was reclassified from a material weakness in 1995 to a reportable condition in 1996. However, in fiscal year 1997, FHA's progress in further reducing the number of notes in the multifamily Secretary-held note inventory slowed. Therefore, we continue to report the multifamily note area as a reportable condition.

FHA has continued to reduce its single family Secretary-held notes portfolio to under 15,000 notes with an unpaid principal balance of $634 million at the end of 1997, and additional notes are not expected to be received due to legislative program changes. Therefore, comments related to single family Secretary-held notes have been removed from the reportable conditions section of our report and are discussed in more detail in Appendix D - Resolution of Prior Year Reportable Condition.

Multifamily Action Plans and Significant Activities to Improve Note Disposition/Resolution

To further reduce the number of multifamily notes in the Secretary-held portfolio and to minimize the number of multifamily notes assigned to FHA in the future, FHA plans to:

- *Continue Selling Performing and Non-performing Notes.* Since the inception of the note sales program in 1994, FHA has completed several note sales, including two in 1997. FHA does not currently have a financial advisor to conduct additional sales. However, FHA is participating with other agencies and the GSA to establish a contract schedule for financial asset management services. The pre-submission conference for potential offerors was held in March 1998. GSA expects to begin issuing contracts in July 1998. Financial advisors selected through this schedule would assist FHA in conducting future note sales. FHA intends eventually to sell substantially all the Secretary-held notes in its multifamily portfolio.

- *Implement Portfolio Reengineering Demonstration Program.* Approximately 8,500 FHA-insured multifamily projects were financed with 20-year Section 8 project-based rental subsidies from HUD. In fiscal year 1996, project-based Section 8 contracts began to expire. Without Section 8 rental assistance, many FHA-insured projects are at serious risk of default. Failure to act proactively could lead to an increase of mortgage assignments and cost the FHA insurance fund an estimated $11 billion.

  In 1996, FHA received authorization from Congress to start a portfolio reengineering demonstration program on insured projects with expiring Section 8 contracts. In 1997, Congress authorized another portfolio reengineering demonstration program impacting up to 50,000 housing units. The demonstration program is continuing in 1998, and in the Multifamily Assisted Housing Reform and Affordability Act (MAHRA), Congress authorized the permanent implementation of the portfolio reengineering program on a portfolio-wide scale starting in fiscal year 1999.

  MAHRA created the Office of Multifamily Housing Assistance Restructuring (OMHAR) which will be responsible for overseeing all Section 8 mortgage restructuring activities. Once operational (by October 1998), OMHAR will have the ability to use contractors, joint venture partners, and Public Administrative Entities to restructure mortgages with expiring Section 8 contracts as efficiently as possible.

- *Sell Certain Subsidized Mortgage Notes to Public/Private Partnerships Through Trust Structures*. FHA has begun negotiating direct sales of certain subsidized mortgage notes to housing finance agencies and other public entities. FHA is now in the process of developing a revised strategy to sell subsidized notes to public/private partnerships using a trust structure and obtaining the required legislative authority from Congress. The private entity will provide capital and asset management services and the public entity will provide regulatory oversight.

- *Section 221(g)(4) Portfolio Analysis*. Mortgagees may assign Section 221(g)(4) mortgages to FHA at the end of 20 years if the loan is then current. Until recently, FHA had been able to use auction authority to perform reflector sales by keeping the project's insurance in-force and paying interest enhancement expenses to the buyer. FHA contracted with a financial advisor to assess the different alternatives available for Section 221(g)(4) mortgages, and FHA is currently in the process of assessing the options identified in the analysis. However, taking the assignment of Section 221(g)(4) notes and selling them through the note auction program is currently the only option available to FHA.

KPMG's Assessment of Planned and Completed Multifamily Actions

As shown in Exhibit 5, FHA completed two Secretary-held multifamily mortgage note sales during fiscal year 1997, reducing the unpaid principal balance by approximately $984 million (31 percent) from the September 30, 1996 level, to $2.2 billion as of September 30, 1997.

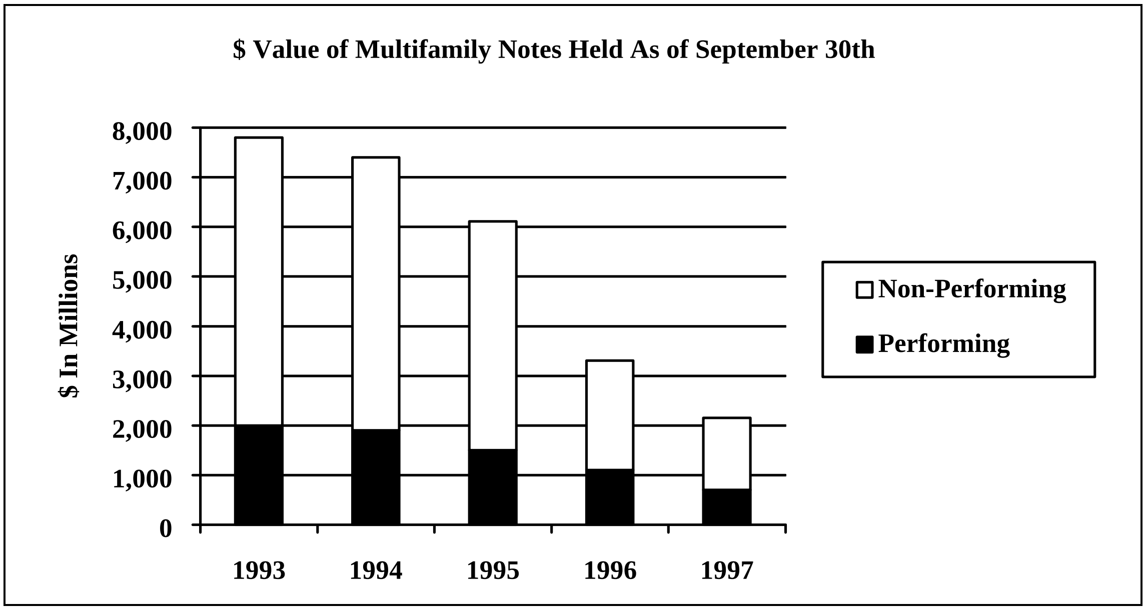
Exhibit 5

Multifamily Note Sales Completed During Fiscal Years 1996 and 1997

Sale	Number of Notes Sold	UPB of Notes Sold
FY 1996		
Non-performing unsubsidized:		
West of Mississippi	152	$ 597 million
North Central	156	847 million
Non-performing subsidized:		
Missouri Housing Finance Agency	26	30 million
Partially Assisted	158	885 million
Total	**492**	**$ 2,359 million**
FY 1997		
Non-performing unsubsidized:		
Midwest	107	$ 873 million
Other:		
Healthcare	30	111 million
Total	**137**	**$ 984 million**

Due to problems experienced with contractors and pending litigation, no other sales were performed during the year, and currently, FHA does not have a financial advisor in place to assist with future sales.

Exhibit 6

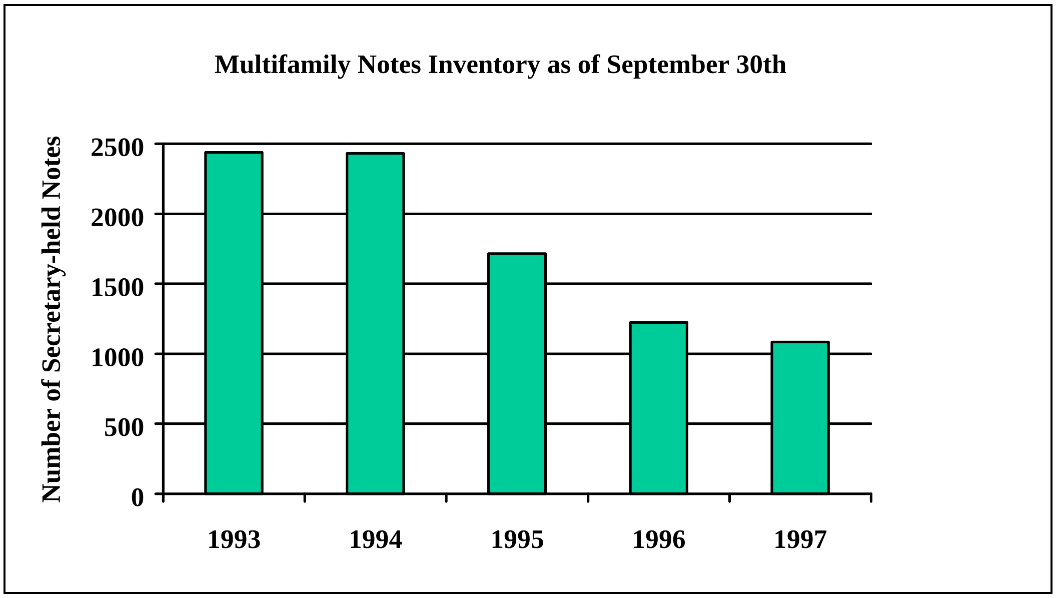


Source: Multifamily Accounting and Reporting System (MARS); Fiscal Year 1995 FHA Management Report

In addition to managing the existing inventory, FHA has a strategy to manage future multifamily claims through the portfolio reengineering program and the development of economic models to manage assignments associated with Section 221(g)(4) notes. The development of these two tools demonstrates Multifamily's commitment to managing future Secretary-held note inventory levels.

Despite the progress made on reducing the value of the Multifamily notes inventory, the total number of notes has not been reduced significantly in recent years as depicted in Exhibit 7. The notes remaining in inventory may be harder to sell because they contain higher risk, partially assisted, and subsidized mortgages, which will require more complicated sales strategies or deep sales discounts. This large number of subsidized loans remaining may require greater effort on the part of project managers to service. Also, despite the strategy developed to manage 221(g)(4) projects, the risk of assignment still exists. There are currently over 3,700 221(g)(4) mortgages outstanding. It is estimated that if interest rates rise to 8.00% or higher, over $7 billion of 221(g)(4) mortgages could be assigned to FHA over the next seven years.

Exhibit 7



Source: Multifamily Accounting and Reporting System (MARS); Fiscal Year 1995 FHA Management Report

KPMG's Multifamily Recommendations

We continue to recommend that FHA:

- Hold mortgage note auctions to reduce its mortgage note inventory.
- Develop a structure to sell subsidized and partially assisted notes to public or private partnerships, and obtain the required authority from Congress.
- Obtain legislative authority to resume auction of section 221(g)(4) notes.
- Aggressively pursue and encourage participation in portfolio reengineering efforts.

FHA MUST SUFFICIENTLY MONITOR AND ACCOUNT FOR SINGLE FAMILY PROPERTY INVENTORY

As reported in fiscal year 1996, FHA has control weaknesses in its single family property acquisition, management, and disposition functions. Factors contributing to this assessment include, but are not limited to:

- Inadequate Field Office oversight of real estate management services, including maintenance and repairs, real estate closing services, and other services provided by contractors, which increases FHA's susceptibility to business risks and losses associated with the property disposition process.

- Input errors, data inconsistencies, and data inaccuracies within the Single Family Asset Management System (SAMS), coupled with system conversion problems, have hindered SAMS use as an efficient property management and accounting system, and rendered information from SAMS unreliable for making decisions relating to Single Family property disposition activities.

- Delayed Field Office recognition and management of newly conveyed properties have resulted in a failure to safeguard FHA's assets and preserve the value of properties.

- SAMS inability to track contract and purchase orders does not (1) ensure payments do not exceed contract limits, and/or (2) prevent the duplicate payment of invoices.

- Failure to perform monthly and annual reviews of vendor listings to confirm the eligibility of vendors for payment of property management services.

- Delayed Field Office reconciliation of property sales proceeds.

- Field Offices deficiencies in monitoring the status of properties in closing proceedings resulted in unsuccessful attempts to close or terminate sales contracts.

- Inadequate oversight of not-for-profit organizations after the purchase of a discounted property through the Direct Sales Program, has the potential for program abuses.

- Inadequate maintenance of case files resulted in missing deeds, title evidence, appraisals, and other pertinent ownership and valuation documentation.

These and other control weaknesses have: (1) decreased FHA's ability to monitor, control, and report accurately on the Single Family Property Division's activities; (2) increased the risk of loss to FHA on the sales of its single family properties as resources may not be safeguarded against waste, loss, or misuse; (3) raised concerns about system reliability as a result of data input errors, data inconsistencies, and incomplete data fields; (4) caused inefficiencies due to the need for expansive clean-up efforts to address data integrity problems; and (5) hindered FHA's objective to reduce inventory in a manner that maximizes the return to the mortgage insurance funds while preserving and protecting residential properties and communities.

Single Family Action Plans and Significant Actions to Improve Monitoring and Oversight of Single Family Property Inventory

FHA has taken the following actions to address these concerns and improve the monitoring and control over its single family property inventory:

- *Reengineer FHA's Property Disposition Function.* As discussed in Appendix A, FHA is evaluating two alternatives to revise its process for managing the disposition of single family properties acquired through conveyances and foreclosures. The alternatives are to: (1) outsource the entire single family property disposition function; or (2) sell the properties through either bulk sales to the private sector or by selling the rights to a stream of future properties. FHA plans to complete the process of identifying a financial advisor and finalize the reengineering of the single family property disposition function prior to fiscal year end 1998. In addition to these two alternatives, legislation was proposed during fiscal year 1998 that, if enacted, would allow FHA to take assignment of single family mortgages upon default, rather than initiating foreclosure and taking the property into inventory. FHA would then sell the note or transfer the note to a third party for servicing, loss mitigation, or foreclosure and property disposition, depending on the circumstances. If enacted, this strategy would not be implemented by FHA before fiscal year 2000.

- *Continue Single Family Real Estate Owned Pilot Contracts.* In fiscal year 1997, FHA began a pilot program to contract out the asset management and property disposition of three Field Offices. FHA evaluated the preliminary results and concluded that the pilot program, thus far, appears to be a valid alternative to FHA's current single family property disposition process. The pilot program has been extended through fiscal year 1998 and subsequent results will be used to evaluate the cost and benefits of contracting these services to the private sector.

- *Confirm Ownership of Aged Inventory.* In August 1996, the Office of Single Family Housing began a nationwide effort to verify the ownership status of its aged inventory and identify erroneous cases listed in SAMS. This effort included reviewing the status of all single family properties owned for more than one year (approximately 2,300 properties at that time) and resulted in approximately 300 invalid case numbers being purged from SAMS. During fiscal year 1998, FHA will again ask the Field Offices to submit a listing of duplicate or erroneous cases that remain in SAMS. Once cases have been researched by headquarters, appropriate action will be taken to purge the cases from SAMS or request additional information from the Field Offices. This effort is expected be completed by the end of fiscal year 1998. In the interim, headquarters will provide additional instructions to the Field Offices to minimize the number of invalid cases manually entered into SAMS.

- *New Releases of SAMS Should Address Data Quality Problems.* FHA has undertaken several initiatives to curb data quality issues in SAMS. Management identified a number of significant SAMS data screens and reports providing incorrect or incomplete case data and will correct the screens and reports in SAMS releases 3.7 through 4.0. The last in the series of SAMS releases is expected to be completed in June 1998. Additionally, FHA is investigating the possibility of automating the interface between the claims system and SAMS, thereby eliminating the need to have the Field Office manually enter this information into SAMS. This analysis will be completed by the Spring of 1998.

KPMG's Assessment of Planned and Completed Single Family Actions

Because FHA is still in the early stages of revising the Single Family property disposition process, evaluating alternatives, and seeking a financial advisor, the possible benefits of the final reengineering plan cannot yet be accurately predicted. FHA's plan to consolidate Single Family asset management and disposition functions to HOC's may cause additional strain during the transition process. The initial confirmation of aged inventory conducted in fiscal years 1996 and 1997 concluded that over 300 properties were erroneously included in SAMS. As these results confirm the possibility that erroneous cases may still exist in SAMS, further action to resolve these discrepancies should be planned in the near term.

KPMG's Single Family Recommendations

We recommend that FHA finalize planned revisions to FHA's asset management and property disposition process. With the assistance of a financial advisor, we recommend FHA continue to evaluate alternatives and ultimately outsource the property management and disposition functions. Once a plan has been devised, FHA should implement the plan promptly and develop oversight tools and reports to effectively and efficiently monitor contractors.

We continue to recommend that, prior to a decision regarding which alternative to pursue, FHA ensure adequate procedures to safeguard its assets and to report accurate and timely financial information and inventory changes are in place. To facilitate that goal, we continue to recommend that FHA:

- Instruct Field Office personnel to verify the accuracy of data in the SAMS system, research possible data entry errors or omissions, and correct inaccurate information.

- Develop procedures that ensure data input by the Field Offices for properties yet to be brought into FHA's portfolio is accurate.

- Enhance current controls or develop procedures to better monitor single family property sales to not-for-profit organizations and the related discounts granted on purchase prices.

- Increase monitoring of contractors responsible for performing property management and closing services to reduce the risk of loss while properties are owned by FHA.

In addition, we recommend that FHA:

- Monitor and resolve delayed sales closings and unreconciled sales proceeds in a timely manner.

- Ensure that proper asset management and disposition functions continue during the transition to FHA's HOC structure.

FHA MUST PERFORM A REVIEW OF PROCESSING CONTROLS FOR ALL COMPUTER SYSTEMS AND PLACE MORE EMPHASIS ON COMPUTER SECURITY.

FHA management must rely heavily on computerized information systems to process the large volume of data required for such a diverse insurance operation. These systems not only process accounting data for functions including insurance 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 errors and unauthorized access.

FHA shares HUD's mainframe EDP systems. In prior year reviews, control weaknesses were noted in FHA's EDP processing environment with respect to overall and application level security that affected the assurance that assets were adequately safeguarded. FHA's systems run in HUD's mainframe environment, which includes both Hitachi and UNISYS mainframe computers. During fiscal year 1997, the HUD has prepared a plan to implement additional security measures for the Hitachi and UNISYS mainframe computers. Further, HUD has made some progress in enhancing overall security. These additional measures should significantly improve security over the mainframe computing environment.

HUD's report on internal controls and compliance with laws and regulations contains a reportable condition regarding the computerized information systems controls that affect FHA's control environment. Presented below are the areas contained in HUD's reportable condition, HUD Needs to Improve System Security and Other Controls. Specific areas affecting FHA that are reported in the HUD report are presented below:

- Security of the Hitachi, Unisys and network environment has improved, but additional measures are needed.
- Disaster recovery for HUD's mainframes has improved but critical tests needs to be conducted.
- Changes to application software must be controlled.
- HUD's ADP Security Division must ensure security administrators attend working group meetings.

HUD is in the process of replacing existing contractors for some of FHA's applications which do not reside on HUD's mainframes. In addition, HUD is enhancing many existing systems as part of its current information strategy plan. As these actions are taking place, we understand that improvements in security and access controls will be undertaken. But until that time, HUD and FHA remain vulnerable to unauthorized access.

KPMG's Recommendations

KPMG recommends, as it has in previous years, that HUD perform application controls reviews for all of the FHA systems, and that these reviews include all aspects of systems access and security controls, and input and processing controls.

KPMG concurs with the recommendations contained in HUD's report on internal controls and compliance with laws and regulations for the computerized information systems reportable condition. Details regarding the recommendations are contained in the HUD report.

COMPLIANCE WITH LAWS AND REGULATIONS

FHA is not in full compliance with data and accounting requirements of the Federal Credit Reform Act of 1990 (Public Law 101-508) (Credit Reform). Specifically, FHA's single family periodic premium collection system does not maintain case-level cash flow data required by Credit Reform. Also, FHA incorrectly paid for some contractor expenses out of financing accounts instead of using program accounts as required by Credit Reform.

Summary of Credit Reform

The major objectives of the Federal Credit Reform Act of 1990 and the implementing Office of Management and Budget (OMB) guidance are to: (1) more accurately measure the costs of federal credit programs; (2) place the cost of credit programs on a budgetary basis; (3) encourage delivery of benefits to beneficiaries; and (4) improve the allocation of resources among credit programs.

To facilitate the measurement and recognition of credit subsidies, losses, and program performance, Credit Reform requires each direct loan and loan guarantee to be categorized into a cohort and a risk category. A cohort (book of business) is defined as all direct loans obligated or loan guarantees committed by a program in the same year, even if the disbursements occur in later fiscal years or if the loan is modified. A risk category (projects with similar risk assessments) is a subdivision of a cohort for loans that are somewhat homogenous in cost, based on the known facts at the time of the obligation or commitment. Risk categories are used to estimate long-term costs, to control budget authority during the budget execution, and to make annual reestimates of costs.

With the assistance and approval of OMB, FHA has developed a new method (called the "balances" approach) for performing reestimates of subsidy cost for its prior year risk categories and cohorts. Unlike current methods described in OMB guidance, the balances approach uses only the projected future cash flows to reestimate credit subsidy from the date of the reestimate. This method allows FHA to obtain an appropriate balance for the estimated future cost of its mortgage insurance programs going forward.

In addition to the classification of direct loans and loan guarantees into cohorts and risk categories, Credit Reform requires that each agency establish budgetary and financing control for each credit program through the use of three accounts: the program account; the financing account; and the liquidating account. The program account receives the appropriation to cover the subsidy cost of a direct loan or loan guarantee program and disburses funds to the financing account. Administrative expenses (including salaries and contractor expenses) are paid out of the program account, and appropriations to fund these expenses are explicitly stated within the budget passed by Congress. The financing account holds balances, receives subsidy cost payment from the credit program account, and includes all other cash flows to and from the government as a result of post-1991 direct loans or loan guarantees. The financing account receives appropriations indirectly through the subsidy rates calculated for FHA's mortgage insurance programs. The liquidating account holds balances and accounts for all cash inflows and outflows related to pre-1992 direct loans or loan guarantees. Credit Reform gives the liquidating account permanent and indefinite authority to incur expenditures related to the pre-1992 portion of the portfolio.

Credit Reform Data Requirements

FHA's single family periodic premium systems cannot generate the required case-specific cash flow data required for reestimating its subsidies in accordance with Credit Reform. Therefore, this data is allocated to cohorts and risk categories using estimates of cash flows (rather than actual cash flows). Credit Reform requires FHA to track the cash flows related to cohorts and risk categories at the case level. FHA maintains all other data used to calculate Credit Reform subsidies at the required case specific level.

FHA's Action Plan

In fiscal year 1996, the Office of the Comptroller developed and proposed a specific multiyear corrective action plan to comply with Credit Reform requirements. This proposed plan was revised in fiscal year 1997, and includes procedures for:

- Maintaining Credit Reform information at the case level;
- Enhancing information systems' capabilities to summarize actual information at the cohort and risk category level and compare performance to budget;
- Strengthening comparability and links between budget and actual data; and
- Improving tools and processes to evaluate portfolio performance at the Credit Reform cohort and risk category levels.

OMB enforces Credit Reform requirements and monitors FHA's credit activities. The proposed action plan was sent to OMB in 1997 for review and approval. Discussions with OMB are ongoing and resolution of this issue is expected during fiscal year 1998.

KPMG's Assessment

If implemented according to the schedule proposed by FHA, systems enhancements to enable collection of case-specific data in the Single Family Premiums Collections System are expected to be completed in fiscal year 1998.

We continue to recommend that FHA work with OMB to obtain approval of its corrective action plan, and implement the plan.

Credit Reform Accounting Requirements

The National Housing Act gives FHA the authority to procure the services of contractors to assist in managing its portfolio, and allows FHA to pay for these services out of cash flows generated from its operations. Prior to the implementation of Credit Reform, all of these expenses were paid from one account that contained all administrative appropriations as well as the appropriations for FHA's insurance operations. With the onset of Credit Reform, and the requirement to track the costs of pre-1992 and post-1991 insured mortgages separately, FHA was required to pay for contractor expenses related to its post-1991 insured mortgages out of its program accounts. FHA incorrectly paid for these contractor expenditures out of its financing accounts. Expenditures were tracked in this manner for both the MMI and GI/SRI funds. FHA believed that the authority given under the National Housing Act allowed for the payment of some contractor expenses from insurance operations (financing account). However, under Credit Reform all contractor expenditures are considered to be administrative and should be accounted for in the program account.

Payment of contractor expenses from financing accounts using assets of the FHA fund affected FHA's calculation of its credit subsidy rates. For the MMI fund, contractor expenses were incorrectly included within the credit subsidy estimation process. Therefore, MMI fund contractor expenses were indirectly included in the annual subsidy calculation. The subsidy rates generated by the calculation were ultimately approved by Congress.

For the GI/SRI fund, contractor expenses were appropriately not included within the credit subsidy estimation process. FHA did not receive direct appropriations to cover contractor expenses incorrectly paid from the financing account. Therefore, under Credit Reform accounting, as contractor expenditures were paid, the financing account was under-funded. Contractor payments made out of the GI/SRI financing account for fiscal years 1997 and 1996 totaled $24 million and $28 million, respectively.

FHA's Action Plan

Upon discovery of the non-compliance, FHA, the HUD-CFO's Office, and OMB developed a plan to comply with the accounting requirements of Credit Reform for fiscal year 1998 and subsequent years. Because contractor expenditures were considered in the development of the fiscal year 1998 subsidy rates for the MMI fund, these contractor expenditures will be made out of the financing account for the remainder of the year. For the GI/SRI fund, a reapportionment was made in early fiscal year 1998 to allow for payment of contractor expenses out of the program account. Both MMI and GI/SRI fiscal year 1998 appropriation balances were restated for the fiscal year 1999 budget submission. Starting in fiscal year 1999, all future appropriations for contractor expenses will be included in the budget approval process and paid out of the program account. Additionally, starting with the fiscal year 1999 budget submission, the MMI fund's subsidy calculation no longer considers contractor expenses. The fiscal year 1997 under-funding of the financing account that occurred under Credit Reform accounting for the GI/SRI fund will be corrected through the balances approach used by FHA to reestimate its subsidy cost for prior year cohorts.

KPMG's Assessment

Credit Reform and the National Housing Act include differing concepts as to whether contract services should be considered general overhead (administrative costs) or whether contract services are assignable to a specific FHA function and therefore eligible for payment from FHA funds. HUD has requested guidance from the Office of Counsel of the Comptroller General of the United States regarding whether certain contract services are eligible for payment using FHA funds. In addition, the OMB approved plan to correct FHA's credit reform accounts in fiscal year 1999 is dependent upon Congressional authorization and appropriation of approximately $304 million. These funds will cover the cumulative non-administrative contract payments made from both the MMI and GI/SRI funds by FHA since the beginning of Credit Reform. The ultimate resolution of these matters cannot be determined and could affect FHA's compliance with laws and regulations.

FHA HAS RESOLVED SINGLE FAMILY SECRETARY-HELD MORTGAGE NOTES AND ELIMINATED THE POSSIBILITY OF ADDITIONAL MORTGAGE NOTE ASSIGNMENTS

Significant accomplishments have been achieved in reducing the single family Secretary-held notes portfolio by over 85 percent from the portfolio high in 1995. This significant reduction in the note portfolio was accomplished through five individual note sales in fiscal years 1996 and 1997. Furthermore, in 1997, legislative action was taken to terminate the mortgage assignment program which has resulted in limiting FHA's exposure to accepting new mortgage assignments into the portfolio. Because FHA has significantly reduced the note portfolio and additional notes are not expected to be received, our comments related to the single family Secretary-held notes have been removed from the reportable conditions section of our report. This section documents the significant accomplishments achieved in reducing the single family Secretary-held notes portfolio which led us to that conclusion.

Single Family Action Plans and Significant Actions to Improve Note Disposition/Resolution

FHA has made significant progress in recent years to resolve the operational inefficiencies resulting from its ownership, processing, and servicing of single family mortgage notes primarily through the note sales program. The servicing of the defaulted mortgage notes required considerable staff time, was not within FHA's principal line of business or mission (providing mortgage insurance and fostering home ownership opportunities), and diverted scarce resources from monitoring the insured portfolio and mitigating losses to FHA.

FHA has significantly reduced its single family notes portfolio in recent years through: (1) a series of note sales to the private sector; and (2) the termination of the assignment program in September 1997. In fiscal years 1996 and 1997, FHA completed five single family note sales that resulted in the reduction of 82,800 notes with an unpaid principal balance of $4,333 million from the note portfolio. Furthermore, in August 1997, the Balanced Budget Act of 1997 extended the legislation to indefinitely eliminate eligibility for the assignment program for loans insured. The termination of the assignment program should significantly reduce the number of notes taken into the portfolio in future years.

To further reduce the portfolio of Secretary-held single family mortgage notes and better service the remaining portfolio, FHA's Office of Single Family Housing plans to:

- *Continue sales of single family Secretary-held notes.* In March 1994, FHA began an aggressive program to sell substantially all of its Secretary-held single family mortgage notes. An additional note sale is planned for fiscal year 1998.

- *Improve asset management for the remaining mortgage note portfolio by consolidating servicing activities.* During fiscal year 1997, FHA started to consolidate the single family note servicing functions into the Denver HOC and the Fort Worth and Salt Lake City Field Offices. Upon the completion of a note sale in fiscal year 1998, FHA plans to consolidate all remaining single family note servicing functions to the Oklahoma City Office. The Oklahoma City office will assist in loss mitigation efforts. After the note sale in fiscal year 1998, FHA plans to review the remaining notes in inventory to identify low balance notes, notes with credit balances, and other notes that should be considered for removal from the note portfolio.

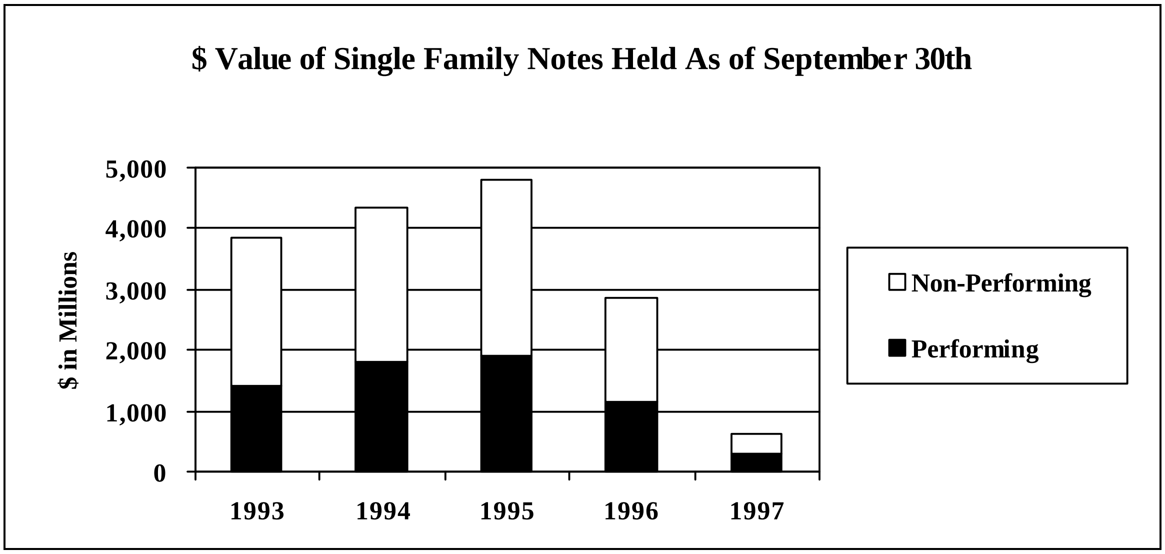
KPMG's Assessment of Planned and Completed Single Family Actions

During fiscal years 1996 and 1997, FHA completed the following Secretary-held single family mortgage note sales:

Sale	Number of Notes Sold	Unpaid Principal Balance of Notes Sold
FY 1996		
1	12,981	$522 million
2	16,196	741 million
3	16,967	803 million
Total	46,144	$2,066 million
FY 1997		
4	18,879	$1,130 million
5	17,821	$1,137 million
Total	36,700	$2,267 million

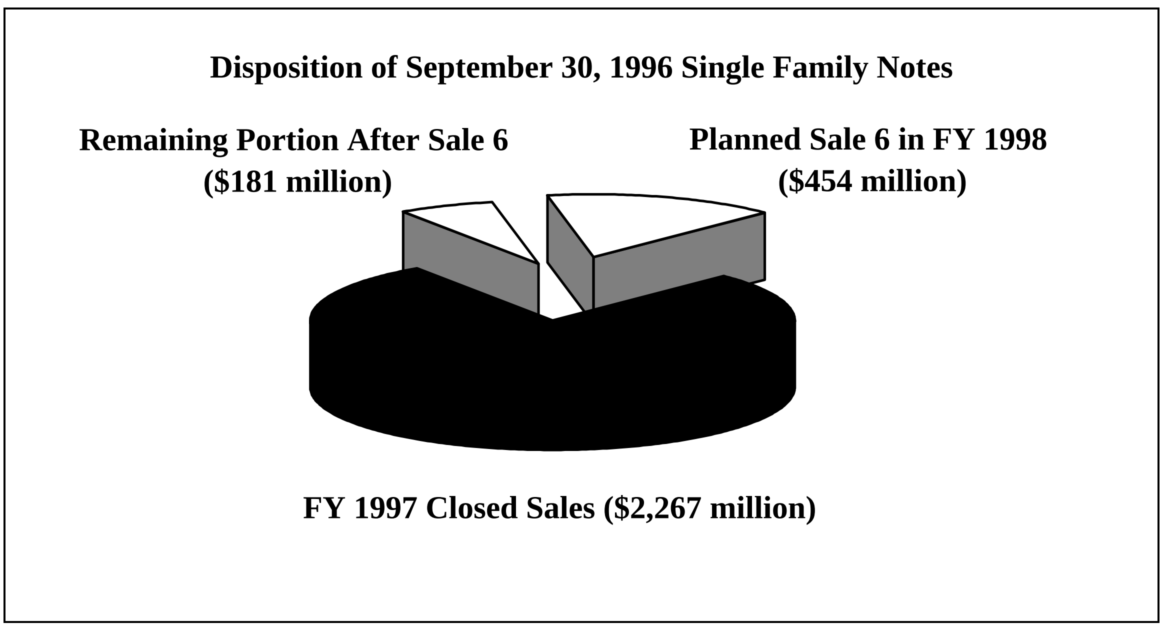
As shown above and in Exhibits 8 and 9 below, the single family mortgage note sales completed during fiscal years 1996 and 1997 reduced the single family note portfolio significantly. The single family notes portfolio decreased approximately $2,267 million (78 percent) from the September 30, 1996 level. Another note sale in fiscal year 1998 is expected to reduce the note portfolio by 7,400 notes with unpaid principal balances of $454 million, which should reduce the number of notes to less than 8,000 notes with an unpaid principal balance of $181 million. Although FHA does not have a financial advisor to assist with the note sale process at this point in time, the procurement process is underway to identify organizations that can provide the needed financial advisory services. The next note sale is expected to be held in the fourth quarter of fiscal year 1998.

Exhibit 8



Source: Single Family Notes Accounting and Reporting System

Exhibit 9



Source: Office of Single Family Housing

Progress has clearly been made in reducing the portfolio of Secretary-held single family mortgage notes, and plans are in place to continue the note sales program.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
SEPTEMBER 30, 1997 AND 1996
(Dollars in Millions)

	1997	1996
ASSETS:		
Fund Balances at the U.S. Treasury:		
Non-Interest Bearing	$ 3,423	$ 5,608
Interest Bearing	759	1,542
Total Fund Balances at the U.S. Treasury	4,182	7,150
Investments in U.S. Government Securities (Note 3)	13,220	7,661
Foreclosed Property Held for Sale, Net (Note 4)	1,471	1,162
Mortgage Notes Held for Sale, Net (Note 5)	1,172	3,971
Other Assets and Receivables	790	577
Total Assets	$ 20,835	$ 20,521
LIABILITIES AND GOVERNMENT EQUITY (DEFICIENCY):		
Claims Payable	$ 399	$ 664
Loss Reserves (Note 6)	13,149	12,986
Unearned Premiums (Note 7)	7,221	6,931
Debentures Issued to Claimants (Note 8)	68	82
Accounts Payable, Accrued Expenses, and Other Liabilities	369	424
Borrowings from the U.S. Treasury (Note 10)	3,639	3,123
Distributive Shares and Premium Refunds Payable	180	154
Total Liabilities	$ 25,025	$ 24,364
Government Equity (Deficiency) (Note 9):		
Mutual Funds Equity	$ 2,662	$ 2,526
Subsidized Funds Cumulative Losses	(21,197)	(21,043)
Appropriated Capital	14,345	14,674
Total Government Deficiency	$ (4,190)	$ (3,843)
Commitments and Contingencies (Notes 11, 12, and 13)		
Total Liabilities and Government Deficiency	$ 20,835	$ 20,521

The notes to the financial statements are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENTS OF OPERATION
FOR THE YEARS ENDED SEPTEMBER 30, 1997 AND 1996
(Dollars in Millions)

	1997	1996
REVENUES:		
Premiums:		
Annual Premiums	$ 1,281	$ 1,084
Earned Portion of Up-front Premiums	1,205	1,058
Total Premiums Earned	2,486	2,142
Interest Income	1,058	978
Other Revenues	115	70
Total Revenues	$ 3,659	$ 3,190
EXPENSES:		
Change in Loss Reserves	$ 163	$ 1,921
Provision for Losses on Properties Held for Sale	2,232	1,975
Provision for Losses on Mortgage Notes Held for Sale	308	(819)
Gain on Sale of Mortgage Notes	(92)	(187)
Salary and Administrative Expenses	723	683
Interest Expense	255	216
Other Expense	87	19
Total Expenses	$ 3,676	$ 3,808
Deficiency of Revenues over Expenses	$ (17)	$ (618)
Government Deficiency, Beginning of Year	(3,843)	(3,285)
Distributive Shares Paid	(1)	(1)
Appropriations, Net	(329)	61
Government Deficiency, End of Year	$ (4,190)	$ (3,843)

The notes to the financial statements 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 GOVERNMENT EQUITY (DEFICIENCY)
FOR THE YEARS ENDED SEPTEMBER 30, 1997 AND 1996
(Dollars in Millions)

	Cumulative Results of Operations		Appropriated Capital		
	Mutual Funds Equity	Subsidized Funds Cumulative Losses	Pre-Fiscal 1992	Post-Fiscal 1991	Equity Total
Balance, September 30, 1995	$ 1,871	$ (19,769)	$ 14,628	$ (15)	$ (3,285)
(Deficiency) Excess of Revenues over Expenses	656	(1,274)	0	0	(618)
Distributive Shares Paid	(1)	0	0	0	(1)
Credit Appropriations Received to Finance:					
Credit subsidies on 1996 mortgages	0	0	0	152	152
Credit subsidies as a result of asset sales	0	0	0	533	533
Administrative expenses	0	0	0	202	202
Resources Returned to Treasury:					
On insured 1996 mortgages	0	0	0	(142)	(142)
As a result of re-estimates	0	0	0	(110)	(110)
As a result of modifications	0	0	0	(40)	(40)
As a result of modifications due to asset sales	0	0	0	(533)	(533)
As a result of budget recissions	0	0	0	(1)	(1)
Balance, September 30, 1996	$ 2,526	$ (21,043)	$ 14,628	$ 46	$ (3,843)
(Deficiency) Excess of Revenues over Expenses	$ 137	$ (154)	$ 0	$ 0	$ (17)
Distributive Shares Paid	(1)	0	0	0	(1)
Credit Appropriations Received to Finance:					
Credit subsidies on 1997 mortgages	0	0	0	95	95
Administrative expenses	0	0	0	207	207
Resources Returned to Treasury:					
On insured 1997 mortgages	0	0	0	(142)	(142)
As a result of re-estimates	0	0	0	(25)	(25)
As a result of modifications	0	0	0	(80)	(80)
As a result of modifications due to asset sales	0	0	0	(384)	(384)
Balance, September 30, 1997	$ 2,662	$ (21,197)	$ 14,628	$ (283)	$ (4,190)

The notes to the financial statements are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED SEPTEMBER 30, 1997 AND 1996
(Dollars in Millions)

	1997	1996
CASH FLOWS FROM OPERATING ACTIVITIES:		
Deficiency of Revenues over Expenses	$ (17)	$ (618)
Adjustments to Reconcile Deficiency of Revenues to		
Net Cash Provided by Operating Activities:		
Provision for Losses on Properties and Mortgage Notes Held for Sale	2,540	1,156
Amortization of U.S. Government Securities	(144)	(57)
Gain on Sales of Mortgage Notes	(92)	(187)
Change in Assets and Liabilities:		
Claims Settlement Payments	(6,131)	(5,542)
Collections of Principal on Notes Acquired in Claims Settlement	187	232
Proceeds from Disposition of Assets Acquired in Claims Settlement	5,986	6,534
Increase in Other Assets	(213)	(33)
(Decrease) Increase in Claims Payable and Other Liabilities	(294)	93
Increase in Loss Reserves	163	1,921
Up-front Premiums Collected	1,789	1,722
Up-front Premiums Earned	(1,205)	(1,058)
Up-front Premiums Refunded	(294)	(418)
Net Cash Provided by Operating Activities	$ 2,275	$ 3,745
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of U.S. Government Securities	$ (18,596)	$ (7,655)
Maturity of U.S. Government Securities	13,181	6,657
Net Cash Used by Investing Activities	$ (5,415)	$ (998)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Borrowings from U.S. Treasury	$ 592	$ 1,616
Repayment of Borrowings from U.S. Treasury	(76)	(140)
Appropriated Capital	302	887
Return of Appropriated Capital	(631)	(826)
Issuance of Debentures to Claimants	47	65
Payment of Debentures to Claimants	(61)	(70)
Participant Distributive Shares Paid	(1)	(1)
Net Cash Provided by Financing Activities	$ 172	$ 1,531
Net (Decrease) Increase in Cash and Cash Equivalents	$ (2,968)	$ 4,278
Cash and Cash Equivalents, Beginning of Year	7,150	2,872
Cash and Cash Equivalents, End of Year	$ 4,182	$ 7,150

The notes to the financial statements are an integral part of these statements.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 1997 AND 1996

Note 1. Description of Entity and Significant Accounting Policies

Entity and Mission

The Federal Housing Administration (FHA) was established in 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 some 40 active mortgage insurance programs, thereby making mortgage financing more accessible to the home-buying public. Its programs are designed primarily to serve first-time home buyers and provide affordable multifamily housing.

The FHA programs are organized into four major Funds: (1) the Mutual Mortgage Insurance Fund (MMI), FHA's largest Fund, provides basic single family mortgage insurance and is a mutual insurance fund, whereby mortgagors, upon non-claim termination of their mortgages, share surplus premiums paid into the MMI Fund that are not required for operating expenses and losses or to build equity; (2) the Cooperative Management Housing Insurance Fund (CMHI), also a mutual fund, provides mortgage insurance for management-type cooperatives; (3) the General Insurance Fund (GI) provides for a large number of specialized mortgage insurance programs, 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) 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 be operated in accordance with "sound actuarial and accounting practice"; therefore, borrowers are charged a premium that is designed to cover default losses and administrative expenses, and to provide equity. These Funds are not to be dependent upon appropriations to sustain operations. The GI and SRI Funds, however, are not to be self-sustaining, and as a result, are dependent on appropriations from Congress.

FHA categorizes its activities as either single family, multifamily, or Title 1. Single family activities support basic home ownership programs, multifamily activities support basic high density housing and medical facility programs, and Title1 activities support manufactured housing and home improvement programs.

Basis of Accounting

The Consolidated Statements of Financial Position, Statements of Operations, Statements of Changes in Government Equity (Deficiency), and Statements of Cash Flows have been prepared in accordance with generally accepted accounting principles. All material interfund transactions and balances have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported. Actual results will invariably differ from those estimates.

Fund Balances at the U.S. Treasury

Prior to the Federal Credit Reform Act of 1990 (Credit Reform) which is discussed in Note 10, cash generated from insurance endorsements, and not needed for short-term operating purposes, was invested in non-marketable U.S. Government Securities with terms similar to Government Securities that are publicly marketed. Substantially all of FHA's cash receipts and disbursements are processed by the U.S. Treasury through either interest-bearing or non-interest-bearing accounts. All cash generated from insurance endorsed on or after October 1, 1991, is deposited in an interest-bearing account in accordance with Credit Reform. The account earns interest similar to that paid on U.S.

Government Securities with maturity intervals of ten years or longer. The non-interest-bearing account is comprised of uninvested cash emanating from insurance endorsed prior to October 1, 1991 (pre-Credit Reform).

Investments in U.S. Government Securities

FHA categorizes its investment portfolio according to its ability and intent to hold the investments to maturity. Since FHA management believes it has both the ability and positive intent to hold its securities to maturity, investments in U.S. Government Securities are reported at amortized cost (see Note 3). Amortization of premiums and discounts is recognized on a straight-line basis throughout the year.

Mortgage Notes Held for Sale

Prior to April 1996, under certain conditions prescribed by law, FHA would take assignment of insured single family mortgages which were in default rather than acquire the related properties through foreclosure. Single family mortgages 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 mortgage could be brought current in the future.

During 1996, Congress mandated that FHA discontinue the single family assignment program and develop and implement a loss mitigation program to reduce claims and related costs. During fiscal year 1997, FHA continued to take single family assignments on those defaulted mortgage notes that were in process at the time the assignment program was terminated.

Multifamily mortgages 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 (see Note 13).

Mortgage notes held for sale are recorded at the lower of cost or fair value. Fair value is estimated based on 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. Mortgage notes held for sale are reported net of the allowance for loss and any unamortized discount. The estimate for the allowance on mortgage notes held for sale is based on historical loss rates and recovery rates resulting from asset sales and property recovery rates, net of cost of sales (see Note 5).

Foreclosed Property Held for Sale

Foreclosed property is obtained in connection with claims settlement. It is reported net of an allowance for loss, which is established to reduce the property carrying value to its fair value less cost of sales. The estimate for the allowance on foreclosed property held for sale is based on historical loss rates and recovery rates resulting from property sales, net of the cost of sales (see Note 4). Foreclosure holding and disposition costs are charged to operations as incurred.

Loss Reserves

Loss reserves for single family insured mortgages are recorded by FHA in the MMI, GI and SRI Funds for defaults that have taken place, but where claims have not yet been filed. Loss reserves for multifamily insured mortgages are recorded in the GI, SRI, and CMHI Funds when defaults are considered probable but have not been reported to FHA (see Note 6).

Premiums and Unearned Revenue

Premiums charged by FHA for single family mortgage insurance provided by its MMI Fund include up-front and risk-based annual premiums. The risk-based annual premiums are recognized on a straight-line basis throughout the year. Up-front 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 (see Note 7).

FHA's other activities, including most of those conducted through the multifamily GI and SRI Funds, charge periodic premiums over the mortgage insurance term. Premiums on annual installment policies are recognized on a straight-line basis throughout the year.

Appropriations, and Funds Received from Other HUD Programs

The GI and SRI Funds were not designed to be self-sustaining. As a result, the National Housing Act, as amended, provides for appropriations from Congress to finance the operations of these Funds.

The Credit Reform Act of 1990 changed the method by which FHA receives appropriations from Congress. Beginning in fiscal year 1992, 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. The revised appropriation structure also authorizes permanent indefinite appropriation authority to finance the cash requirements of operations resulting from endorsements in years prior to fiscal year 1992.

Funds received from other HUD programs, such as interest subsidies and rent supplements, are recorded as revenue when services are rendered.

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 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 (see Note 9). Although the capitalization requirements were met at September 30, 1997 and 1996, no distributive shares were declared in those years. The National Affordable Housing Act does not affect the distributions from the CMHI Fund.

Fair Values of Financial Instruments

The fair value of a financial instrument is defined as the amount at which the instrument could be exchanged in a current transaction between willing parties.

The fair value and amortized costs of FHA's Investments in U.S. Government Securities (see Note 3), Mortgage Notes Held for Sale (see Note 5), and Debentures Issued to Claimants (see Note 8), are disclosed in the related footnotes.

FHA's loan guarantees resulting from its mortgage insurance programs are considered financial instruments. The fair value of FHA's mortgage insurance instruments are based on discounted cash flow calculations, considering historical data and expected future claim and loss experience, adjusted for judgments concerning general and regional economic conditions and mortgage collateral values. The recorded loss reserves for the GI and SRI Funds represent the estimated fair values of FHA's liabilities for this insurance. Actual results may differ, perhaps significantly, from the estimates.

The MMI Fund receives both up-front premiums and monthly premiums on its mortgage insurance instruments. The Fund currently holds $13.7 billion in cash and investments that are available to offset the liabilities for the loan guarantees.

The carrying value of the MMI Fund mortgage insurance is a combined liability of $9.6 billion, consisting of liabilities for losses and loss adjustments expenses of $2.6 billion and unearned premiums of $7.0 billion. Based on discounted future cash flows, the fair value of the MMI Fund loan guarantees is estimated to be $1.3 billion. Both the recorded liabilities and the estimated fair value of the loan guarantees exclude substantial assets FHA has already received in exchange for these guarantees.

Given the assets on hand and future cash flows, as indicated in the discussion of the capital ratio, the MMI Fund is projected to remain financially self sufficient. The discussion of the capital ratio and economic net worth of the MMI Fund is disclosed in Note 9.

The estimated fair value of FHA's borrowings from the U.S. Treasury approximate their carrying value because the weighted average of the stated interest rates at September 30, 1997 and 1996, approximated the U.S. Treasury borrowing rates at those dates.

The carrying values for all other financial statement line items (Fund Balances at the U.S. Treasury; Other Assets and Receivables; Claims Payable; Accounts Payable, Accrued Expenses, and Other Liabilities; and Distributive Shares and Premium Refunds Payable) approximate the estimated fair values for those instruments, due to their short-term nature.

Reclassifications

Reclassifications were made to the 1996 financial statements to conform with the presentation used in 1997. The changes in classifications have no effect on previously reported net income.

Note 2. Intragovernmental Financial Activities

FHA is not a separate federal entity. It is an integral part of the operations of HUD and is, therefore, subject to the financial decisions and management controls of the Secretary of HUD. Similarly, FHA is also subject to the directives and financial decisions of the Office of Management and Budget (OMB).

Rent Supplements and Interest Subsidies

HUD provides rent supplements and interest subsidies to lenders on behalf of certain eligible mortgagors and/or occupants of single and multifamily properties which FHA insures, or for which it holds the mortgage. In cases where FHA holds the mortgage, FHA receives any benefit payments directly from HUD on behalf of those individuals who are repaying the loan or occupying the property.

During fiscal years 1997 and 1996, FHA received the following interest subsidy and rent supplement payments from HUD (dollars in millions):

Description	1997	1996
Multifamily Notes-Interest Subsidy	$35	$36
Rental Supplements For Low And Very Low Income Families	4	9
Total	$39	$45

Amounts receivable from HUD as of September 30, 1997 and 1996, for the above assistance programs are not material.

To the extent FHA-insured mortgagors receive rent supplement payments and/or interest subsidy, FHA benefits indirectly since these assistance payments will reduce the risk of the mortgagors failing to repay the FHA-insured loans.

With respect to rent supplement payments, it is estimated that during fiscal year 1997, approximately 54% of projects with FHA-insured loans (accounting for 35% of the insured unpaid principal balance) of the GI/SRI Funds received rent supplement payments from HUD. Such payments accounted for approximately 59% of the aggregate rent revenue received by these projects.

With respect to interest subsidy payments, lenders for approximately 20% of insured mortgages (accounting for 9% of the insured unpaid principal balance) of the GI/SRI Funds receive such subsidies under the Section 236 program. During fiscal year 1997, interest subsidy payments amounted to approximately 63% of the aggregate mortgage payments on these insured mortgages.

Administrative Expenses Reimbursed to HUD

HUD is reimbursed by FHA for personnel, property and equipment, and administrative services costs, since virtually all FHA operations are performed by HUD personnel. For fiscal years 1997 and 1996, the reimbursements totaled $558 million and $544 million, respectively. These annual reimbursements are budgeted amounts approved by Congress each fiscal year. They are based on the estimated staff levels used to carry out FHA activities, not the time actually worked by HUD personnel on these activities.

All permanent employees participate in the contributory Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS) which became effective January 1, 1987. Temporary employees and employees participating in FERS are covered under the Federal Insurance Contributions Act (FICA). FHA reimburses HUD for matching contributions to the CSRS, FERS and FICA. FHA also reimburses HUD for matching contributions to the Thrift Savings Plan component of FERS up to 5% of basic pay but has no liability for future payments to employees under these programs. In addition, all permanent employees are eligible to participate in the contributory Federal Employees Health Benefit Program (FEHBP) and may continue to participate after retirement. Furthermore, FHA reimburses HUD for matching contributions to the FEHBP for active employees but is not responsible for contributions on behalf of retirees.

Note 3. Investments in U.S. Government Securities

FHA's investment portfolio consists of non-marketable U.S. Government Securities. FHA categorizes its investment portfolio according to its intent and ability to hold its investments. FHA management has demonstrated, through both policy and performance, its ability to hold its investments to maturity. Accordingly, investments are reported at amortized cost. The following tables summarize investments in U.S. Government Securities as of September 30, 1997 and 1996 (dollars in millions).

Investments in U.S. Government Securities as of September 30, 1997

Maturity	Weighted Average Interest Rate	Purchase Price	Par Value	Amortized Cost	Fair Value	Unrealized Gain /(Loss)	Unamortized Discount / (Premium)
One Year or Less	6.31%	$ 913	$ 923	$ 922	$ 925	$ 3	$ 1
After One Year Through Five	6.19%	2,857	2,901	2,879	2,924	45	22
After Five Years Through Ten	6.13%	6,449	6,613	6,463	6,579	116	150
After Ten Years Through Fifteen	9.30%	626	619	621	727	106	(2)
After Fifteen Years	6.28%	2,332	2,411	2,335	2,348	13	76
Total		**$ 13,177**	**$ 13,467**	**$ 13,220**	**$ 13,503**	**$ 283**	**$ 247**

Investments in U.S. Government Securities as of September 30, 1996

Maturity	Weighted Average Interest Rate	Purchase Price	Par Value	Amortized Cost	Fair Value	Unrealized Gain / (Loss)	Unamortized Discount / (Premium)
One Year or Less	6.39%	$ 1,680	$ 1,698	$ 1,697	$ 1,712	$ 15	$ 1
After One Year Through Five	6.18%	2,474	2,513	2,494	2,516	22	19
After Five Years Through Ten	6.21%	2,427	2,472	2,431	2,402	(29)	41
After Ten Years Through Fifteen	8.68%	989	985	986	1,095	109	(1)
After Fifteen Years	7.25%	51	62	53	62	9	9
Total		**$ 7,621**	**$ 7,730**	**$ 7,661**	**$ 7,787**	**$ 126**	**$ 69**

Investment income was $673 million and $542 million for the years ended September 30, 1997 and 1996, respectively, and is included in interest income on the Consolidated Statements of Operations.

FHA's interest-bearing account at the U.S. Treasury earns interest at rates established by Treasury for Credit Reform accounts. The rates are based on the maturity of mortgage loans FHA insures. Accordingly, FHA earns interest based on a maturity interval of ten years and longer and earned interest at a weighted average rate of 7.18% for fiscal year 1997 and 7.14% for fiscal year 1996. There are no penalties if FHA must use the cash in this account over a shorter period to finance credit losses from post-fiscal year 1991 insurance endorsements.

Interest income on interest-bearing accounts at the U.S. Treasury was $126 million and $163 million for the years ended September 30, 1997 and 1996, respectively.

Note 4. Foreclosed Property Held for Sale

Foreclosed property held for sale was comprised of the following classes of property at September 30, 1997 and 1996 (dollars in millions):

Description	1997	1996
Single Family Properties		
Balance, Beginning of Year	$1,860	$1,806
Acquisitions, Net	5,482	4,687
Dispositions, Net	(4,907)	(4,633)
Balance, End of Year	$2,435	$1,860
Multifamily Properties	355	490
Total Properties	2,790	2,350
Allowance for Losses	(1,319)	(1,188)
Property, Net	$1,471	$1,162

Changes in the allowance for losses on property for the years ended September 30, 1997 and 1996, were as follows (dollars in millions):

Description	1997	1996
Balance, Beginning of Year	$1,188	$1,121
Provision for Losses Charged to Operations	2,232	1,975
Realized Losses on Property Disposal	(2,101)	(1,908)
Balance, End of Year	$1,319	$1,188

Realized losses on the disposal of foreclosed property, for each fund, for the years ended September 30, 1997 and 1996, were as follows (dollars in millions):

Fund	1997	1996
MMI	$1,492	$1,355
CMHI	0	0
GI	535	502
SRI	74	51
Total	$2,101	$1,908

Note 5. Mortgage Notes Held for Sale

Mortgage notes held for sale was comprised of the following classes of notes at September 30, 1997 and 1996 (dollars in millions):

Description	1997	1996
Performing		
Single Family	$292	$1,158
Multifamily	1,084	1,049
Title I	20	18
Total Performing	1,396	2,225
Nonperforming		
Single Family	385	1,865
Multifamily	1,172	2,210
Title I	336	276
Total Nonperforming	1,893	4,351
Total Mortgages	3,289	6,576
Unearned Discount	(204)	(247)
Allowance for Losses	(1,913)	(2,358)
Total Unearned Discount & Allowance for Losses	(2,117)	(2,605)
Total Mortgages, Net	$1,172	$3,971

Most of the mortgage notes held were assigned to FHA when mortgagors defaulted. Lenders holding defaulted multifamily mortgages may make mortgage insurance claims by assigning the mortgages to FHA. In addition, prior to April 1996, FHA would take assignment of single family notes when defaults resulted from temporary hardship conditions. However, during 1996, Congress mandated that FHA discontinue the single family assignment program and develop and implement a loss mitigation program to reduce defaults and related costs. FHA continues to take assignment on those defaulted mortgage notes that were in process at the time the assignment program was terminated. In addition, performing single family and multifamily notes insured pursuant to Section 221(g)(4) of the National Housing Act may be assigned automatically to FHA at a pre-determined point (see Note 13).

Mortgages acquired at interest rates below the market rate are recorded at a discount. This discount reduces the value of the mortgages such that the effective interest rate approximates the market interest rate in the year of acquisition. The weighted average nominal interest rates for all mortgages are 9.05% on single family notes; 6.85% on multifamily notes; and 5.85% on Title I notes. The effective interest rates at September 30, 1997, after discounting are 9.30% on single family notes; 9.71% on multifamily notes; and 5.85% on Title I notes. Mortgages which are considered current but which are under forbearance agreements comprise approximately $278 million of the entire single family portfolio. The amount of multifamily notes under workout agreements is $134 million.

Interest income on performing mortgage notes was $253 million and $271 million for the years ended September 30, 1997 and 1996, respectively. If interest on the nonperforming mortgages had been accrued, that interest income would have approximated $228 million for the year ended September 30, 1997, and $491 million for the year ended September 30, 1996.

Changes in the allowance for losses and unearned discounts on mortgage notes held for sale for the years ended September 30, 1997 and 1996, were as follows (dollars in millions):

Description	1997	1996
Balance, Beginning of Year	$2,605	$4,963
Provision for Losses Charged to Operations	308	(819)
Realized Losses & Write Offs, Net of Recoveries	(796)	(1,539)
Balance, End of Year	$2,117	$2,605

Escrow funds held by FHA were $198 million as of September 30, 1997, and $238 million as of September 30, 1996. Escrow advances for mortgage notes held, net of allowance for loss, were $58 million and $69 million as of September 30, 1997 and 1996, respectively.

FHA foreclosure costs during fiscal years 1997 and 1996 totaled $385 million and $550 million, respectively. The unpaid principal balance on pending foreclosures was $328 million for fiscal year 1997 and $674 million for fiscal year 1996.

During fiscal year 1997, FHA conducted four mortgage note sales, which are summarized below (dollars in millions):

	No. of Sales	Mortgage Notes Sold	Gross Sales Proceeds	Gain on Sales
Single Family	2	36,700	$2,061	$ 51
Multi-family	2	137	$839	$41

In fiscal year 1996, FHA conducted ten mortgage note sales, the more significant of which are summarized below (dollars in millions):

	No. of Sales	Mortgage Notes Sold	Gross Sales Proceeds	Gain on Sales
Single Family	3	46,144	$1,740	$ 78
Multi-family	5	493	$1,637	$109

One of the 1996 multifamily mortgage notes sales was accomplished through 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% equity interest in subordinate class B trust certificates recorded at $60 million. FHA has no guarantees resulting from this transaction and risk of loss is limited to the trust certificates held. The $60 million equity interest at September 30, 1997 and 1996, is included in the Other Assets and Receivables line of the Consolidated Statements of Financial Position. The fair value of this equity interest was $78 million at September 30, 1997.

Note 6. Loss Reserves

Loss reserves for claims and the related loss adjustment expenses (LAE) for processing claims for single family, multifamily, and Title I mortgages, were as follows as of September 30, 1997 and 1996 (dollars in millions):

Fund	Loss Reserve	LAE Reserve	1997 Total	1996 Total
MMI	$ 2,452	$121	$ 2,573	$2,235
CMHI	27	0	27	6
GI	8,222	214	8,436	9,426
SRI	2,069	44	2,113	1,319
Total	$12,770	$379	$13,149	$12,986

The MMI Fund records loss reserves to provide for anticipated losses incurred by FHA to pay claims on insured mortgages where defaults have taken place but where claims have not yet been filed. The reserve is estimated based on historical claim and loss experience data, adjusted for judgments concerning current economic factors. Management believes the loss reserves and loss adjustment expenses are adequate to cover the ultimate net cost of unreported single family claims arising from losses which had occurred by fiscal year end.

Discounted amounts for the loss reserves for claims in the GI and SRI Funds are recorded when loan defaults are considered probable but have not yet been reported as such to FHA. Management has conducted special projects to review the credit risk of projects with insured mortgages in its insured multifamily portfolio and to calculate loss reserves as of September 30, 1997 and 1996. Based on the results of the 1997 review, multifamily loss reserves decreased by $306 million through a charge to fiscal year 1997 operations. The multifamily loss reserves recorded at September 30, 1997, for the GI and SRI Funds, including loss adjustment expense, amounted to $7.8 billion and $2.1 billion, respectively.

In the aggregate, loss reserves were established for approximately 19.17% and 20.58% of the multifamily unpaid principal balance at September 30, 1997 and 1996, respectively.

Management believes that this level of loss reserves is adequate to cover anticipated multifamily insurance claim payments. This assessment is based upon management's consideration of: (1) the current financial and operational status of the multifamily projects in the portfolio and (2) the anticipated availability of cash inflows in the form of rent or rent assistance, particularly Section 8 subsidy programs, for these projects (see Note 13).

Aggregate premiums generated by the GI and SRI Funds' various programs will not be sufficient to cover losses in the Funds, or to sustain their operations. The severity of the losses in these Funds and the insufficiency of their premiums leave the Funds dependent on budget appropriations to sustain their operations as originally intended under statutes. While activity in the GI Fund programs continues to be significant, activity in all of the SRI Fund's major programs has decreased substantially in recent years.

The LAE reserve is provided for estimated administrative expenses of settling anticipated claims included in the claims loss reserve.

The following table provides a reconciliation of beginning and ending loss reserves and LAE as of September 30, 1997 and 1996 (dollars in millions):

	1997	1996
Balance, Beginning of Year	$12,986	$11,065
Losses and LAE Provisions, Principally in Respect of Default Notices Occurring in		
Current Year	265	656
Prior Years	2,362	3,288
Total Losses and LAE Provisions	2,627	3,944
Losses and LAE Payments, Principally in Respect of Default Notices Occurring in		
Current Year	(675)	(761)
Prior Years	(5,456)	(4,781)
Total Losses and LAE Payments	(6,131)	(5,542)
Net Losses and LAE Provisions and Payments	(3,504)	(1,598)
Estimated Recoveries	3,667	3,519
Net Change to the Loss and LAE Reserves	163	1,921
Balance, End of Year	$13,149	$12,986

Note 7. Unearned Premiums

The following presents the activity in unearned premiums during 1996 and 1997 (dollars in millions):

	MMI	CMHI	GI	SRI	TOTAL
Balance, September 30, 1995	**$6,549**	**$1**	**$118**	**$17**	**$6,685**
Premiums Collected	1,417	1	269	35	1,722
Premiums Earned	(768)	(1)	(254)	(35)	(1,058)
Premiums Refunded	(410)	0	(8)	0	(418)
Balance, September 30, 1996	**$6,788**	**$1**	**$125**	**$17**	**$6,931**
Premiums Collected	1,459	1	294	35	1,789
Premiums Earned	(899)	(1)	(270)	(35)	(1,205)
Premiums Refunded	(287)	0	(7)	0	(294)
Balance, September 30, 1997	**$7,061**	**$1**	**$142**	**$17**	**$7,221**

Note 8. Debentures Issued to Claimants

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 Treasury. Interest rates related to the outstanding debentures range from 4.00% to 12.875%. They may be redeemed by lenders prior to maturity to pay mortgage insurance premiums to FHA or may be called with the approval of the Secretary of the Treasury.

Debentures outstanding at September 30, 1997 and 1996, based on original maturity dates, were as follows (dollars in millions):

Due:	Par Value 1997	Par Value 1996
One Year or Less	$1	$1
After One Year Through Five	0	0
After Five Years Through Ten	22	3
After Ten Years Through Fifteen	14	13
After Fifteen Years	31	65
Total	$68	$82

The fair value of debentures outstanding at September 30, 1997, based on scheduled maturity dates, was $79 million at September 30, 1997 and $104 million at September 30, 1996. On January 1, 1998, the Federal Housing Commissioner called all callable debentures outstanding as of September 30, 1997 with a coupon rate of 6.75% or above. The par value and fair value of the called debentures at the call date was $27 million. The remaining $41 million in debentures (par value) includes $16 million of debentures which are not callable and bear interest at rates ranging from 10.375% to 12.875%. The fair value of the debentures outstanding at September 30, 1997, based on the January 1, 1998, call date, or the original maturity date where applicable, was $73 million.

Interest expense for debentures during the years ended September 30, 1997 and 1996, was $5 million and $18 million, respectively. Interest is payable on January 1 and July 1 of each year.

Note 9. Government Equity (Deficiency)

As mutual insurance funds, the MMI and CMHI Funds generate surplus which is held in equity accounts. Such equity is either held to meet capital ratio requirements or distributed to eligible policyholders.

Under the National Affordable Housing Act of 1990 (Affordable Housing Act), the MMI Fund must attain a capital ratio of at least 2.0% by fiscal year 2000. The Affordable Housing Act defines the capital ratio as the ratio of the economic net worth of the MMI Fund to unamortized insurance in force.

Unamortized insurance in force is defined by the Affordable Housing Act to be the remaining obligation on outstanding mortgages and is, therefore, the same as the MMI Fund's insurance in force. The economic net worth, as defined by the Affordable Housing Act, is the current cash available to the MMI Fund, plus the present value of all future cash inflows and outflows expected to result from the outstanding mortgages insured by the MMI Fund. The MMI Fund's economic net worth differs from the MMI Fund's equity determined in accordance with generally accepted accounting principles (GAAP), because GAAP-determined equity is not based on the net present value of future cash flows.

Since fiscal year 1989, FHA has commissioned independent annual studies of the actuarial soundness of the MMI Fund. These studies may be used, in part, to estimate the economic net worth of the MMI Fund. The results of the most recent study indicate that the MMI Fund has an economic value of approximately $11.3 billion and a capital ratio of 2.81% as of September 30, 1997, based on unamortized insurance in force. The results of the fiscal year 1996 study indicated an economic value of approximately $9.4 billion and a capital ratio of 2.54% as of September 30, 1996, based on the unamortized insurance in force.

Whereas the Affordable Housing Act defines unamortized insurance in force as "the remaining obligation on outstanding mortgages", this definition is more commonly understood to be the amortized insurance in force. Use of amortized insurance in force increases the capital ratio as of September 30, 1997 and 1996, to 3.02% and 2.71% , respectively.

Standing legislation provides for appropriations to cover cumulative losses in the GI and SRI Funds and, as discussed in Note 10, any upward adjustments to subsidy re-estimates. These appropriations are available when needed, with the concurrence of OMB.

Note 10. Credit Program Funding

Credit Reform

FHA's activities are subject to the Federal Credit Reform Act of 1990 ("Credit Reform"), which became effective on October 1, 1991. A primary purpose of Credit Reform is to more accurately measure the "subsidy" costs of Federal credit programs. FHA subsidy costs generally comprise the present value of estimated disbursements for costs associated with mortgage defaults, net of the present value of estimated collections for insurance premiums and claim recoveries.

For mortgages insured on or after October 1, 1991, up-front appropriations are required to finance credit subsidy costs. Appropriations to finance subsidy costs in the GI/SRI Funds were $95 million and $152 million in fiscal years 1997 and 1996, respectively. FHA's MMI Fund has not received credit subsidy appropriations because the premiums charged are estimated to exceed associated costs.

For mortgages insured prior to October 1, 1991, permanent indefinite appropriations are available to finance costs associated with such mortgages to the extent premiums, recoveries and financing are insufficient to do so. There were no appropriations drawn for pre-Credit Reform mortgages for fiscal years ended September 30, 1997 and 1996.

Administrative Expenses

Administrative expenses of the GI/SRI Funds are funded by annual appropriations which are separate from subsidy appropriations and are not determined on a present value basis. The GI/SRI Funds administrative costs were $207 million and $202 million for fiscal years 1997 and 1996, respectively.

The MMI Fund administrative expenses are not covered by appropriations and are funded by operating revenues. For fiscal years 1997 and 1996, the MMI Fund incurred administrative costs of $351 million and $342 million, respectively.

Asset Sales

During fiscal year 1997, mortgage note sales generated additional cash flows of $449 million and $384 million for the MMI and GI/SRI Funds, respectively. In fiscal year 1996, additional cash flows of $265 million and $533 million were generated from mortgage note sales for the MMI and GI/SRI Funds, respectively. In 1996, Congress provided standing authorization to use the proceeds to help fund program operations.

Subsidy Re-estimates

Periodic subsidy re-estimates are required by Credit Reform to assure that the amount of monies necessary for credit subsidies is sufficient to cover estimated costs. Downward adjustments result from having received more subsidy than is believed needed, and the excess is deposited to a special receipt account at the Treasury. Upward adjustments result in additional monies due, which are financed by standing legislation and do not require additional Congressional action, although approval to receive and utilize the monies must be made by the Office of Management and Budget.

The following subsidy re-estimates were made during fiscal years 1997 and 1996 to bring the subsidy amount to that necessary to cover estimated costs (dollars in millions):

Fund	1997	1996
MMI	Downward, $340	Upward, $181
GI/SRI	Downward, $ 25	Downward, $110

Borrowings From the U.S. Treasury

During fiscal year 1997, FHA borrowed $592 million from the U.S. Treasury for the MMI and GI and SRI Funds to cover re-estimates of prior years insurance and expected gains from new MMI insurance activity as required by the Credit Reform Act. FHA repaid $76 million of prior year borrowings to cover borrowings related to the GI and SRI Fund.

The changes in the borrowings from the U. S. Treasury were as follows (dollars in millions):

	MMI	GI/SRI	Total
Balance, September 30, 1995	$1,171	$ 476	$ 1,647
Borrowings	1,530	86	1,616
Repayments	0	(140)	(140)
Balance, September 30, 1996	$2,701	$ 422	$3,123
Borrowings	365	227	592
Repayments	0	(76)	(76)
Balance, September 30, 1997	$3,066	$ 573	$3,639

All funds borrowed from the U.S. Treasury may be repaid in whole or in part prior to loan maturity without penalty. The balance of borrowings from the U.S. Treasury at September 30, 1997 and 1996, have maturity dates and interest rates as summarized below (dollars in millions):

Fund	1997	1996	Interest Rate	Year of Maturity
MMI:				
	$ 286	$ 286	6.21%	2000
	205	205	6.33%	2003
	3	3	6.33%-7.11%	2004
	1	0	6.51%	2005
	885	885	6.65%-6.77%	2014
	1,322	1,322	6.65%-7.59%	2015
	364	0	6.77%-7.39%	2016
Subtotal	$3,066	$2,701		
GI/SRI:				
	$ 260	$ 336	6.21%	2000
	61	61	6.33%	2003
	80	0	6.51%	2004
	25	25	6.55%-7.59%	2015
	147	0	6.65%-7.59%	2016
Subtotal	$ 573	$ 422		
Grand Total	$3,639	$3,123		

Note 11. Insurance in Force/Off Balance Sheet Risk

Insurance in force, which constitutes off balance sheet risk, is the original insured balance of all cases still in force, less principal payments made on the mortgages to date. Insurance in force involves elements of credit and market risk in excess of amounts recognized as liabilities on the Consolidated Statements of Financial Position. Insurance in force outstanding as of September 30, 1997, was as follows (dollars in millions):

Fund	Single Family	Multifamily	Title I	Total
MMI	$360,289	$ 0	$ 0	$360,289
CMHI	0	247	0	247
GI	33,285	44,680	6,240	84,205
SRI	1,987	6,873	0	8,860
Total	$395,561	$51,800	$6,240	$453,601

Insurance in force outstanding as of September 30, 1996, was as follows (dollars in millions):

Fund	Single Family	Multifamily	Title I	Total
MMI	$337,449	$ 0	$ 0	$337,449
CMHI	0	271	0	271
GI	30,526	42,277	5,950	78,753
SRI	2,361	7,199	0	9,560
Total	$370,336	$49,747	$5,950	$426,033

Insurance written during fiscal years 1997 and 1996 was as follows (dollars in millions):

Fund	1997	1996
MMI	$61,135	$ 59,296
GI	12,516	11,985
SRI	58	192
Total	$73,709	$71,473

FHA's insurance covers losses that result when borrowers default on their mortgage payments. FHA mortgage insurance covers only default risk, and thus FHA is not exposed to losses resulting from interest rate fluctuations, except in the case of mortgages insured pursuant to Section 221(g)(4) of the National Housing Act, as discussed in Note 13. In most cases, FHA insures 100% of the mortgage principal. However, when FHA pays claims resulting from mortgage defaults, a portion of the claim can normally be recovered through foreclosure and subsequent sale of the mortgaged property. In recent years, FHA has also recovered a portion of claims paid through public sale of the mortgage notes as discussed in Note 5.

The MMI Fund provides mortgage insurance principally for 30-year fixed rate home mortgages. By law, the MMI Fund must be operated in accordance with "sound actuarial and accounting practice." Borrowers should be charged a premium that will cover default losses and administrative expenses, and provide equity. Like all FHA activities, the MMI Fund suffers losses when premium income is insufficient to cover default losses and administrative costs. The magnitude of these losses is greater when there is either an increase in the number of mortgage defaults or a decrease in amounts recovered from the sale of foreclosed properties or mortgage notes sold.

Since the MMI Fund primarily insures low down payment mortgages, it is more susceptible to losses resulting from economic downturns. Such downturns may increase the number of defaults and result in lower claim recoveries when foreclosed properties are sold. Either situation could result in the MMI Fund experiencing greater losses than have been provided for in the accompanying consolidated financial statements.

The GI Fund provides mortgage insurance for loans involving cooperatives, condominiums, nursing homes, and hospitals; and for low and moderate income multifamily loans involving construction, rehabilitation, and refinancing. While the GI Fund's insurance in force is much less than that of the MMI Fund, its exposure to loss may be much greater. Unlike the MMI Fund, the GI Fund has no statutory requirement to be sound. In carrying out its mission, the GI Fund assumes levels of default risk not generally borne by commercial insurers or lenders. Furthermore, the GI Fund is susceptible to losses resulting from weaknesses in commercial and residential real estate markets at both the regional and national levels. Aggregate premiums charged by the GI Fund have not been sufficient to cover default losses and administrative costs. As a result, the GI Fund is dependent on appropriations to sustain its operations.

Activity for FHA's other two funds, SRI and CMHI, has been minimal in recent years. Since these funds have very little activity, FHA's exposure to additional loss from these funds is comparatively small.

Note 12. Concentrations of Credit Risk

Concentrations of credit risk exist when a significant number of counterparties (e.g., borrowers, lenders) engage in similar activities or are susceptible to similar changes in economic conditions that could affect their ability to meet contractual obligations.

The significant geographic concentration for the single family unpaid principal insurance balance at September 30, 1997 is located in California (14%), Texas (8%), and Florida (6%). No other state equals 5% or more of the unpaid single family insurance principal balance.

The concentration of risk is geographically dispersed for multifamily, except for the Hospital Program. The insurance in force for the Hospital Program is located primarily in the Northeast, with 92% of the $4.8 billion unpaid principal balance of the insurance in force attributed to the New York/New Jersey HUD Regions. New York state constitutes over 88% of the insurance in force for hospitals. The highest geographic concentration of risk for the remaining multifamily programs is in New York (13%), California (9%), Maryland (6%), Illinois (5%) and Ohio (5%). No other state equals 5% or more of the unpaid multifamily insurance principal balance.

The significant concentrations of FHA's multifamily insurance risk by program, and the percent that the program is to the total multifamily insurance in force (IIF), are as follows (dollars in billions):

Program	IIF	Percent
Section 221(d)(4) - Market Rate	$ 18.4	35.6%
Section 207 - Rental Housing	9.0	17.3%
Section 232 - Nursing Homes	5.9	11.3%
Section 236 - Interest Subsidy	5.5	10.7%
Section 242 - Hospitals	4.8	9.3%

The top five lenders service approximately 26% and 46% of the actively insured single family and multifamily mortgage loans, respectively, at September 30, 1997. As of January 1, 1998, 21% of the Hospital portfolio is with one mortgagor.

Note 13. Commitments and Contingencies

Section 221(g)(4) Program

Prior to the passage of the National Affordable Housing Act of 1990 (Affordable Housing Act), single family and multifamily mortgages insured under Section 221 of the National Housing Act that were neither delinquent nor in default could be assigned to FHA pursuant to Section 221(g)(4) by lenders in exchange for FHA debentures bearing current interest rates. Eligible mortgagees could elect to assign their current mortgages to FHA during the year following the 20th anniversary after final endorsement of the mortgage. The assignment of these mortgages resulted in an additional cost to FHA to the extent that U.S. Treasury debenture rates exceeded the mortgage interest rates.

However, under the Affordable Housing Act, FHA was required to arrange for the sale of the beneficial interest in the multifamily mortgages in lieu of accepting assignment after the 20th anniversary. The sales price to be paid to the lenders was to be equal to the outstanding principal balance at the time of the sale plus accrued interest. To ensure this price was realized, FHA was required to make subsidy interest payments. The Affordable Housing Act, as amended, only provided for the auction of multifamily mortgages assigned through September 30, 1996.

Proposed legislation is in process to extend the auction authority through December 31, 2005, the natural sunset of the assignment program based on the November 30, 1983, Congressionally mandated termination date. It is unclear if, or when, this legislation will be approved.

However, until an approval is received, FHA will issue debentures to those eligible Section 221(g)(4) mortgagees. FHA management estimates that a maximum of 3,715 mortgages with an unpaid principal balance of $8.3 billion could be assigned through 2005.

Termination of the Single Family Assignment Program

Historically, FHA has taken assignment of a significant number of insured single family mortgage notes which are in default rather than settle the claims through foreclosure or other alternatives. Legislation was enacted in April 1996, to eliminate the single family mortgage note assignment program. It authorized FHA to implement new loss mitigation tools and expand existing alternatives to foreclosure.

Section 8 Subsidies

At September 30, 1997, FHA estimates that approximately 8,400 projects (with an insured mortgage value of $17 billion) were receiving rental subsidies from a variety of non-FHA Section 8 subsidy programs.

Previously, the 1997 Budget set limits on Section 8 contract terms to one year and made changes to limit the level of rental subsidies paid under new Section 8 contract renewals and amendments. Various proposals to further reduce future subsidy payments made directly to project owners either were advanced as part of the formal fiscal year 1998 budget process and related legislative submissions to Congress or are expected as part of the Congressional debate about the future of public and subsidized housing in the country.

H.R. 2158 - The VA, HUD & Independent Agencies Apportion Act for FY 1998, Subtitle A- FHA-Insured Multifamily Housing Mortgage and Housing Assistance Restructuring provides for a “mark to market” program to reduce the costs of over-subsidized Section 8 multifamily housing properties insured by FHA.

Under the “mark-to-market” program, FHA-insured Section 8 housing properties with above market rents are eligible for debt re-structuring to reduce rent levels to those of comparable market rate properties or to the minimum level necessary to support proper operations and maintenance. In response to limitations with HUD capacity, the legislation shifts the administration and management of this portfolio from HUD to entities (termed participating administrative entities), charged with protecting the affordable housing stock in a fiscally responsible manner. Additionally, the legislation terminates the government’s relationship with owners who fail to comply with Federal requirements and ends the practice of subsidizing properties that are not economically viable.

While the act includes extensive guidance on the selection of participating administrative entities development and submission of portfolio restructuring agreements covering the insured and subsidized mortgages, and determination, from a number of alternatives, of the best methods to restructure the project mortgage and subsidies, the Secretary is charged to develop additional regulations, rules and procedures to implement the program.

The impact of these proposals would vary from project to project depending on such factors as the then current financial and physical condition, size and timing of subsidy changes, and local market conditions. In addition, final costs to FHA of these additional claims would depend upon the methods used to restructure project mortgages or to minimize the actual transfer of the mortgages or properties to FHA ownership, and the methods used to dispose of any mortgages or properties assumed in a timely fashion. The claims which would result almost all relate to insurance issued prior to 1991. FHA has available permanent indefinite appropriation authority to pay these claims.

FHA estimates that approximately $5.3 billion of loss reserves on subsidized projects have been accrued, for financial reporting purposes but not for budget purposes, as part of its estimation of potential losses on the entire insured portfolio at September 30, 1997. Loss reserves accrued for subsidized projects at September 30, 1996, were $6.2 billion. These reserves include the estimated overall financial impact on FHA of the changes to the present rent subsidy structure. Management believes these reserves adequately provide for estimated losses on subsidized projects.

Year 2000 Planning

HUD began converting its computer systems for the Year 2000 changes in fiscal year 1996, and completed a portion of the necessary systems renovations in that same year. All systems are scheduled to be compliant by the end of fiscal year 1998, and scheduled to be fully certified and implemented by March 30, 1999. The cost for the Year 2000 effort is estimated at about $47.5 million, including all the costs of modifying the FHA systems. Such estimate includes provisions for new software and hardware purchases, and all required readiness certifications.

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 consolidated financial position or results of operations as of, and for, the fiscal year ended September 30, 1997.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATING SCHEDULE - STATEMENTS OF FINANCIAL POSITION INFORMATION
SEPTEMBER 30, 1997 AND 1996
(Dollars in Millions)

	MMI		CMHI		GI		SRI		CONSOLIDATED	
	1997	1996	1997	1996	1997	1996	1997	1996	1997	1996
ASSETS:										
Fund Balances at the U.S. Treasury:										
Non-Interest Bearing	$ 80	$ 2,888	$ 7	$ 6	$ 2,809	$ 2,230	$ 527	$ 484	$ 3,423	$ 5,608
Interest Bearing	448	975	0	0	295	554	16	13	759	1,542
Total Fund Balances at the U.S. Treasury	528	3,863	7	6	3,104	2,784	543	497	4,182	7,150
Investments in U.S. Government Securities	13,201	7,642	19	19	0	0	0	0	13,220	7,661
Foreclosed Property Held for Sale, Net	1,254	949	0	0	206	203	11	10	1,471	1,162
Mortgage Notes Held for Sale, Net	483	2,344	1	1	649	1,573	39	53	1,172	3,971
Other Assets and Receivables	459	332	0	0	270	204	61	41	790	577
Total Assets	15,925	15,130	27	26	4,229	4,764	654	601	20,835	20,521
LIABILITIES AND GOVERNMENT EQUITY (DEFICIENCY):										
Claims Payable	202	532	0	0	187	115	10	17	399	664
Loss Reserves	2,573	2,235	27	6	8,436	9,426	2,113	1,319	13,149	12,986
Unearned Premiums	7,061	6,788	1	1	143	125	16	17	7,221	6,931
Debentures Issued to Claimants	0	0	0	0	59	80	9	2	68	82
Accounts Payable, Accrued Expenses, and Other Liabilities	160	194	1	0	155	179	53	51	369	424
Borrowings from the U.S. Treasury	3,066	2,701	0	0	573	422	0	0	3,639	3,123
Distributive Shares and Premium Refunds Payable	180	153	0	1	0	0	0	0	180	154
Elimination of Interfund Balances	0	0	0	0	(20)	(20)	20	20	0	0
Total Liabilities	13,242	12,603	29	8	9,533	10,327	2,221	1,426	25,025	24,364
Government Equity (Deficiency):										
Mutual Funds Equity	2,664	2,508	(2)	18	0	0	0	0	2,662	2,526
Subsidized Funds Cumulative Losses	0	0	0	0	(15,511)	(16,095)	(5,686)	(4,948)	(21,197)	(21,043)
Appropriated Capital	19	19	0	0	10,207	10,532	4,119	4,123	14,345	14,674
Total Government Equity (Deficiency)	2,683	2,527	(2)	18	(5,304)	(5,563)	(1,567)	(825)	(4,190)	(3,843)
Total Liabilities and Government Equity (Deficiency)	$ 15,925	$ 15,130	$ 27	$ 26	$ 4,229	$ 4,764	$ 654	$ 601	$ 20,835	$ 20,521

See Accompanying Independent Auditors' Report.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATING SCHEDULE - STATEMENTS OF OPERATION INFORMATION
FOR THE YEARS ENDED SEPTEMBER 30, 1997 AND 1996
(Dollars in Millions)

	MMI		CMHI		GI		SRI		CONSOLIDATED	
	1997	1996	1997	1996	1997	1996	1997	1996	1997	1996
REVENUES:										
Premiums:										
Annual Premiums	$ 1,128	$ 938	$0	$0	$ 143	$ 135	$ 10	$ 11	$ 1,281	$ 1,084
Earned Portion of Up-front Premiums	899	768	1	1	270	254	35	35	1,205	1,058
Total Premiums Earned	2,027	1,706	1	1	413	389	45	46	2,486	2,142
Interest Income	786	812	1	1	218	115	53	50	1,058	978
Other Revenues	60	27	0	0	52	42	3	1	115	70
Total Revenues	2,873	2,545	2	2	683	546	101	97	3,659	3,190
EXPENSES:										
Change in Loss Reserves	337	66	21	0	(989)	1,626	794	229	163	1,921
Provision for Losses on Properties Held for Sale	1,688	1,431	0	0	492	478	52	66	2,232	1,975
Provision for Losses on Mortgage Notes Held for Sale	35	(166)	0	0	287	(673)	(14)	20	308	(819)
Gain on Sale of Mortgage Notes	(50)	(72)	0	0	(38)	(113)	(4)	(2)	(92)	(187)
Salary and Administrative Expenses	457	429	0	0	265	252	1	2	723	683
Interest Expense	208	167	0	0	47	49	0	0	255	216
Other Expense	42	36	0	0	35	(16)	10	(1)	87	19
Total Expenses	2,717	1,891	21	0	99	1,603	839	314	3,676	3,808
(Deficiency) Excess of Revenues over Expenses	156	654	(19)	2	584	(1,057)	(738)	(217)	(17)	(618)
Government Equity (Deficiency), Beginning of Year	2,527	1,873	18	17	(5,563)	(4,567)	(825)	(608)	(3,843)	(3,285)
Distributive Shares Paid	0	0	(1)	(1)	0	0	0	0	(1)	(1)
Appropriations, Net	0	0	0	0	(325)	61	(4)	0	(329)	61
Government Equity (Deficiency), End of Year	$ 2,683	$ 2,527	$ (2)	$ 18	$ (5,304)	$ (5,563)	$ (1,567)	$ (825)	$ (4,190)	$ (3,843)

See Accompanying Independent Auditors' Report.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONOLIDATING SCHEDULE - STATEMENTS IN GOVERNMENT EQUITY (DEFICIENCY) INFORMATION
FOR THE YEARS ENDED SEPTEMBER 30, 1997 AND 1996
(Dollars in Millions)

	Mutual Funds Equity			Subsidized Funds Cumulative Losses			Appropriated Capital				Equity
	MMI	CMHI	TOTAL	GI	SRI	TOTAL	MMI	GI	SRI	TOTAL	Total
Balance, September 30, 1995	$ 1,854	$ 17	$ 1,871	$ (15,038)	$ (4,731)	$ (19,769)	$ 19	$ 10,471	$ 4,123	$ 14,613	$ (3,285)
(Deficiency) Excess of Revenues over Expenses	654	2	656	(1,057)	(217)	(1,274)	0	0	0	0	(618)
Distributive Shares Paid	0	(1)	(1)	0	0	0	0	0	0	0	(1)
Credit Appropriations Received to Finance:											
Credit subsidies on 1996 mortgages	0	0	0	0	0	0	0	152	0	152	152
Credit subsidies as a result of asset sales	0	0	0	0	0	0	0	533	0	533	533
Administrative expenses	0	0	0	0	0	0	0	202	0	202	202
Resources Returned to Treasury:											
On insured 1996 mortgages	0	0	0	0	0	0	0	(142)	0	(142)	(142)
As a result of re-estimates	0	0	0	0	0	0	0	(110)	0	(110)	(110)
As a result of modifications	0	0	0	0	0	0	0	(40)	0	(40)	(40)
As a result of modifications due to asset sales	0	0	0	0	0	0	0	(533)	0	(533)	(533)
As a result of budget recissions	0	0	0	0	0	0	0	(1)	0	(1)	(1)
Balance, September 30, 1996	2,508	18	2,526	(16,095)	(4,948)	(21,043)	19	10,532	4,123	14,674	(3,843)
(Deficiency) Excess of Revenues over Expenses	156	(19)	137	584	(738)	(154)	0	0	0	0	(17)
Distributive Shares Paid	0	(1)	(1)	0	0	0	0	0	0	0	(1)
Credit Appropriations Received to Finance:											
Credit subsidies on 1997 mortgages	0	0	0	0	0	0	0	95	0	95	95
Administrative expenses	0	0	0	0	0	0	0	207	0	207	207
Resources Returned to Treasury:											
On insured 1997 mortgages	0	0	0	0	0	0	0	(142)	0	(142)	(142)
As a result of re-estimates	0	0	0	0	0	0	0	(25)	0	(25)	(25)
As a result of modifications	0	0	0	0	0	0	0	(80)	0	(80)	(80)
As a result of modifications due to asset sales	0	0	0	0	0	0	0	(380)	(4)	(384)	(384)
Balance, September 30, 1997	$ 2,664	$ (2)	$ 2,662	$ (15,511)	$ (5,686)	$ (21,197)	$ 19	$ 10,207	$ 4,119	$ 14,345	$ (4,190)

See Accompanying Independent Auditors' Report.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATING SCHEDULE - STATEMENTS OF CASH FLOWS INFORMATION
FOR THE YEARS ENDED SEPTEMBER 30, 1997 AND 1996
(Dollars in Millions)

	MMI		CMHI		GI		SRI		CONSOLIDATED	
	1997	1996	1997	1996	1997	1996	1997	1996	1997	1996
CASH FLOWS FROM OPERATING ACTIVITIES:										
(Deficiency) Excess of Revenues over Expenses	$ 156	$ 654	$ (19)	$ 2	$ 584	$ (1,057)	$ (738)	$ (217)	$ (17)	$ (618)
Adjustments to Reconcile (Deficiency) Excess of Revenues to										
Net Cash Provided by Operating Activities:										
Provision for Losses on Properties and Mortgage Notes Held for Sale	1,723	1,265	0	0	779	(195)	38	86	2,540	1,156
Amortization of U.S. Government Securities	(144)	(57)	0	0	0	0	0	0	(144)	(57)
Gain on Sale of Mortgage Notes	(50)	(72)	0	0	(38)	(113)	(4)	(2)	(92)	(187)
Change in Assets and Liabilities:										
Claims Settlement Payments	(4,675)	(4,527)	0	(1)	(1,333)	(920)	(123)	(94)	(6,131)	(5,542)
Collections of Principal on Notes Acquired in Claims Settlement	46	125	0	0	109	96	32	11	187	232
Proceeds from Disposition of Assets Acquired in Claims Settlement	4,513	4,233	0	0	1,404	2,250	69	51	5,986	6,534
(Increase) Decrease in Other Assets	(127)	(13)	(0)	0	(66)	(39)	(20)	19	(213)	(33)
(Decrease) Increase in Claims Payable and Other Liabilities	(337)	186	(0)	1	48	(101)	(5)	7	(294)	93
Increase (Decrease) in Loss Reserves	337	66	21	0	(989)	1,626	794	229	163	1,921
Up-front Premiums Collected	1,459	1,417	1	1	294	269	35	35	1,789	1,722
Up-front Premiums Earned	(899)	(768)	(1)	(1)	(270)	(254)	(35)	(35)	(1,205)	(1,058)
Up-front Premiums Refunded	(287)	(410)	(0)	0	(7)	(8)	0	0	(294)	(418)
Net Cash Provided by Operating Activities	1,715	2,099	2	2	515	1,554	43	90	2,275	3,745
CASH FLOWS FROM INVESTING ACTIVITIES:										
Purchase of U.S. Government Securities	(18,596)	(7,655)	0	0	0	0	0	0	(18,596)	(7,655)
Maturity of U.S. Government Securities	13,181	6,657	0	0	0	0	0	0	13,181	6,657
Net Cash Used by Investing Activities	(5,415)	(998)	0	0	0	0	0	0	(5,415)	(998)
CASH FLOWS FROM FINANCING ACTIVITIES:										
Borrowings from U.S. Treasury	365	1,530	0	0	227	86	0	0	592	1,616
Repayment of Borrowings from U.S. Treasury	0	0	0	0	(76)	(140)	0	0	(76)	(140)
Appropriated Capital	0	0	0	0	302	887	0	0	302	887
Return of Appropriated Capital	0	0	0	0	(627)	(826)	(4)	0	(631)	(826)
Issuance of Debentures to Claimants	0	0	0	0	40	63	7	2	47	65
Payment of Debentures to Claimants	0	0	0	0	(61)	(70)	0	0	(61)	(70)
Participant Distributive Shares Paid	0	0	(1)	(1)	0	0	0	0	(1)	(1)
Net Cash Provided (Used) by Financing Activities	365	1,530	(1)	(1)	(195)	0	3	2	172	1,531
Net (Decrease) Increase in Cash and Cash Equivalents	(3,335)	2,631	1	1	320	1,554	46	92	(2,968)	4,278
Cash and Cash Equivalents, Beginning of Year	3,863	1,232	6	5	2,784	1,230	497	405	7,150	2,872
Cash and Cash Equivalents, End of Year	$ 528	$ 3,863	$ 7	$ 6	$ 3,104	$ 2,784	$ 543	$ 497	$ 4,182	$ 7,150

See Accompanying Independent Auditors' Report.

Appendix A

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