Audit Report

Financial Audits Division
Office of Audit

Federal Housing Administration Audit of Fiscal Year 1998 Federal Basis Financial Statements

99-FO-131-0002
March 12, 1999

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

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Report: 99-FO-131-0002 *Issued: March 12, 1999*

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

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

SUBJECT: Audit of the Federal Housing Administration's Fiscal Year 1998 Federal Basis Financial Statements

This report presents the results of KPMG LLP's (KPMG) audit of the Federal Housing Administration's (FHA) financial statements for the year ended September 30, 1998 prepared in conformity with the hierarchy of accounting principles and standards recommended by the principals of the Federal Accounting Standards Advisory Board. This hierarchy is a comprehensive basis of accounting other than generally accepted accounting principles. We concur with KPMG's opinion, that the financial statements present fairly, in all material respects, FHA's financial position as of September 30, 1998, and its net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations, for the year then ended on the basis of accounting described in Note 1 to the financial statements.

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

Audit Scope and OMB Audit Requirements

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

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

To address the first additional OMB requirement, we engaged KPMG to expand their review of FHA's internal controls. The section discussing internal controls presents the results of this work. With respect to the other additional requirements, FHA, with the Office of Management and Budget's approval, is not presenting performance measures as a component of its financial statements prepared in accordance with OMB Bulletin 97-01, *Form and Content of Agency Financial Statements.* However, HUD will be reporting FHA's performance measures at the HUD consolidated level. With respect to FFMIA, the reporting requirements do not apply to the FHA audit, but will be reported at the HUD consolidated level.

Results of KPMG's Audit

In addition to KPMG's unqualified opinion on FHA's financial statements, the audit results were similar to those reported in prior years, except for a new material weakness relating to federal basis and budgetary accounting. KPMG reported four 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 1998 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.

Comments of FHA Officials

On March 1, 1998 we provided a draft of KPMG's report to FHA officials for their review and comment. FHA's response is included as Appendix D of KPMG's report.

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

Table of Contents

INDEPENDENT AUDITORS' REPORT

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

We have audited the accompanying consolidated balance sheet of the Federal Housing Administration (FHA) as of September 30, 1998, and the related consolidated statements of net cost and changes in net position, the combining statement of budgetary resources, and the combined statement of financing (hereinafter collectively referred to as "financial statements") for the year then ended. The objective of our audit was to express an opinion on the fair presentation of FHA's 1998 financial statements. In connection with our audit, we also considered FHA's internal control over financial reporting and tested FHA's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on its financial statements.

In our opinion, FHA's financial statements as of and for the year ended September 30, 1998, are presented fairly, in all material respects, in conformity with the hierarchy of accounting principles and standards recommended by the principals of the Federal Accounting Standards Advisory Board. This hierarchy is a comprehensive basis of accounting other than generally accepted accounting principles.

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

- Addressing staff and administrative resource issues,
- Placing more emphasis on early warning and loss prevention regarding the insured portfolio,
- Improving federal basis and budgetary accounting,
- Improving technology systems in order to support business processes more effectively,
- Resolving Secretary-held mortgage notes and minimizing additional mortgage note assignments and note servicing responsibilities,
- Monitoring and accounting for single family property inventory, and
- Enhancing the design and operation of information systems general and application controls.

Regarding our tests of compliance with certain provisions of laws and regulations, we noted noncompliance with data and accounting requirements of the Credit Reform Act of 1990.

Our conclusions and the scope of our work are discussed in more detail below.

OPINION ON FINANCIAL STATEMENTS

We have audited the accompanying consolidated balance sheet of FHA as of September 30, 1998, and the related consolidated statements of net cost and changes in net position, the combining statement of budgetary resources, and the combined statement of financing for the year ended. As described in Note 1, these financial statements were prepared in conformity with the hierarchy of accounting principles and standards recommended by the principals of the Federal Accounting Standards Advisory Board. This hierarchy is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of FHA as of September 30, 1998, and its net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations, for the year then ended on the basis of accounting described in Note 1.

INTERNAL CONTROL OVER FINANCIAL REPORTING

We noted certain matters involving internal control over financial reporting and its operation that we consider to be material weaknesses under standards established by the American Institute of Certified Public Accountants (AICPA) and OMB Bulletin No. 98-08, *Audit Requirements for Federal Financial Statements*, as amended.

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions under standards issued by the AICPA and OMB Bulletin No. 98-08, as amended, and, accordingly, would not necessarily disclose all reportable conditions that are material weaknesses. Reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of internal control over financial reporting that, in our judgment, could adversely affect FHA's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Material weaknesses, which apply to the single family and multifamily programs in varying degrees as addressed by program area in Appendix A, exist in four major interrelated areas. The 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 available to conduct its mortgage insurance programs. As implementation of the 2020 reorganization proceeds, these issues remain critical to the management of FHA's programs.

- **FHA must continue to 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.

- **FHA must improve federal basis and budgetary accounting.** FHA must perform analysis and reconciliation of obligations to ensure that obligated amounts are properly stated. In addition, formal documentation must be developed to support the preparation of federal basis financial statements, budgetary standard forms, and FHA's cost allocation process. Furthermore, FHA's methodology for calculation of the liability for loan guarantees required refinement.

- **Information technology systems must be improved in order to support business processes more effectively.** Improvements to the information systems are hindered because of the existence of other critical system priorities at the U.S. Department of Housing and Urban Development (HUD).

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

- **FHA must continue actions to quickly resolve 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 that could be better deployed elsewhere.

- **FHA must sufficiently monitor and account for its single family property inventory.** FHA has control weaknesses in its single family property acquisition, management and disposition functions which 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.

- **FHA/HUD must enhance the design and operation of information systems general and application controls.** Control weaknesses exist in overall and application level security in the electronic data processing environment.

These conditions were considered in determining the nature, timing, and extent of audit tests applied in our audit of the 1998 financial statements. We have not considered internal control over financial reporting subsequent to the date of this report.

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

COMPLIANCE WITH LAWS AND REGULATIONS

The following instance of noncompliance is required to be reported herein under *Government Auditing Standards* and OMB Bulletin No. 98-08, as amended:

- **FHA is not in full compliance with data requirements of the Federal 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.

This matter is discussed further in Appendix C.

Other Matter 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 financial statements. FHA is an agency operated by HUD. Management is responsible for:

- preparing the financial statements in conformity with the comprehensive basis of accounting described in Note 1 to the financial statements,
- establishing and maintaining internal controls over financial reporting, and
- complying with applicable laws and regulations.

In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies and procedures.

The objectives of internal control over financial reporting are to provide management with reasonable, but not absolute, assurance that:

- transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in accordance with applicable accounting principles described in Note 1 to the financial statements;
- assets are safeguarded against loss from unauthorized acquisition, use or disposition; and
- transactions are executed in accordance with laws governing the use of budget authority and other laws and regulations that could have a direct and material effect on the financial statements.

Auditors' Responsibility. Our responsibility is to express an opinion on the financial statements of FHA as of and for the year ended September 30, 1998, based on our audit. We conducted our audit in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin No. 98-08. Those standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement and presented fairly in conformity with the comprehensive basis of accounting described in Note 1 to the financial statements. We believe that our audit provides a reasonable basis for our opinion. Our audit was not designed to test the requirements of OMB Bulletin No. 98-08 relating to the *Federal Financial Management Improvement Act* (FFMIA) or performance measures, which are not considered applicable at the FHA level. FFMIA requirements and performance measures are reviewed and reported on at the HUD consolidated level.

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

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

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; and

- tested compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts

With respect to internal control, we obtained an understanding of FHA's significant internal controls, determined whether these internal controls had been placed in operation, assessed control risk, and performed tests of controls.

Because of inherent limitations in internal control over financial reporting, fraud may occur and not be detected. Also projection of any evaluation of internal controls over financial reporting to future periods is subject to the risk that the internal control procedures may become inadequate because of changes in conditions, or that the effectiveness of the design and operations of the policies and procedures may deteriorate.

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

/s/ KPMG LLP

March 5, 1999
Washington, D.C.

INTRODUCTION

Material weaknesses in FHA's internal control, as of and for the year ended September 30, 1998, are summarized in the four 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 available to conduct its mortgage insurance programs. As implementation of the 2020 reorganization proceeds, these issues remain critical to the management of FHA's programs.

- **FHA must continue to 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.

- **FHA must improve Federal basis and budgetary accounting.** FHA must perform analysis and reconciliation of obligations to ensure that obligated amounts are properly stated. In addition, formal documentation must be developed to support the preparation of federal basis financial statements, budgetary standard forms, and FHA's cost allocation process. Furthermore, FHA's methodology for calculation of the liability for loan guarantees required refinement.

- **Information technology systems must be improved in order to support business processes more effectively.** Improvements to the information systems are hindered because of the existence of other critical system priorities at HUD.

The first two and the fourth material weakness, all repeat conditions from our prior year audit report, 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.

As reported in prior years, implementing sufficient change to mitigate the internal control weaknesses is a multiyear task due to the complexity of the issues and impediments to change that FHA and HUD face. These impediments involve interaction with large numbers of relevant constituencies outside of HUD and resource constraining actions, which can affect the timing of corrective action plan implementation.

The following sections describe each material weakness as of and for the period ended September 30, 1998; our recommendations; FHA management's response to the material weakness and recommendations; and our assessment of that response. The full text of management's response is included as Appendix D.

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 increase the risk of borrower default, inhibit effective servicing, and lengthen time necessary for the disposition of assets.

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. Staffing and administrative resource issues adversely affect both single family and multifamily programs.

Planned reductions in single family staffing levels were predicated on significant assumptions and programmatic changes, including streamlining or outsourcing Real Estate Owned (REO) property, selling single family Secretary-held notes, and consolidating single family functions into four Home Ownership Centers (HOC). While staffing reforms occurred under HUD 2020, programmatic reforms related to single family REO and note operations did not keep pace, creating obstacles to the effective monitoring and servicing of FHA's portfolios during fiscal year 1998.

FHA made progress in consolidating single family operations from 81 field offices into four HOCs. However, FHA experienced delays in the consolidation and implementation of REO and note servicing program reforms. Since fiscal year end 1998, FHA has completed several critical milestones necessary to implement these program reforms.

In February 1999, FHA awarded Management and Marketing (M&M) contracts to outsource the single family REO operation, nationwide, to 16 private sector real estate firms. The M&M contracts are slated to start providing management, marketing, and disposition services in March 1999. Additionally, FHA awarded a contract, in February 1999, to a private sector group to service all single family Secretary-held notes.

During fiscal year 1998, FHA recognized a need to retain REO personnel as the M&M contracts were not yet in place. However, buyouts and attrition depleted staff at a number of sites. Because significant programmatic reforms were slow to be implemented, single family operations were adversely impacted during fiscal year 1998. As the Office of the Inspector General (OIG) noted in its September 30, 1998 Semiannual Report to Congress, "It was never intended that the HOCs would handle the full range of loan management and property management and disposition functions that they are currently handling."[1] These factors also contributed to additional weaknesses relating to single family notes and single family property described in Appendix B of this report.

FHA's business related to its single family programs has changed significantly over the years. Improvements in automated technology and electronic data interchange have created efficiencies. Additionally, the single family Secretary-held notes inventory has decreased dramatically. However, the effort to service post-insurance portfolios, including single family property and notes, has drawn necessary resources away from focusing on the primary responsibility of program oversight and portfolio management, during a period when business volume has grown dramatically.

Single family staffing levels are decreasing, as depicted in Exhibit 1. Since 1996, buyouts and downsizing reduced single family staff by approximately 50 percent. During the same period, single family business volume increased, as summarized below.

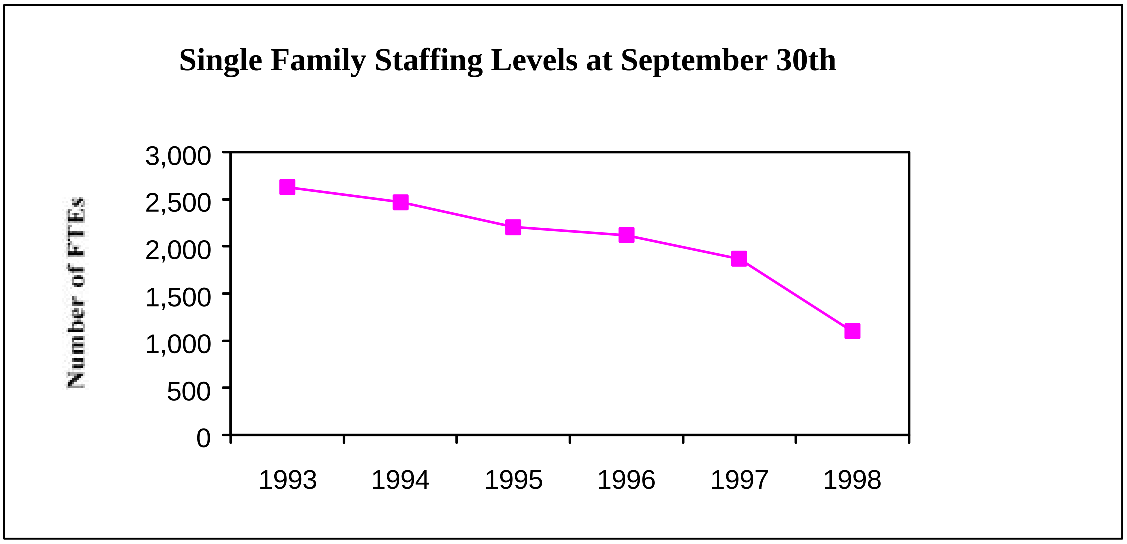
- Insurance-in-force increased by more than 12 percent, from $370 billion at September 30, 1996 to $417 billion at September 30, 1998, and has increased 33 percent since September 30, 1993.

- Insurance claim volume increased over 25 percent between fiscal years 1996 and 1998, from 60,884 claims to 76,086 claims.[2] The total amount of claim payments increased 38 percent, from $4.2 billion to $5.8 billion during the same period.

- REO property levels have risen over 25 percent during the past two fiscal years. While on-hand inventory levels in the early 1990's (before elimination of the assignment program) averaged around 25,000 properties, the average on-hand inventory during fiscal years 1997 and 1998 increased to 31,000 and 40,000 properties, respectively. The number of properties sold also increased over 20 percent, from 53,000 properties during fiscal year 1996 to 64,000 properties during fiscal year 1998.

[1] U.S. Department of Housing and Urban Development OIG Semiannual Report to the Congress, September 30, 1998.
[2] To avoid double counting, this claim data does not include final claim payments, supplemental claim payments, and loss mitigation claims.

Exhibit 1

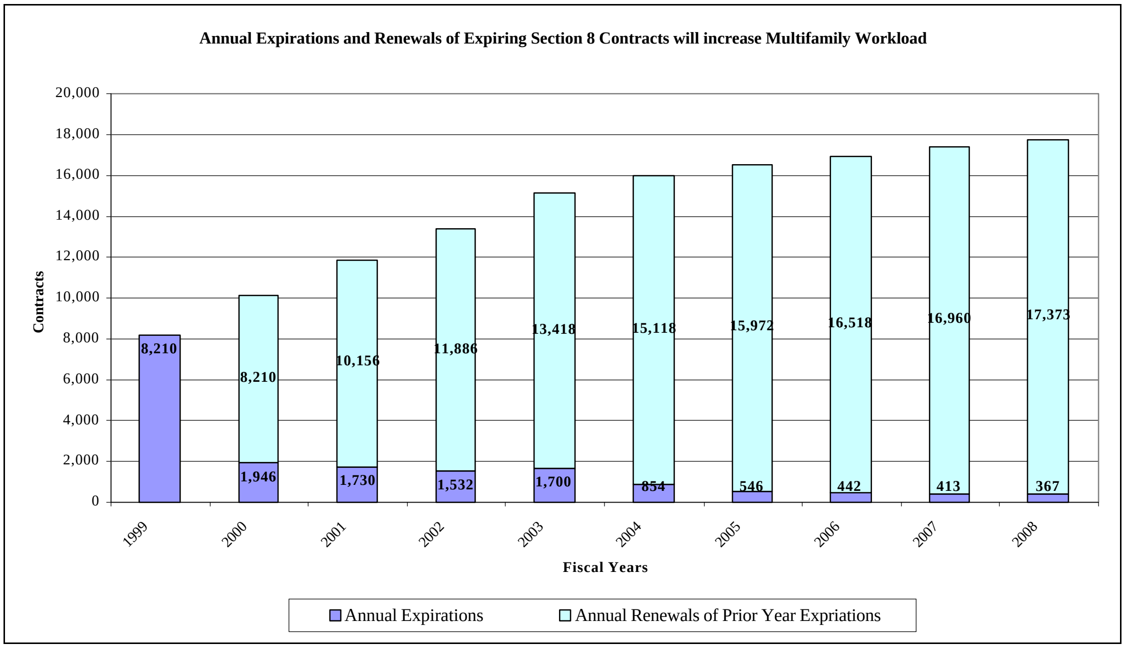


Source: Single Family Program Office

FHA's reduced single family workforce and personnel inexperienced with their current responsibilities, due to FHA's consolidation and reorganization efforts, have hindered FHA's ability to manage its portfolios, service Secretary-held notes, and manage its REO inventory during fiscal year 1998. Due to downsizing, staffing reassignments, and delays in timely contracting for outsourced processes, there was (1) a premature migration of workload; (2) a mismatch between workloads, skill sets and skill needs; and (3) a shift in workload among offices that had the capacity to assist regardless of experience.

For the Office of Multifamily Housing, a decrease in staffing has been coupled with an increase in the workload at the Multifamily Hubs and Program Centers. During fiscal year 1998, approximately 880 Section 8 contracts expired and were processed for annual renewal. As detailed in Exhibit 2, this increase in workload will continue during fiscal year 1999 with the expiration of over 8,200 Section 8 contracts, and the requirement to renew fiscal year 1998 and prior year annual contracts.

Exhibit 2

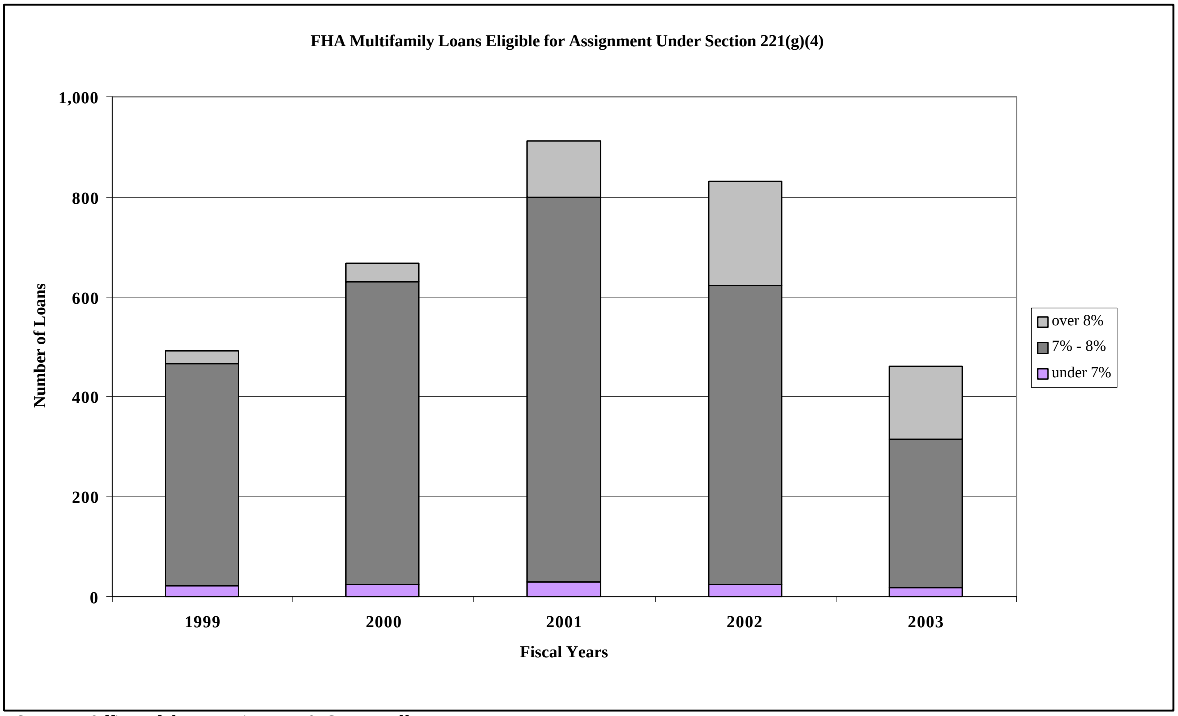


Source: Office of Multifamily Housing

Currently, Multifamily Hubs and Program Centers Administer over 20,000 Section 8 contracts. In the fiscal year 2000 Budget, the President has requested the resources to outsource the Section 8 contract renewal and contract management process to local contract administrators. However, until the contract administrators are in place, multifamily personnel must manually process contract expirations and renewals, and continue to administer Section 8 contracts.

In addition to the Section 8 contract renewal process, Section 221(g)(4) of the National Housing Act enables mortgagees to automatically assign current mortgages to the Secretary after 20 years. Section 221(g)(4) assignments comprised approximately 29 percent (43 out of 159) and 46 percent (76 out of 170) of all multifamily assignments during fiscal years 1998 and 1997, respectively. The aging of the Section 221(g)(4) portfolio over the next three years could result in over 1,800 additional claims to the Secretary (see Exhibit 3). Although the servicing of assigned notes was outsourced during fiscal year 1998, managing the disposition of these assigned notes will increase the administrative burden on the FHA staff.

Exhibit 3



Source: Office of the Housing-FHA Comptroller

HUD 2020 contained sweeping changes to the way the Office of Multifamily Housing conducts business, including the establishment of the Real Estate Assessment Center (REAC), the Enforcement Center, and the Financial Management Center. These centers are designed to consolidate (and automate, where applicable) risk assessment, enforcement, and processing activities, and remove some responsibilities from project managers in the field. While these centers should decrease the current workload in multifamily's field operations, they had not become fully operational during fiscal year 1998. Until these centers are fully operational, the new Multifamily Hubs and Program Centers must continue performing functions that were not originally envisioned when the new field organization was created (i.e., initial review and analysis of physical and financial information).

Another initiative included in HUD is the movement of Multifamily Housing from a retail to a wholesale operation by delegating some production responsibilities to mortgagees or contractors. One of the important aspects of this plan is the Development Application Processing (DAP) system to facilitate the insurance application process and reduce labor-intensive processes. However, the reassignment of production responsibilities to other parties has not occurred, and full implementation of DAP system is yet to occur. As a result, the Hubs and Program Centers are required to continue performing labor-intensive production activities.

Recommendations to address the above weakness continue to include:

- Complete single family consolidation efforts and programmatic reforms through the implementation of (1) single family Management and Marketing REO contracts, and (2) a national servicing contract for Secretary-held notes.

- Continue with the implementation of the Real Estate Assessment Center and Enforcement Center to relieve some of the workload at the Hub and Program Center level.

- Continue the implementation of the human resource strategy, using a thorough workflow analysis, that:

  - plans for resource redeployment based on shifts in workload;
  - contains a comprehensive training program for personnel performing single family functions as many of these roles have changed; and
  - identifies specific performance measures for single family personnel that are linked to their roles and responsibilities;

- Review the consolidation of single family processes into the four 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.

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

In addition, we also recommend that FHA:

- Conduct a benchmarking study over single family and multifamily operations that considers full time equivalents (FTE's), business volume, and productivity measures to identify best practices.

- Streamline the customer service function through the implementation of a national call center system staffed with technical personnel capable of handling specific FHA customer inquiries.

- Establish effective performance based measures for project managers in the field to assess their contributions to meeting management's goals and make them accountable for their work. For example, track number of completed troubled project workouts per project manager.

Management's Response

Management states that at the time that KPMG performed its visits to HUD field offices for the audit, many of the critical HUD 2020 reforms addressing staff and administrative resources were underway but not complete. Since those visits, management asserts that FHA has continued to make strong progress in implementing these reforms. Management represents that most of the changes and improvements envisioned under HUD 2020 are now in place. The reforms most relevant to these concerns fall under five categories: reorganization, consolidation, increasing staff capacity, increasing use of technology, and contracting. These categories are discussed in full in management's response included in Appendix D.

KPMG's Assessment of Management's Response

We recognize that FHA has been in the process of implementing a number of major initiatives included in HUD 2020. Since fiscal year end 1998, FHA has completed several critical milestones that address staffing and administrative resource issues noted in this report. However, these initiatives are new, and it is too early to determine their impact on resolving this weakness in its entirety.

FHA MUST CONTINUE TO 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 and mortgagees with risky underwriting practices are key elements of FHA's efforts to target resources to insured mortgages and lenders that represent the greatest financial risks to FHA. Troubled insured mortgages and potentially problem lenders must be identified before FHA can institute loss mitigation techniques and lender enforcement measures that can reduce eventual claims.

The Office of Multifamily Housing has progressed with several major initiatives that are in the process of being implemented. These initiatives include:

- The Real Estate Assessment Center (REAC). In fiscal year 1998, HUD continued with the implementation of the REAC. At the end of fiscal year 1998, the REAC began performing physical inspections of Multifamily properties for the purpose of risk assessment. With the submission and analysis of December 31, 1998 year end project financial statements, REAC expects to be able to produce integrated assessments of the financial and physical condition of the Multifamily portfolio by late-fiscal year 1999. The full implementation of the REAC should improve risk assessment at Multifamily Hubs and Program Centers in the field.

- The Enforcement Center. In the beginning of fiscal year 1999, the Enforcement Center began to assess over 100 cases referred by Multifamily Housing. The Enforcement Center should assist the field in conducting enforcement activities related to the most troubled properties, and reduce time-consuming responsibilities of project managers in the field.

However, because these centers were not fully operational in fiscal year 1998, they had not yet affected the Hubs and program centers ability to perform risk assessment over the portfolio.

In addition, both KPMG and the HUD Office of Inspector General continued to notice problems in monitoring the insured and Secretary-held portfolios in the areas of management reviews, financial statement reviews, and physical inspections. Only 30 percent of troubled and potentially troubled projects tested during the audit had management reviews completed by FHA during the fiscal year. For financial statement reviews, unaudited data provided by the Office of Housing stated that less than 85 percent of financial statements submitted were reviewed; the standard is 100 percent. Only 26 percent of troubled and potentially troubled projects reviewed had physical inspections. Failure to monitor and manage the portfolio on a proactive basis increases the risk of projects becoming troubled, thereby escalating the risk of future claims and placing additional stress on limited resources.

The Office of Insured Single Family Housing made significant progress towards taking a proactive and preventive role in monitoring insured single family mortgages during fiscal year 1998. This progress includes:

- Increasing lender monitoring and enforcement activities performed by the Quality Assurance Division (QAD). The QAD staff increased from 23 monitors to 154 monitors, and the number of annual on-site lender reviews performed increased from 256 reviews to 440 reviews between fiscal year 1997 and 1998.

- Developing automated systems to monitor insured loan performance. The Neighborhood Watch System and Credit Watch System are examples of two systems that augment FHA's monitoring process. The Neighborhood Watch system, implemented in May 1998, tracks FHA insured loan performance by several different characteristics and is available to HUD employees and lenders via FHA Connection. The Credit Watch system, planned for release in fiscal year 1999, will track mortgagee's early default and claim rates by mortgagee branch office and census tract. FHA will impose sanctions and terminate the approved status of mortgagees whose early claim and default rates greatly exceed the average rates for corresponding areas. Data from these and other indicator systems also assists QAD in targeting lenders for on-site reviews.

- Expanding the use of loss mitigation. The number of seriously delinquent loans that are cured through borrower self-help and avoid foreclosure through relief measures provided by loss mitigation tools is increasing. The total number of loss mitigation interventions more than double between fiscal years 1997 and 1998, from 5,019 to 10,900. Based on the first quarter's activity, the fiscal year 1999 projection is 20,000 loss mitigation interventions.

While FHA has made significant progress monitoring the insured single family portfolio, these initiatives are relatively new, several are still developing, and the benefits have not yet been fully recognized. Additional steps should be taken to effectively monitor the insured single family portfolio as described below.

FHA performs post-endorsement technical reviews on a case level basis to monitor the quality of underwriting and valuations performed by lenders and appraisers. We found that while HOC staff performed these reviews during fiscal year 1998, there was little analysis and lender follow up based on the results of these reviews, even though certain lenders were identified with risky underwriting practices. Identifying deficient underwriting practices before loans go to default or claim is FHA's best defense against risky lenders.

During a review of the Santa Ana HOC's production division, the HUD Office of Inspector General identified both understaffing and lack of experienced staff as primary contributors to FHA's inability to monitor lenders and take immediate action against lenders identified with poor underwriting practices. In January 1999, GAO also reported that HUD has an insufficient mix of staff with the proper skills that hamper the effective monitoring and oversight of HUD's programs.[3]

Additional problems have been identified in appraisals obtained on FHA insured mortgages. A recent GAO report,[4] dated May 1998, noted that (1) FHA was not adequately monitoring the performance of appraisers tasked with valuing property securing FHA-insured mortgages, and (2) appraisals did not reflect property conditions noted upon subsequent house inspections. Because FHA did not immediately act on indicators of risky underwriting and appraisal practices, certain of these lenders and appraisers continue to do business with FHA.

Recommendations to address the above weakness continue to include:

- Continue with the development of the Real Estate Assessment Center and Enforcement Center to improve risk assessment, management, and enforcement capabilities;

- Strengthen requirements to obtain payment history information for insured multifamily projects, including delinquency and default information, from mortgagees. This

[3] Performance and Accountability Series: Major Management Challenges and Program Risks, Department of Housing and Urban Development (GAO/OCC-99-8).
[4] Appraisals for FHA Single-Family Loans: Information on Selected Properties in New Jersey and Ohio, May 6, 1998 (GAO/RCED-98-145R).

information should be obtained in electronic format on a monthly basis. Monetary penalties for mortgagees who fail to report should be considered to promote reporting compliance;

- Prepare a comprehensive work program for quality control for and conduct on-site reviews of multifamily mortgagees and reviews of closed development packages at the Multifamily Hubs and Program Centers; and

- 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.

In addition, we also recommend that FHA:

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

- Develop a process to timely capture, analyze, and follow up on results of the single family post-endorsement technical reviews to immediately identify and take corrective action against problem lenders, underwriters, and appraisers.

- Implement revisions to the single family appraisal process to identify homes in need of a physical inspection and ensure that the appraisal process is thorough and examines the conditions and features of the house.

Management's Response

Management represents that during the past year, FHA has made tremendous progress in implementing new approaches and strategies for reducing the frequency and loss severity of defaults on insured mortgages. Their response discusses a number of functional centers, including REAC, the Enforcement Center, the Property Disposition Hubs, and the Quality Assurance Center. Management asserts that staff in these centers are pursuing a number of highly-focused strategies to better monitor, and ultimately mitigate defaults on, FHA-insured mortgages. In addition, management discusses the new loan loss mitigation program and enhanced lender monitoring and enforcement activities in the single family program, as critical elements in monitoring and mitigating overall default frequency and severity. Further discussion is included in management's response in Appendix D.

KPMG's Assessment of Management's Response

As with the previous material weakness relating to staffing and administrative resources, we recognize that FHA has been in the process of implementing initiatives included in its HUD 2020 management reforms. The initiatives implemented by FHA, including the Real Estate Assessment Center, should assist Housing in improving its risk assessment capabilities, and result in better monitoring of the insured portfolio. However, the most significant initiatives had not been implemented at the end of fiscal year 1998, subsequent to the year under audit. We continue to believe, based on the results of our audit, that early warning and loss prevention capabilities and performance could be improved in the future.

FEDERAL BASIS AND BUDGETARY ACCOUNTING MUST BE IMPROVED

FHA has historically maintained accounting records in accordance with generally accepted accounting principles (GAAP). Fiscal year 1998 is the first year that FHA prepared financial statements in accordance with the hierarchy of accounting principles and standards recommended by the principals of the Federal Accounting Standards Advisory Board and OMB Bulletin 97-01, *Form and Content of Agency Financial Statements*. This hierarchy is a comprehensive basis of accounting that differs from GAAP. With the exception of the U.S. Treasury Standard General Ledger (SGL) each of these issues were initially identified during the independent audit process, rather than by FHA's internal controls over the reporting. During the fiscal year ended September 30, 1998, we noted the following weaknesses with FHA's budgetary and Federal basis accounting:

Obligations needed to be reviewed and reconciled. At our request, FHA identified 194 contracts and approximately 1,300 purchase orders, which appeared to have been fulfilled, but not de-obligated. FHA de-obligated those contracts and purchase orders for a total adjustment to the financial statements of approximately $29,700,000. Also at our request, FHA reconciled the commitments and endorsements in the accounting system to those in the budget system, and identified nine items, which had not been recorded in the budget system. In addition FHA identified errors in mortgage amounts and subsidy rates between the accounting and budget systems. As a result, FHA recorded $7,500,000 in additional obligations in the budget system. Finally, FHA identified approximately $6,900,000 of unrecorded unliquidated obligations related to contractor processed disbursements and adjusted the financial statements, accordingly.

FHA's general ledger was not compliant with the SGL at the transaction level and preparation of the Report on Budget Execution (SF133) was not well documented. The FHA general ledger does not use the series of accounts required by U.S. Treasury to record budgetary activity, i.e., the U.S. Government Standard General Ledger. FHA analyzed the GAAP accounts and translated those accounts to the Federal basis to prepare both the financial statements and the SF-133s, *Report on Budget Execution*.

Methodology for allocating costs in accordance with Statement of Federal Financial Accounting Standard No. 4, Managerial Cost Accounting, was not documented and implemented throughout the year. The current method of allocating costs between

FHA's programs is based on a survey of the Housing employees. All supervisors are surveyed and requested to allocate the costs of their staff among three programs: (1) unsubsidized, (2) subsidized, and (3) non-FHA. Difficulties encountered in this initial process included receiving timely responses and reconciling those responses to ensure all employees were accounted for properly.

Methodology for calculation of the liability for loan guarantees (LLG) required refinement. Based on our audit, FHA's methodology and assumptions for calculation of the LLG required refinement. The need for additional refinement was not consistently identified through FHA's own review process. FHA has developed an action plan to address identified financial management issues related to the LLG. This plan included accumulating supporting data for estimating the cost of its loan programs and reviewing its cash flow models to identify additional improvements that could reduce the chance of error. Additionally, the plan included establishing formal policies and procedures that include a formal supervisory review process. This plan, if fully implemented, should help FHA further refine its liability for loan guarantee calculation. FHA plans to continue use of contract resources to perform this calculation for fiscal 1999.

Recommendations to address the above weakness include:

- Implement routine procedures to analyze unliquidated obligations for contracts and purchase orders and de-obligate those items which have expired, timely;
- Reconcile the accounting and budget systems for loan guarantee commitments and endorsements, to ensure all credit subsidy amounts are recorded properly;
- Prepare formal documentation of the process to prepare federal basis financial statements and the SF-133, which includes cross walks of GAAP accounts to the Federal basis, and identify all required sources of budgetary system information;
- Prepare formal documentation of the cost allocation time survey process, and conduct the survey periodically during the year; and
- Implement existing plans to address identified financial management issues related to the LLG.

Management's Response

FHA agrees with the finding and the associated recommendations. Management has already developed workplans to implement each recommendation provided in the report.

KPMG's Assessment of Management's Response

We agree with management's response.

INFORMATION TECHNOLOGY SYSTEMS MUST BE IMPROVED IN ORDER TO SUPPORT BUSINESS PROCESSES MORE EFFECTIVELY.

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. 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.

There are a number 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. HUD continues to report material system non-conformances in its *Fiscal Year 1998 Accountability Report* several of which relate to FHA systems. As reported by the OIG, this includes reporting of FHA general ledger and subsidiary systems at the case level and other incomplete program and geographical information. In addition, OIG addresses the project planning, cost and management of the Financial Systems Integration (FSI) project, of which FHA is a part.

Recommendations, as reported in prior years, include:

- Enhancing the general ledger and subsidiary systems to facilitate better case level reporting for compliance with Credit Reform;
- 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);
- Fully implementing an "umbrella" system at FHA that will integrate all financial management systems; and
- Enhancing systems for reporting by program, geographical area, or other relevant components.

Management's Response

Although FHA agrees with KPMG's assessment of the problem, they believe emphasizing new technology and modernization alone will not fix the problem. FHA suggests instead that more attention be placed on proper integration of systems to resolve weaknesses.

They believe the need exists to ensure that the methods of providing accounting information are standard in all systems.

Management states that FHA systems will have achieved significant improvement in the availability of needed management information with a measurable level of confidence in the quality and reliability of the information within the next two fiscal years. Better information systems will support strategic decision-making and make monitoring more productive and staff more efficient. Management further discusses the implementation of the US Standard General Ledger; system development, enhancement and integration; and the 'umbrella system' in their response, included in Appendix D.

KPMG's Assessment of Management's Response [to do based on formal response]

We agree with management's response.

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

Since 1994, FHA has made significant progress to reduce its Secretary-held note portfolio. However, efforts to reduce the single family and multifamily note inventory ceased during fiscal year 1998. Furthermore, note servicing weaknesses contributed to adverse changes in the performance of the single family notes portfolio during fiscal year 1998. Inadequate servicing:

- Increases the amount of time notes remain delinquent;
- Delays inevitable foreclosures;
- Allows borrowers to sink further into debt; and
- Impairs the value of the notes by decreasing FHA's return when notes are foreclosed upon or subsequently sold.

At September 30, 1998, FHA had approximately 12,000 single family notes with an outstanding balance of $731 million. Although FHA has considerably reduced the single family notes portfolio in recent years and is currently under contract with a special servicer who will assume the portfolio in April 1999, we noted the following weaknesses in fiscal year 1998: (1) an inability to consolidate servicing into one location; (2) restricted servicing efforts; and (3) shifts in the portfolio to substantially non-performing notes.

As we reported last year, FHA planned to improve asset management for the remaining single family mortgage notes portfolio by consolidating servicing functions into one location, Oklahoma City. However, this plan was not implemented during fiscal year 1998. FHA determined that there were too many notes to consolidate into one location as a result of the cancelled asset sale number six. Currently, servicing is performed at seven field offices. Furthermore, the servicing of these notes was limited during fiscal year 1998 due to staffing changes, workload transitions, the anticipated note sale, and programmatic reforms. We were told this occurred because workload shifts were based on available staffing resources and not servicing experience. The HUD Office of Inspector General also noted deficiencies in servicing and found that many of the HUD staff possessed little or no knowledge of HUD servicing requirements.[5]

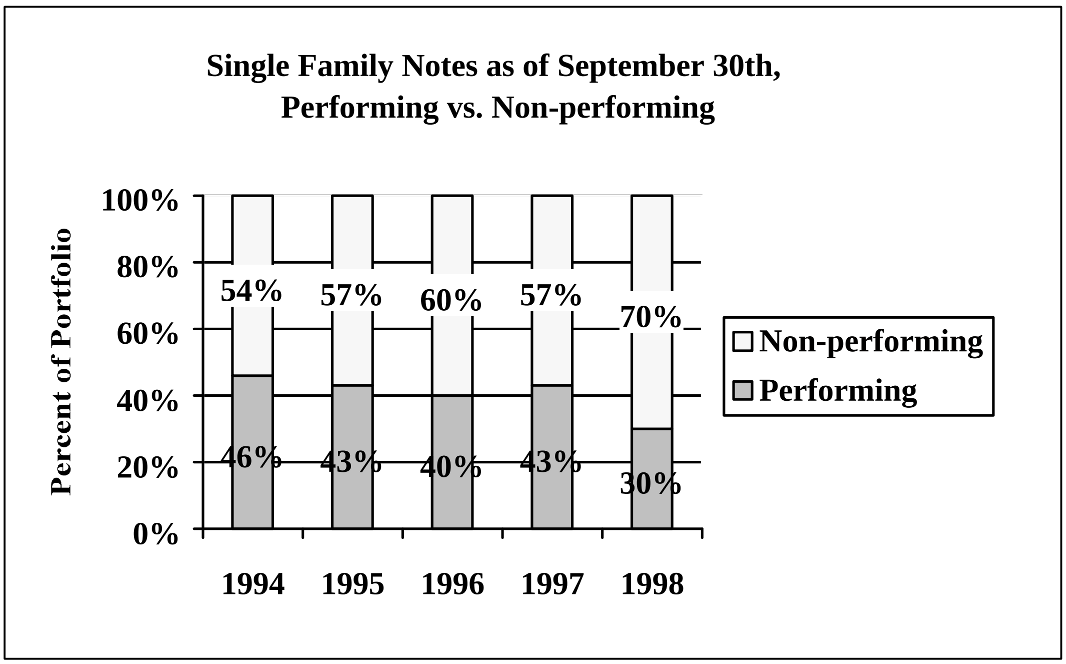
Because asset sales and consolidation plans were not implemented during fiscal year 1998, FHA began the concept of 'limited' or 'interim' servicing. Under these guidelines, FHA continued to issue standard delinquency letters. However, if borrowers were unresponsive after the issuance of the 120-day delinquent letter, no foreclosure action was taken.

[5] Statement of Inspector General, U.S. Department of Housing and Urban Development, before the Committee on Government Reform, February 10, 1999.

Additionally, FHA did not aggressively pursue other servicing alternatives, such as workout plans or increased collection efforts.

The composition of the single family notes portfolio shifted dramatically between performing and non-performing notes as depicted in Exhibit 6. The non-performing portion of the single family notes portfolio typically ranged between 55 and 60 percent in recent fiscal years. However, at September 30, 1998, over 70 percent of the single family notes portfolio was classified as non-performing, representing notes that were delinquent under either the terms of the original mortgage or subsequent forbearance agreements. Troubled assets are more difficult to manage and typically require a greater number of experienced staff to service.

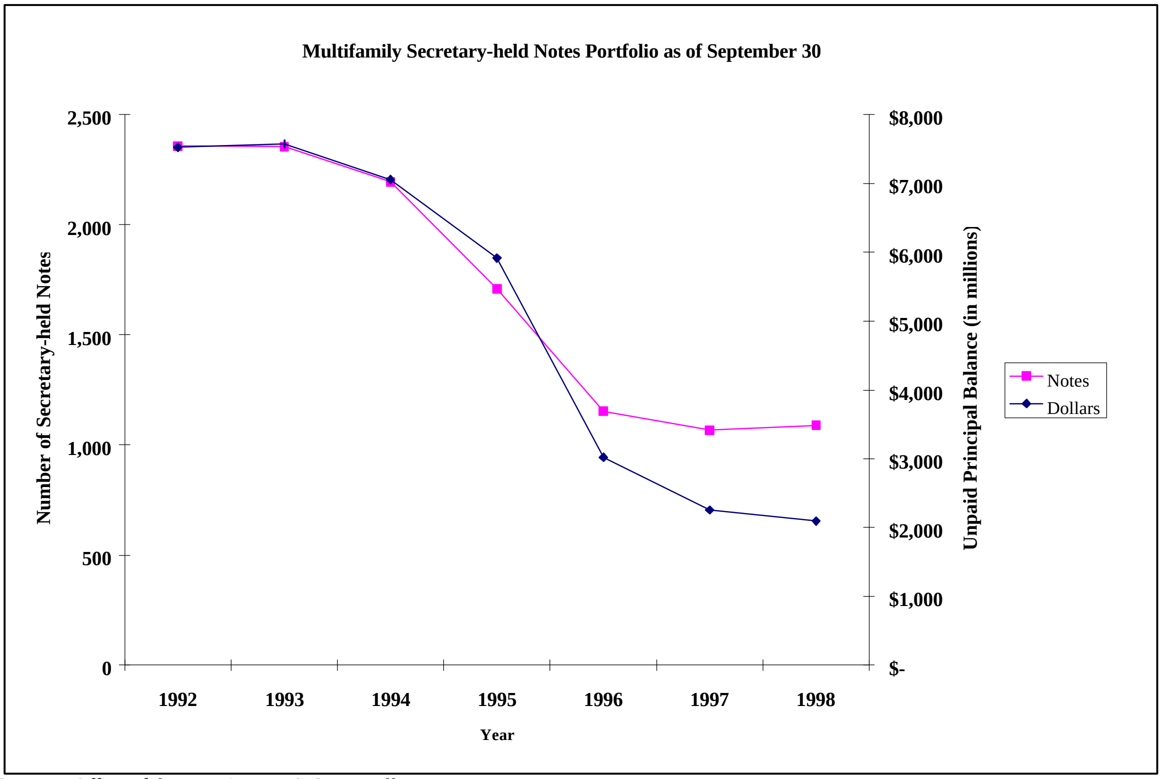
Exhibit 6



Source: Single Family Note GAAP Extracts

FHA has been successful in the past with reducing the Secretary-held multifamily note inventory, from over 2,300 mortgages with an unpaid principal balance (UPB) of $7 billion in 1994 to the current level of 1,150 mortgages with a UPB of $2.1 billion. As depicted in Exhibit 7, the number of multifamily notes and unpaid principal balance on hand have remained steady from fiscal year end 1997 to fiscal year end 1998, primarily as a result of the discontinuation of the note sale program in 1997. Further reductions in the number and unpaid principal balance of Secretary-held multifamily notes must be made to improve FHA's ability to monitor the insured portfolio and multifamily mortgagees and reduce the risk of further losses. Also, despite the strategy developed to manage Section 221(g)(4) projects, the risk of assignment still exists.

Exhibit 7



Source: Office of the Housing-FHA Comptroller

Recommendations to address the above weaknesses continue to include:

- Conduct mortgage note auctions to reduce both the single family and multifamily 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.

- Conduct Section 221(g)(4) mortgage note auctions to reduce the risk of future claims to the insurance fund.

In addition, we recommend that FHA:

- Execute the single family special servicing contract to assist FHA with (1) servicing Secretary-held notes, and (2) performing due diligence necessary for future note sales.

- Develop a comprehensive plan and implement oversight tools to facilitate the effective monitoring of both the single family and multifamily Secretary-held note contract servicers.

Management's Response

Management states that the multifamily mortgage inventory is not growing and, given that 55 percent of the inventory is either current or not significantly in arrears, these mortgages do not present an undue management/servicing burden. In addition, management believes their ongoing efforts as related to the first material weakness, many of which they assert have been completed in fiscal year 1999, will reduce future mortgage note assignments and insurance claims and thereby protect the FHA insurance fund.

Single family management points to the dramatic reduction of the number of Secretary-held single family notes from more than 100,000 in 1994 to approximately 12,000 in 1998 through several successful note sales. They further state that FHA is now in the process of retaining private sector professionals to assume all functions related to servicing remaining single family notes. Finally, management states that the plan was always to partially implement the servicing consolidation during fiscal year 1998, using outstationed staff, and to complete implementation during fiscal year 1999 when a contract was in place for the servicing.

KPMG's Assessment of Management's Response

While we agree with FHA's assessment that significant progress has been made to reduce the Secretary-held note portfolio, several significant initiatives to resolve this issue were not completed during fiscal year 1998. Due to problems experienced with contractors and pending litigation, no mortgage note auctions were performed during fiscal year 1998, and FHA does not currently have a financial advisor in place to assist with future note sales. Despite the progress made during the previous fiscal years, the number of notes has not been reduced significantly in the last fiscal year. Additionally, the limited note servicing efforts during fiscal year 1998 lead to a deterioration of the Single Family Secretary-held note portfolio.

FHA MUST SUFFICIENTLY MONITOR AND ACCOUNT FOR SINGLE FAMILY PROPERTY INVENTORY

FHA continues to experience control weaknesses in its single family property acquisition, management, and disposition functions. Examples of control weaknesses noted by KPMG and others[6] include:

- Inadequate oversight of real estate management services, including maintenance and repairs, real estate closing services, and other services provided by contractors.

- Deficient management, maintenance, and upkeep of REO properties, including properties that were not secured and lacked signs identifying them as government properties available for sale, and properties where Real Estate Asset Managers (REAMs) appeared to be signing in for multiple visits.

- Delayed recognition and management of newly conveyed properties.

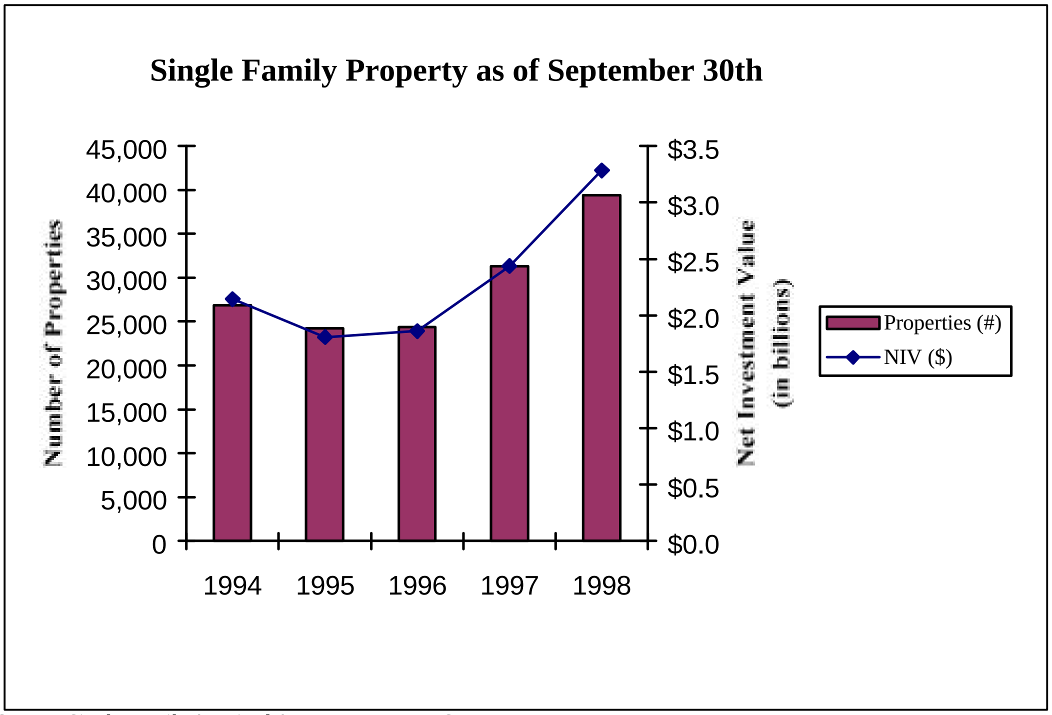
- Inability of the Single Family Acquired Asset Management System (SAMS) to track contracts and purchase orders does not (1) ensure that payments do not exceed contract limits, or (2) prevent the duplicate payment of invoices.

- Input errors, data inconsistencies, and data inaccuracies within SAMS.

Fiscal year 1998 key portfolio statistics confirm the deficiencies noted above. An aging of single family REO reveals that properties remained in inventory for longer periods of time. The average disposition lag time increased from 5.4 months during fiscal year 1997, to 6.6 months during fiscal year 1998, and continues to rise. As depicted in Exhibit 8, the number of on-hand REO properties increased over 25 percent between fiscal year end 1997 and 1998. At some field offices, inventory more than doubled between fiscal year 1997 and 1998. Over 35 percent of the single family REO inventory exceeded SAMS standard processing times at fiscal year end 1998. Additionally, property loss rates based on FHA's acquisition cost increased significantly during fiscal year 1998. Finally, FHA is incurring additional costs as a result of increases in property disposition lag time, on-hand inventory, and property holding costs.

[6] GAO Single Family Housing - Improvements Needed in HUD's Oversight of Property Management Contractors, March 1998 (GAO/RCED-98-65).

Exhibit 8



Source: Single Family Acquired Asset Management System

The control weaknesses noted above have:

- Decreased FHA's ability to monitor, control, and report accurately on the single family property inventory activity;
- Increased the risk of loss to FHA on the sales of its single family properties as resources may not be safeguarded against waste, fraud, loss, or abuse; and
- Raised concerns about SAMS data reliability as a result of data input errors, data inconsistencies, and incomplete data fields

Recommendations to address the weaknesses noted above continue to include:

- Implement current plans to outsource FHA's property disposition process.
- Develop comprehensive oversight tools and management reports to facilitate effective and efficient monitoring of M&M contractors.
- Increase monitoring of contractors responsible for performing property management and closing services.
- Enhance SAMS purchase order capabilities to ensure the recording of essential contract information and disbursement detail related to REO properties.

- Verify the accuracy of data in the SAMS system, research possible data entry errors or omissions, and correct inaccurate information.

In addition, we recommend that FHA:

- Train FHA staff to help their transition from property management responsibilities to a contractor oversight and monitoring role.

- Train M&M contractors on SAMS and FHA's property management and disposition requirements.

Management's Response

Management throughly discusses the implementation of the Management and Marketing (M&M) contracting model nationwide in their response in Appendix D. Under this new approach, FHA will rely on private sector real estate professionals to perform all property management, marketing and sales activities related to the single family REO inventory. FHA has awarded contracts for each of sixteen geographic areas covering the entire country, and M&M contractors are scheduled to begin providing services in the Spring of 1999. During more than two years of pilot testing of the M&M contracting model, private contractors proved able to sell REO properties more quickly and at a higher rate of return. Following transition to the M&M contracting environment, FHA REO field staff will focus exclusively on monitoring and evaluating contractor activities.

KPMG's Assessment of Management's Response

We agree with the information presented in management's response. However, this important initiative was not implemented during the period covered by our audit, and it is too early to determine the overall benefits of outsourcing REO nationwide.

FHA/HUD MUST ENHANCE THE DESIGN/OPERATION OF INFORMATION SYSTEMS GENERAL AND APPLICATION CONTROLS.

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.

Control weaknesses regarding FHA's general and application level security systems were identified in three areas, as summarized below:

Entity-Wide Security Program. There are several areas in the enterprise-wide security program that need improvement. Without a well designed security program, security controls may be inadequate; responsibilities may be unclear, misunderstood, and improperly implemented; and controls may be inconsistently applied. Examples of weaknesses include:

- A financial management system plan has not been prepared as a part of FHA/HUD's overall planning process.
- A five year IT Strategic Management Plan has not been prepared.
- The Security Program Plan is out of date. An updated plan has not been finalized nor implemented.

Access Control. Certain access controls need improvement to provide a more secure EDP environment. These controls include controls over physical access to computer resources, and controls that prevent unauthorized access to sensitive files. Examples of weaknesses include:

- HUD has not provided adequate protection over sensitive programs and files on the Unisys #1 and #2 machines.
- HUD has not disabled the GUEST account on network fileservers.
- The Unisys audit trail suspicious system activity data is not consistently investigated.

Application Change Control and Systems Development. Controls over the modification of application software programs are deficient. Without proper controls, there is a risk that security features could be inadvertently or deliberately omitted or "turned off" or that processing irregularities or malicious code could be introduced. Examples of weaknesses include:

- Application change request forms are not completed and approved prior to programmers accessing source code in the production environment.
- HUD has not fully implemented a Configuration Management Tool in either of the mainframe environments, Unisys or Hitachi.
- FHA/HUD does not maintain test documentation for all application changes.

Recommendations to address the above weakness include:

- FHA and HUD develop a formal action plan to review and revise its EDP general controls. This plan should address each of the areas discussed above as well as other areas that impact the general EDP control environment, set forth appropriate corrective action steps, assign responsibilities to employees, and establish target completion dates for each action. This plan should be adopted by top management of FHA and HUD and provide for periodic reviews of progress towards achievement of corrective actions.

- The entity-wide security program should establish a framework for assessing risk, developing and implementing effective security procedures, and monitoring the effectiveness of these procedures.

- Controls should provide reasonable assurance that computer resources (data files, application programs, and computer-related facilities and equipment) are protected against unauthorized modification, disclosure, loss, or impairment.

- Controls should be designed to ensure that only authorized programs and modifications are implemented.

Management's Response

FHA agrees that "application change request forms are not completed and approved prior to programmers accessing source code in the production environment" and has taken steps to create and institutionalize procedures that will address this problem. Project Management Procedures, which represented a joint effort of Housing/FHA and the Department's Information Technology group were finalized in February, 1999. These procedures will address KPMG's recommendation that "controls should be designed to ensure that only authorized programs and modifications are implemented."

KPMG's Assessment of Management's Response

We agree with management's response.

COMPLIANCE WITH LAWS AND REGULATIONS

FHA is not in full compliance with certain data requirements of the Federal Credit Reform Act of 1990 (Public Law 101-508) (Credit Reform). The major objectives of Credit Reform 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 the 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 known facts at the time of the obligation or commitment. Risk categories are used to estimate long-term costs, to control budget authority during budget execution, and to make annual reestimates of costs.

FHA's single family periodic premiums systems cannot generate the required case-specific cash flow data required to reestimates its subsidies. 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.

Recommendations to address the above noncompliance are to continue with the OMB-approved corrective action plan to ensure compliance with the data requirements of Credit Reform in the future.

Management's Response

Regarding the finding that FHA is not in full compliance with certain Credit Reform Act data requirements, FHA agrees that its single family premiums systems cannot generate the required case-specific cash flow data. FHA is continuing development of a new system, expected to be operational during fiscal year 2000, that will resolve this issue.

KPMG's Assessment of Management's Response

We agree with management's response.

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

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

March 8, 1999

MEMORANDUM FOR: Timothy Kenny, Partner, KPMG

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

SUBJECT: FHA response to KPMG's 3/1/99 FHA Draft Audit Reports

FHA management hereby presents to you our responses to your March 1, 1999, draft audit reports on the Fiscal Year 1998 FHA financial statements prepared under Federal accounting standards ("Fed-GAAP").

Report on Internal Controls -- Material Weaknesses

FHA Must Address Staff and Administrative Resource Issues

At the time that KPMG performed its visits to HUD field offices for the Audit, many of the critical HUD 2020 reforms addressing staff and administrative resources were underway but not complete. Since those visits, FHA has continued to make strong progress in implementing these reforms, progress that is not consistently recognized in KPMG's draft report. Most of the changes and improvements envisioned under HUD 2020 are now in place. The reforms most relevant to these concerns fall under five categories: reorganization, consolidation, increasing staff capacity, increasing use of technology, and contracting.

Reorganization

To streamline its program delivery and portfolio oversight responsibilities, Multifamily Housing consolidated its functions into 18 Program Hubs and Single Family Housing consolidated all single family operations into four Home Ownership Centers during the last year. This reorganization shifts the focus and control of resources to these geographic centers and gives them oversight responsibilities for all out-stationed staff, including staff in 33 Multifamily Program Centers. By eliminating redundancy across many functions, this improved operating structure has lowered field staffing to 1,723 Multifamily employees and 937 Single Family employees while improving service to FHA's customers and partners.

Multifamily headquarters staff have been reorganized as well, with a combined total of 107 employees serving in the offices of Portfolio Management, Business Products, and Program Management and Oversight. Single Family headquarters staff consist of a combined total of 107 employees serving in the offices of Insured Single Family Housing, Lender Activities and Program Compliance and Consumer and Regulatory Affairs. Including other functional areas such as Operations and Comptroller, FHA headquarters and other staff total 666, resulting in a combined total staffing of 3,326 for FHA headquarters and field office employees.

At a number of points in the draft report, KPMG comments on these changes and reductions in staffing and appears to draw the conclusion that the changes are problematic without providing any evidence of negative consequences. Contrary to the tone of the report, these changes are planned and result from FHA operating in a more streamlined and efficient manner, a goal FHA management believes KPMG and OIG share. For example, on page 9 the report points to reductions in single family staffing and increases in insurance and claim volumes, yet cites no specific consequences of these changes.

At other points in the report, KPMG takes the opposite position: it criticizes earlier processes that continue to be used within FHA, and implies that problems result because changes have not yet occurred. Again, the report provides no evidence of negative consequences. For example, on page 11 the report cites the increasing volume of Section 8 contracts that are expiring, but provides no analysis that shows this increased volume will be problematic for FHA to process. In addition, on page 12 the report states that the multifamily MAP and DAP initiatives have yet to be implemented, but provides no discussion of how the current underwriting process is causing delays or issues that contribute to a Material Weakness.

In one of the few specific references that KPMG uses to support its findings, a HUD human resources report is cited to show that HOC staff are inexperienced in their current positions. While it is accurate that NFC data indicates HOC staff have less than 9 months experience, on average, performing their current assignment, it only provides information on how long persons have occupied their current positions, not how long they have worked in a particular function. While most of the Single Family staff in the HOCs either changed position titles or locations during the transition, these staff qualified for their positions based on 1) being in the same function in the previous organization, or 2) skills that were developed in previous positions. The majority of the HOC staff work in the same functional area as they did previously. NFC data does not reflect experience prior to the current position. The majority of the HOC staff who are in technical positions have years of experience handling their function.

In order to ensure that the HOC reorganization is proceeding successfully, FHA plans to conduct a thorough review of all strengths and weaknesses resulting from consolidation into the HOCs in the Fall of 1999, when all HOCs have been fully operational for one year. In the meantime, FHA is continually monitoring the HOCs' performance and assessing staffing needs and evaluating the match of personnel skills to skill needs. For example, as the result of a mid-year review of HOC staffing needs in FY 1998, FHA implemented a plan to modify the structure of all four HOCs to account for the reduced need for marketing and outreach staff, in light of the arrival of Community Builders, and the somewhat greater need for technical support staff with the capacity to perform a variety of location-specific work. FHA managers also are continually re-assessing the match of personnel skills and skill needs and making necessary adjustments. During a mid-year review in FY 1998, senior HOC and Headquarter's managers determined that field staffing plans called for too many marketing and outreach staff and too few staff with technical expertise and the ability to perform location-specific work, such as appraisal, lender and/or REO property management monitoring. As a result of this assessment, FHA implemented a structural change to all four HOCs.

Consolidation

As an essential element of HUD 2020, independent centers have been created to consolidate certain multifamily functions previously performed by individual field offices. These new centers include the Real Estate Assessment Center, Enforcement Center, Financial Management Center, and Property Disposition Hubs, and the single family Loan Loss Mitigation Center and Loan Servicing Center. By consolidating tasks that can be performed more efficiently at increased scale, these centers allow multifamily and single family field staff to focus on their primary responsibilities of program oversight and portfolio management. Despite the tremendous progress made during FY 1998 to establish these centers, the draft report recognizes little of this progress. Instead, the report suggests that a number of the centers are not fully operational, yet provides no specific discussion or evidence. In fact, the centers mentioned are either fully operational or nearly so.

Most importantly, the implementation of the new centers has improved FHA's early warning systems for troubled properties in the multifamily and single family portfolios, thereby allowing FHA to focus its monitoring and enforcement efforts on high-risk properties and reduce losses to the FHA insurance fund. Because the new centers have significantly improved FHA's early warning and servicing capabilities, the implementation of these centers is discussed in more detail below under Material Weakness No. 2 and Reportable Condition No. 1, which focus on early warning and loss prevention systems and Secretary-held notes.

Increasing Staff Capacity

Improving staff capacity through the provision of comprehensive training is a key component of the HUD 2020 Management Reform Plan. During Fiscal Year 1998 training sessions were conducted for newly assigned/reassigned staff on customer service, lender monitoring, marketing and outreach, loan servicing and loss mitigation, and the

SAMS computer system for tracking real estate owned (REO) properties. Additional training scheduled for FY 1999 includes a comprehensive two day session on Marketing and Management (M&M) contract administration and monitoring, additional SAMS training, GTR/GTM general contract management skills training, and new sessions for staff moving to assignments in customer service and lender monitoring.

Upon implementation of HUD 2020, the Office of Multifamily Housing provided transitional training for Project Managers nationwide in all 18 Multifamily Hubs. This training was critical in developing the broad skills of the more generalist perspective of the Project Manager. The transitional training was followed up by a continuing series of more in-depth sessions. Training was also provided to help Multifamily staff understand the role of the new specialized centers discussed above. For FY 1999, comprehensive training continues for a broad range of Multifamily staff.

Increasing the Use of Technology

By developing new systems and improving existing systems to achieve integration, an important goal of HUD 2020, FHA has improved the management and oversight of its programs and portfolios while reducing staff. These efforts are described in detail below under Material Weakness No. 4

Contracting

While HUD 2020 foresaw using a smaller, more efficient workforce to deliver FHA programs more effectively, it also envisioned outsourcing selected FHA functions to complement HUD's revitalized workforce. Where appropriate, public- and private-sector partners offer HUD new expertise and increased efficiencies for tasks that FHA may not be well equipped to perform. As the draft report recognizes, the most important example for Multifamily Housing is the administration of project-based Section 8 subsidy contracts, including all processing and interaction with property owners. Currently, FHA administers approximately 20,000 project-based Section 8 contracts, while more than 4,000 are already overseen by Public Housing Agencies throughout the country. Implementation of this initiative is proceeding, and contractors should be in place to begin processing of contracts at the beginning of FY 2000.

As also recognized in the draft report, the most important example of more effective use of contracting for Single Family housing is the management and marketing of REO properties. Under a new Management and Marketing (M&M) contracting model, FHA will rely on private sector real estate professionals to perform all property maintenance and marketing functions. In pilot testing over the last two years, the M&M contacting model has proven to reduce the time REO properties are in inventory, and increase the return on sale to FHA. Through implementation of this contracting model nationwide, FHA expects to greatly improve its REO property maintenance and disposition operations, and benefit communities across the country. FHA has selected and awarded contracts to M&M contractors in each of the 16 separate regions covering the entire country, and will commence transfer of work to these new contractors this Spring.

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

During the past year, FHA has made tremendous progress in implementing new approaches and strategies for reducing the frequency and loss severity of defaults on insured mortgages. On the Multifamily side, a number of functional centers, including REAC, the Enforcement Center, the Property Disposition Hubs and the Quality Assurance Center, now are implemented and operational. Staff in these centers are pursuing a number of highly-focused strategies to better monitor, and ultimately mitigate defaults on, FHA-insured mortgages.

Within Single Family, the new loan loss mitigation program is taking hold, with current projections indicating that the program should serve as many as 20,000 households in default this year, a remarkable increase over activity in previous years. FHA also is making great strides in enhancing lender monitoring and enforcement activities, a critical element to monitoring and mitigating overall default frequency and severity.

Multifamily Housing

Before turning to new approaches and strategies for early warning and loss prevention, this response must address the claim on page 14 in the draft report that "HUD did not perform physical inspections of multifamily housing projects for the purpose of risk assessment during the last four months of fiscal year 1998". Analysis of multifamily monitoring performed by field offices and recorded in REMS show that, in fact, HUD continued to perform inspections of properties during this period.

The data also show that, contrary to KPMG's implication that monitoring and risk assessment declined during FY 1998, overall monitoring actually increased from FY 1997 to FY 1998. The total number of properties inspected went from about 13,300 in FY 1997 to about 12,800 in FY 1998. While this reflects a slight decrease, the FY 1998 figures do not include over 1,700 additional inspections performed by REAC, which served some value for portfolio monitoring. And while the total number of properties inspected remained about even between FY 1997 and FY 1998, other forms of monitoring increased dramatically. The total number of properties that had financial reviews went from under 5,900 to almost 10,000 between FY 1997 and FY 1998, an increase of 70%. The total number of properties with management reviews went from under 600 to almost 1,500 between FY 1997 and FY 1998, an increase of over 150%.

At the same time, substantial progress was made during FY 1998 in implementing the strategy developed by the Office of Multifamily Housing to improve early warning and asset management efforts, which rests on a three part reform plan envisioned as part of

HUD 2020: 1) improve the quality and risk ranking of information available to FHA on its multifamily portfolio, 2) utilize this improved information to focus enhanced asset management tools on the highest risk properties, and 3) aggregate the improved information to assess the quality of mortgagee performance and prevent further issuance of high risk insurance commitments before they are underwritten.

The Real Estate Assessment Center

The linchpin of Multifamily's early warning strategy is the creation of the Real Estate Assessment Center (REAC). The draft report does not recognize the extensive progress made in implementing this new center. REAC has already begun to provide consistent, accurate and timely data on the physical and financial condition of HUD's portfolios through state-of-the-art electronic collection and risk ranking of individual property information: since the beginning of FY 1999, more than 8,000 inspections of Multifamily and Public Housing properties have been conducted. The results of the almost 4,000 Multifamily inspections are already available to the field offices through REMS, and the field offices are using the results for risk ranking and improvement of the portfolio. REAC is on target to complete inspections of the entire portfolio in calendar year 1999. Furthermore, REAC analysis of financial statements is beginning this month and will be completed for the portfolio by the end of FY 1999.

Once property information has been collected and ranked relative to the rest of FHA's multifamily portfolio, the data will be used to shift resources away from the best performing properties to focus effectively on those identified as high risk. To quickly resolve problems with these troubled and potentially troubled assets, FHA now has a range of complementary asset management tools, including the Enforcement Center, Senior Project Managers and Property Disposition Hubs.

The Departmental Enforcement Center

Again, although not recognized in the draft report, the Departmental Enforcement Center (EC) has been established and is operational. The Enforcement Center offers dedicated staff and other resources to deal with enforcement activities on the most troubled properties, thereby freeing Multifamily staff in the field offices from a significant portion of this demanding and time-consuming responsibility. The EC began work on over 100 cases referred by Multifamily Housing at the beginning of FY 1999.

Senior Troubled Project Managers

Whether or not high-risk properties have severe enough problems to require referral to the Enforcement Center, Multifamily Housing will continue to carry out at least some asset management for the properties. To ensure high quality attention to the particular needs of high-risk properties, Senior Troubled Project Managers have been designated in the Multifamily Hubs. Creation and staffing of Senior Project Management positions in Hub jurisdictions was completed in October 1998. In total, 106 Senior Project Managers were selected, and of these, 78 are designated for troubled project responsibility.

These Senior Troubled Project Managers, some of the best staff in Multifamily Housing, meet the need for concentrated efforts in monitoring the Multifamily portfolio and resolving troubled project conditions. The Senior Troubled Project Managers, well-trained and experienced in asset management, are a significant investment in focusing on early warning and loss prevention.

Property Disposition Hubs

Should a decision be made to pursue property disposition actions with a troubled property, Multifamily Housing relies on the services of two Multifamily Property Disposition (PD) Hubs, which were established in October 1997. These Hubs, located in Ft. Worth and Atlanta, handle all property disposition functions for the 18 Multifamily Program Hubs with a total of about 50 staff in the two offices. Prior to the establishment of the PD Hubs, the same activities were being handled by more than 150 people in more than 30 offices. Furthermore, a single person in headquarters now adequately manages a process that used to require 15 headquarters staff. Despite these reductions in staff, the PD hubs are meeting management goals for property disposition. Clearly, consolidating this activity provides more efficient processing of foreclosure activities and will contribute significantly to the reduction of the foreclosed inventory.

The Quality Assurance Center

Finally, to ensure that improved information on the multifamily portfolio is used not only to identify troubled projects, but also to prevent poor underwriting by mortgagees that leads to troubled properties, Multifamily Housing implemented the Quality Assurance Center in October 1998. The Quality Assurance Center is staffed with 71 employees who are responsible for overseeing the quality of mortgagee performance and assuring that FHA's high standards are met.

Single Family Housing

Over the last several months, FHA has taken a number of steps to enhance three distinct strategies to monitor insured loan performance and mitigate losses due to defaults on insured mortgages. These strategies, which were recognized in the draft report, include:

(1) Facilitating greater use of FHA's loan loss mitigation program designed to provide troubled borrowers effective options to foreclosure, and thereby reduce the number of FHA defaults and claims;

(2) Enhancing FHA lender monitoring and enforcement activities; and

(3) Developing automated systems to monitor insured loan performance.

Specific enhancements in these areas include the following:

Facilitating Greater Use of FHA's Loan Loss Mitigation Program

FHA's new National Loss Mitigation Center located in Oklahoma City with thirty-seven staff dedicated to facilitating greater use of the loan loss mitigation program, opened the Summer of 1997 and became fully operational in February, 1998. Staff in this new functional center focus solely on providing foreclosure avoidance counseling to FHA homeowners in default, performing on-site training and monitoring of high volume servicing lenders, and conducting large group training seminars for smaller loan servicers across the country.

The Center's work already is showing results. FHA is seeing a dramatic increase in the number of homeowners in default who are gaining access to one or more foreclosure avoidance options offered by FHA. In FY 1998, FHA helped more than 11,000 homeowners take advantage of foreclosure avoidance options, with the number of assisted families increasing each month as the program continues to gain momentum. During the first quarter of FY 1999 this momentum continued to build, as FHA lenders put more than 4,800 borrowers into one of the loan loss mitigation options. If this rate of use continues throughout the year, as FHA expects it will, then the program should serve approximately 20,000 borrowers this year, a remarkable increase over activity levels in previous years.

FHA also is beginning to see a marked increase in use of loan loss mitigation program options that keep borrowers in their homes. Of the more than 4,800 program cases during the first quarter of FY 1999, more than 3,600 cases, or approximately 75 percent of all cases, were options that keep the borrower in their home (options such as mortgage modifications, special forbearance or partial claims).

Moreover, FHA officials worked closely with Congress last fall to craft legislation creating new authority for FHA to impose financial penalties up to triple the amount of the outstanding insurance claim on lenders who do not follow FHA's loan loss mitigation requirements. This powerful new enforcement tool, which was included in the FY 1999 HUD/VA Appropriations Act, will greatly enhance FHA's ability to enforce existing program requirement and also should encourage even greater use of the loan loss mitigation program.

Enhancing FHA Lender Monitoring and Enforcement Activities

FHA has taken several steps to enhance its lender monitoring and quality assurance activities, to ensure lenders are conducting quality underwriting of insured-loans and servicers are thoroughly evaluating every candidate for the loan loss mitigation program. Since FY 1997, the Department has increased the number of lender monitors from approximately 23 to154 monitors, and nearly doubled the number of annual on-site monitoring reviews from 256 to 440. FHA has nearly completed all monitor training and has established a goal of performing 900 on-site reviews for FY 1999. This increase in activity, naturally, increases lender awareness of FHA program requirements, and is designed to improve lender performance and mitigate losses due to defaults and claims.

Developing Automated Systems to Monitor Insured Loan Performance

FHA has developed a new automated system for monitoring loan performance data by lender and geographic area. The Neighborhood Watch system, which was designed to track FHA insured loan performance by several different characteristics including the originating lender, the FHA loan program, specific loan characteristics, and geographic areas, was implemented nationwide in May, 1998. This new automated system gives FHA staff a powerful automated tool for monitoring defaults and making relative comparisons of lender performance.

FHA also is preparing to launch a new performance-based lender enforcement program. The Quality Assurance Division in HUD Headquarters is on schedule to restart the Credit Watch/Termination initiative in FY 1999. This initiative is designed to improve lender origination performance by regularly reviewing mortgagees' early payment default and claim rates by branch office within regional markets, and alerting mortgagees of deficient performance.

Federal Basis and Budgetary Accounting Must Be Improved.

FHA agrees with the finding and the associated recommendations. We have already developed workplans to implement each recommendation provided in the report.

Information Technology Systems Must Be Improved In Order To Support Business Processes More Effectively.

Because enhanced information and management reporting are central to a broad range of HUD 2020 reform goals, improvement of automated systems has been a top FHA priority. As part of this effort, FHA staff have completed an extensive effort to purify and verify existing portfolio data. To make this data more useful and accessible, FHA is also developing new systems and redesigning existing systems to achieve integration. And to ensure this integration is not limited to FHA, the Department has initiated an integrated systems working group that meets regularly to ensure systems compatibility and coordination across all of HUD.

The initiatives undertaken by FHA cover the following major categories:

1. US Standard General Ledger (Fed GAAP)

This is an initiative that reaches throughout HUD. The Department developed a new chart of accounts based on the US Standard General Ledger as part of the effort to implement FFS as the Departmental General Ledger. The CFO's office and FHA staff have developed posting models using the new chart of accounts that incorporate the concepts needed for both credit reform and GAAP reporting. Work is underway to collect the business activity of FHA into these posting models and interface to the Departmental general ledger. The immediate effort is to generate a financial data warehouse which captures the monthly detailed transactions from all FHA accounting systems into one integrated database. This will permit FHA to meet both the Departmental accounting needs and support an extensive set of reporting and analysis needs within the FHA programs. The estimated date of completion is December 1999.

At the same time, and in concert with the CFO's office, research proceeds to identify a COTS general ledger software package that meets the Fed GAAP requirements. The Department contracted with KPMG to research this field and determine if there are COTS packages currently meeting the Credit Reform requirements. KPMG reported that no commercial package currently meets these requirements but did recommend the Department monitor the market as there is a demand for such a product. Both FHA and the CFO's office feel the combination of the FHA Financial Data Warehouse and a commercial accounting package offer a significant benefit in terms of functionality, auditability, analysis, and reporting.

2. Systems Development, Enhancement and Integration

FHA's Multifamily housing staff have been particularly active over the last year in addressing weaknesses in automated information systems. During FY 1998, Multifamily staff accomplished several tasks in this area, including the continued development of the Real Estate Management System (REMS). This system answers the draft report's call for an integrated multifamily system for use by both field and headquarters staff in monitoring the portfolio. REMS Phases 1 and 2 have been developed and implemented; completeness and accuracy have been verified for Phase 2 data. These phases focused on data collection and verification, creation of a user-friendly Web-based environment, Enforcement Center tracking, and property level reporting. In Fiscal Year 1999, REMS Phases 3 and 4 are projected to be implemented. The budgeted amount is estimated at $4,700,000 for systems, procurement and support. These system enhancements will provide comprehensive reports capability and coordination with data systems being developed by the Real Estate Assessment and Departmental Enforcement Centers.

Central to the development of REMS was implementation of the Housing Enterprise Real Estate Management System (HEREMS) database on November 9, 1998. HEREMS is a single integrated database designed to cover virtually all Multifamily program operations. This system includes a modular design covering Multifamily development, management, insurance, assessment, and enforcement activities. This effort integrates the needs of

Multifamily Housing, the Real Estate Assessment Center (REAC), and the Enforcement Center (EC). Additionally it includes the Portfolio Reengineering module to support activities of the Office of Multifamily Housing Assistance Restructuring (OMHAR). Phase I and Phase II applications to support REAC and the EC have been implemented. Also nearing completion is the Financial Assessment Subsystem (FASS) for the review and analysis of annual financial statements by REAC, a key indicator of project performance.

Single Family programs are also making important progress. As a result of the Credit Reform Act and actions required for risk based premiums, FHA has already implemented the Single Family Premiums Collection Subsystem for Upfront premiums. The next step is to complete the Single Family Premiums Collection Subsystem for Periodic Premiums, expected to be operational during FY2000. With the Periodic Premiums system completed, the Single Family FHA programs will have completed a very significant step that addresses the findings in the cited weakness.

FHA is also developing technology to speed underwriting reviews, facilitate communication and data transfer with lenders, and enhance lender monitoring and enforcement activities. Over the last year, FHA implemented broad market use of Freddie Mac's Loan Prospector automated underwriting system and continued developing its own mortgage credit scorecard, which is scheduled for release in FY 1999. These automated underwriting systems reduce the time it takes FHA to underwrite a loan from several weeks to two days.

FHA also is developing new ways to use FHA Connection, a highly successful Internet-based system that gives approved lenders real-time access to HUD information systems. With direct data entry and query access to HUD systems, lenders can bypass FHA customer service representatives, and instead directly access information from FHA systems. Likewise, FHA now requires lenders to directly transmit virtually all loan level data, saving staff time previously spent key-punching data into the systems.

Finally, FHA is developing new technology to monitor lender performance. Neighborhood Watch, an automated system for tracking insured loan performance on the census tract level, was launched nationwide in 1998, and Lender Credit Watch, an automated system for tracking insured loan performance by geographic area and by lender, is scheduled for release in the Spring of 1999.

3. 'Umbrella' System

If the recommendation concerns a system to tie all of the FHA financial data into a single set of information, then we believe substantial progress has been accomplished. As noted in the response to the first recommendation, work is underway to collect the business activity of FHA, based on the posting models and interface to the Departmental general ledger. The immediate effort is to generate a financial data warehouse which captures the monthly detailed transactions from all FHA accounting systems into one integrated database. This will permit FHA to meet both the Departmental accounting needs and support an extensive set of reporting and analysis needs within the FHA programs. The estimated date of completion is December 1999.

At the same time, and in concert with the CFO's office, research proceeds to identify a COTS general ledger software package that meets the Fed GAAP requirements. Both FHA and the CFO's office feel the combination of the FHA Financial Data Warehouse and a commercial accounting package offer a significant benefit in terms of functionality, auditability, analysis, and reporting.

4. Data Quality

A significant portion of the FHA assets are represented by legacy data. Past audits and studies have stressed the need to ensure a high level of accuracy and reliability for the data in the FHA systems. FHA is applying significant efforts to review, correct and verify data critical to the performance and financial health of the FHA programs.

Starting in Fiscal Year 1998 and continuing in Fiscal Year 1999, FHA has been proactive in addressing data quality issues. In Fiscal Year 1999, the Information Technology Investment Portfolio includes specific projects for Single Family and Multifamily data quality with funding of nearly $1 million.

The actions taken are in two areas. The first included the identification of key data for the Multifamily and Single Family programs and a goal for review and correction of this data. This goal was stated as a Management Plan item and tracked. Following on, and independently performed, was a data quality review process. The data quality effort involves independent, statistically significant sampling of the data and validation against source documents and use of commercial data sources and systems.

CONCLUSION:

As an integrated strategic set of actions, the items noted above answer the issues in the Material Weakness. FHA systems will have achieved significant improvement in the availability of needed management information with a measurable level of confidence in the quality and reliability of the information. The better information systems will support strategic decision-making and make monitoring more productive and staff more efficient.

In addition, while FHA agrees with KPMG's assessment of the problem, we believe emphasizing new technology and modernization alone will not fix the problem. FHA suggests instead that more attention be placed on proper integration of systems to resolve weaknesses. We need to ensure that the methods of providing accounting information are standard in all systems.

FHA Must Continue Actions to Quickly Resolve Secretary-Held Mortgage Notes and Minimize Additional Mortgage Note Assignments and Note Servicing Responsibilities.

Multifamily

The response to Material Weakness 2 above lays out FHA's strategy to strengthen early warning systems and loss mitigation techniques. These ongoing efforts, many of which are already complete, will reduce future mortgage note assignments and insurance claims and thereby protect the FHA insurance fund.

In addition, the Office of Multifamily Housing has continued efforts to manage and resolve this portfolio. At the beginning of FY 1994, FHA owned approximately 2,400 mortgage notes; by February 1999, the inventory of Secretary-held Multifamily mortgages had been reduced to 1,075. Of these, 594 mortgages, or 55 percent, were current under their mortgage terms and do not present an undue management/servicing burden. A total of 481 notes are delinquent and more than half of these are less than 3 months delinquent. The multifamily mortgage inventory is not growing and, given that most of the inventory is either current or not significantly in arrears, these mortgages do not present an undue management/servicing burden.

Going forward, Multifamily Housing has established a FY 1999 Management Plan goal for dealing with the Secretary-held notes that are delinquent. Under this goal, 75 percent of the non-performing loans that are 3 months or more delinquent are to be: 1) placed under a plan to bring the loan current, 2) identified for note sale disposition, or 3) recommended for foreclosure.

Single Family

After dramatically reducing the number of Secretary-held single family notes from more than 100,000 in 1994 to approximately 12,000 in 1998 through several successful note sales, FHA is now in the process of retaining private sector professionals to assume all functions related to servicing remaining single family notes. In November, 1998 FHA issued a request for proposals for a national contract to consolidate all servicing activities. As recognized in the draft report, the contract was awarded in February, 1999, with implementation slated for Spring, 1999.

The draft report does not recognize, however, that the servicing function was consolidated as planned under the direction of the Servicing and Loss Mitigation Division in Oklahoma City during 1998. The plan was always to partially implement the servicing consolidation during FY 1998, using outstationed staff, and to complete implementation during FY 1999 when a contract was in place for the servicing.

FHA Must Sufficiently Monitor and Account for Single Family Property Inventory

As recognized in the draft report, FHA is entirely revamping its approach to monitoring and accounting for properties in the single family Real Estate Owned (REO) inventory. As discussed above, FHA is far along in the process of implementing the REO property Management and Marketing contracting model nationwide. Under this new approach, FHA will rely on private sector real estate professionals to perform all property management, marketing and sales activities related to the single family REO inventory. FHA has awarded contracts for each of sixteen geographic areas covering the entire country, and M&M contractors are scheduled to begin providing services this Spring. During more than two years of pilot testing of the M&M contracting model, private contractors proved able to sell REO properties more quickly and at a higher rate of return. Following transition to the M&M contracting environment, FHA REO field staff will focus exclusively on monitoring and evaluating contractor activities.

Terms of the M&M contracts require contractors to follow specific procedures for monitoring and accounting for properties in the single family REO inventory. Contractors will be required to input critical property data on an ongoing basis into FHA's SAMS system, the primary computerized information system for all asset management activities. The quality and frequency of this data input will be a primary focus of FHA field staff's monitoring efforts.

Over the last several months, a team of senior headquarters and field REO staff have been working intensively with a private management consulting firm, Booze-Allen & Hamilton, to develop a comprehensive quality assurance/quality control plan and performance monitoring and evaluation system for the M&M environment. The system will include a comprehensive set of new financial controls, systems controls and management controls. All FHA field REO staff will focus exclusively on monitoring M&M and other contractor activities. Furthermore, FHA will retain third party property condition monitors, and through a separate contract due diligence contractors to review M&M contractors files and records on a regular (monthly) basis.

FHA staff will rely on SAMs information system reports and data from third party property and file/records review contractors to monitor the M&M contractors' performance of all required activities, including tracking and accounting for the overall inventory.

FHA's monitoring and performance evaluation plan for the M&M environment also includes a number of upgrades and improvements to the SAMS system, designed to improve the REO operation's overall data management capacity.

FHA/HUD Must Enhance the Design/Operation of Information Systems General and Application Controls.

FHA agrees that "application change request forms are not completed and approved prior to programmers accessing source code in the production environment" and has taken steps to create and institutionalize procedures that will address this problem. Project Management Procedures, which represented a joint effort of Housing/FHA and the Department's Information Technology group. were finalized in February, 1999.

These procedures will address KMPG's recommendation that "controls should be designed to ensure that only authorized programs and modifications are implemented."

Report on Compliance with Laws and Regulations

Regarding the finding that FHA is not in full compliance with certain Credit Reform Act data requirements, FHA agrees that our single family premiums systems cannot generate the required case-specific cash flow data. FHA is continuing development of a new system, expected to be operational during FY2000, that will resolve this issue.

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

	Consolidated Total
ASSETS	
Entity Assets	
Intragovernmental	
Fund Balances with the U.S. Treasury (Note 2)	$ 6,474
Investments in U.S. Government Securities (Note 3)	14,108
Interest Receivable from U.S. Government Securities	174
Other Assets (Note 4)	217
Total Intragovernmental	20,973
With the Public	
Credit Program Receivables and Related Foreclosed Property, net (Note 5)	3,133
Other Assets (Note 4)	194
Total With the Public	3,327
Total Entity Assets	**24,300**
Non-Entity Assets	
Intragovernmental	
Fund Balances with the U.S. Treasury (Note 2)	134
Other Assets (Note 4)	6
Total Intragovernmental	140
With the Public	
Other Assets (Note 4)	64
Total Non-Entity Assets	**204**
TOTAL ASSETS	**$ 24,504**
LIABILITIES AND NET POSITION	
Liabilities Covered by Budgetary Resources	
Intragovernmental Liabilities	
Accounts Payable	$ 15
Borrowings from U.S. Treasury (Note 6)	6,579
Payable to Special Receipt Account for Subsidy Reestimate	154
Other Liabilities (Note 7)	210
Total Intragovernmental	6,958
With the Public	
Accounts Payable	569
Unearned Premiums	891
Liabilities for Loan Guarantees (Note 5)	9,404
Debentures Issued to Claimants (Note 6)	166
Premium Refunds and Distributive Shares Payable	205
Other Liabilities (Note 7)	318
Total With the Public	11,553
Total Liabilities Covered by Budgetary Resources	18,511
TOTAL LIABILITIES	**18,511**
NET POSITION	
Unexpended Appropriations (Note 9)	1,704
Cumulative Results of Operations	4,289
TOTAL NET POSITION	**5,993**
TOTAL LIABILITIES AND NET POSITION	**$ 24,504**

The accompanying notes are an integral part of this financial statement.

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

		Consolidated Total
Unsubsidized Program Costs		
Intragovernmental	$	387
With the Public		1,973
Total Unsubsidized Program Costs		2,360
Less: Earned Revenues		2,777
Net Unsubsidized Program Costs (Surplus)		(417)
Subsidized Program Costs		
Intragovernmental	$	83
With the Public		763
Total Subsidized Program Costs		846
Less: Earned Revenues		548
Net Subsidized Program Costs (Surplus)		298
NET COST (SURPLUS) OF OPERATIONS	$	(119)

The accompanying notes are an integral part of these statements.

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

		Consolidated Total
Net Cost (Surplus) of Operations	$	(119)
Financing Sources:		
Appropriations Used		1,838
Imputed Financing		5
Transfers-out:		
HUD		(237)
US Treasury		(830)
Miscellaneous Receipt Account		(1,601)
Total Financing Sources		(825)
Net Results of Operations		(706)
Net Change in Cumulative Results of Operations		(706)
Increase in Unexpended Appropriations		1,143
Change in Net Position		437
Net Position-Beginning of Period		5,556
Net Position - End of Period	$	5,993

The accompanying notes are an integral part of these statements.

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

	MMI / CMHI FUNDS			GI / SRI FUNDS			
	Program 8680183	**Liquidating 86X4070**	**Financing 86X4587 and 86X4242**	**Program 86X0200**	**Liquidating 86X4072**	**Financing 86X4077 and 86X4105**	**Combined Total**
Budgetary Resources: (Note 14)							
Budget Authority							
Unobligated Balances Carried Forward		$ 13,072	$ 331	$ 506	$ 2,428	$ 414	$ 16,751
New Resources:							
Appropriations	$ 1,602			1,395			2,997
Borrowing Authority			2,628		126	737	3,491
Offsetting Collections		4,425	4,950		733	2,115	12,223
Recoveries of Prior Year Obligations		13	5	18	9	2	47
Less Restrictions on Availability of Resources:							
Permanently not Available pursuant to PL				(16)			(16)
Payment on Debt			(205)		(28)	(220)	(453)
NET BUDGETARY RESOURCES	**$ 1,602**	**$ 17,510**	**$ 7,709**	**$ 1,903**	**$ 3,268**	**$ 3,048**	**$ 35,040**
Status of Budgetary Resources:							
Obligations Incurred	338	3,105	7,161	1,448	1,244	1,951	15,247
Unobligated Balances - Available		1,177	544	83	298	357	2,459
Unobligated Balances - Not Available	1,264	13,228	4	372	1,726	740	17,334
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 1,602**	**$ 17,510**	**$ 7,709**	**$ 1,903**	**$ 3,268**	**$ 3,048**	**$ 35,040**
Outlays:							
Obligations Incurred	338	3,105	7,161	1,448	1,244	1,951	15,247
Less: Spending Authority from Offsetting Collections		(4,425)	(4,950)		(733)	(2,115)	(12,223)
and Adjustments		(13)	(5)	(18)	(9)	(2)	(47)
Obligated Balance, Net - Beginning of Period		474	(169)	55	422	(82)	700
Less: Obligated Balance, Net - End of Period		(693)	128	15	(519)	17	(1,052)
TOTAL OUTLAYS	**$ 338**	**$ (1,552)**	**$ 2,165**	**$ 1,500**	**$ 405**	**$ (231)**	**$ 2,625**

The accompanying notes are an integral part of these statements.

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

	Combined Total
Obligations and Nonbudgetary Resources	
Obligations incurred	
Category B Direct	$ 15,247
Less: Spending authority for offsetting collections and adjustments	
Earned Reimbursement	
Collected	(12,060)
Change in Unfilled Customer Orders	(163)
Recoveries of Prior-Year Obligations	(47)
Financing Imputed for Cost Subsidies	5
Transfers Out	(2,668)
Exchange revenue not in the budget	(1,955)
Total obligations as adjusted, and nonbudgetary resources	(1,641)
Resources That Do Not Fund Net Cost of Operations	
Change in undelivered orders	(72)
Change in unfilled customer orders	163
Costs capitalized on the balance sheet	
Loans made by Liquidating Funds	8
Financing sources that fund costs of prior periods	(1,075)
Other	364
Total resources that do not fund net cost of operations	(612)
Costs That Do Not Require Resources	
Revaluation of assets and liabilities	(129)
Loss on disposition of assets	589
Other	(2,595)
Total costs that do not require resources	(2,135)
Financing Sources Yet to be Provided (Note 15)	4,269
Net Cost (Surplus) of Operations	$ (119)

The accompanying notes are an integral part of these statements.

Notes to Principal Financial Statements

Note 1. Significant Accounting Policies

Entity and Mission

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

FHA administers approximately 40 mortgage insurance activities, thereby making mortgage financing more accessible to the home-buying public. FHA insures private lenders against loss on mortgages which finance single family homes, multifamily projects, health care facilities, property improvements, and manufactured homes. The objectives of the activities carried out by FHA relate directly to developing affordable housing.

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

FHA's major programs are classified as unsubsidized and subsidized. These programs are composed of four major Funds. The unsubsidized program is comprised of (1) the Mutual Mortgage Insurance Fund (MMI), FHA's largest Fund, which provides basic single family mortgage insurance and is a mutual insurance fund, whereby mortgagors, upon non-claim termination of their mortgages, share surplus premiums paid into the MMI Fund that are not required for operating expenses and losses or to build equity; and (2) the Cooperative Management Housing Insurance Fund (CMHI), which also is a mutual fund, that provides mortgage insurance for management-type cooperatives. The subsidized program is comprised of (3) the General Insurance Fund (GI) which provides for a large number of specialized mortgage insurance activities, including insurance of loans for property improvements, cooperatives, condominiums, housing for the elderly, land development, group practice medical facilities and nonprofit hospitals; and (4) the Special Risk Insurance Fund (SRI) which provides mortgage insurance on behalf of mortgagors eligible for interest reduction payments who otherwise would not be eligible for mortgage insurance.

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

Basis of Accounting

The financial statements have been prepared in accordance with an other comprehensive basis of accounting (OCBOA), as illustrated in Office of Management and Budget (OMB) Bulletin 97-01, “Form and Content of Agency Financial Statements” and in conformance with the Federal Accounting Standards Advisory Board's (FASAB) Statements of Federal Financial Accounting Standards.

The financial statements include the accounts of all funds under FHA control, consisting of two general fund appropriations and six revolving funds.

The primary requirements under which the Consolidated Balance Sheet is prepared are contained in Statement of Federal Financial Accounting Standard (SFFAS) No. 2, “Accounting for Direct Loans and Loan Guarantees” and the Federal Credit Reform Act of 1990 (Credit Reform). This criteria requires that assets and liabilities related to loans and loan guarantees made after October 1, 1991, be accounted for on a net present value basis. Present value accounting is optional for those assets and liabilities associated with loans or loan guarantees prior to October 1, 1991 (pre-Credit Reform). FHA has elected to account for pre-Credit Reform assets and liabilities based upon their net realizable value.

The Consolidated Statements of Net Cost and of Changes in Net Position, and the Combined Statement of Financing are prepared in accordance with the requirements set forth in SFFAS No. 4, “Managerial Cost Accounting Concepts & Standards”, and No. 7, “Accounting for Revenue and Other Financing Sources.” Standard No. 4 addresses the requirement to identify full cost for financial statement reporting, while No. 7 distinguishes revenue between exchange, non-exchange and other financing sources, among other topics.

Recognition and measurement of budgetary resources, for purposes of preparing the Combining Statement of Budgetary Resources, is based on budget concepts and definitions provided by OMB Circular A-11, “Federal Credit Data” and A-34, “Instructions on Budget Execution.”

Use of Estimates

The preparation of financial statements in conformity with OCBOA, see comprehensive basis of accounting described above, as promulgated by FASAB, requires management to make estimates and assumptions that affect the amounts reported.

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

To estimate the liability for loan guarantees, FHA used cash flow models assumptions associated with loans subject to credit reform, as described in detail in Note 5, to estimate the cash flows associated with future loan performance. To make reasonable projections of future loan performance, FHA developed assumptions, as described in detail in Note 5, based on historical data and current and forecasted economic assumptions.

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

Fund Balances with the U.S. Treasury

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

Credit Reform Accounting

Credit Reform accounts consist of program and financing accounts. The program accounts receive appropriations for subsidy expenses and channel these through the financing accounts to pay default claims and related obligations. Also, program accounts receive appropriations for, and incur and pay for, administrative costs of Credit Reform programs. The financing accounts receive insurance premiums, borrowings from the U.S. Treasury, and interest on uninvested funds. Financing account disbursements include payments on defaulted guaranteed loans and costs of acquiring, maintaining, and disposing foreclosed property. Cash receipts in excess of payments projected for loan guarantees and direct loans programs are transferred to a miscellaneous receipt account of the Treasury. The MMI Financing Fund is an exception. To accumulate fund reserves in accordance with the National Housing Act, FHA retains MMI Financing Fund's negative subsidies through transfers to the MMI Liquidating Fund.

Liquidating accounts have been established for pre-Credit Reform activities. These accounts were established to facilitate accounting for pre-Credit Reform receipts and outlays until the related loans are paid or prove uncollectible. The major sources of funding are insurance premiums and permanent indefinite appropriations. The liquidating accounts' fund balances with Treasury are entity assets.

Investments in U.S. Government Securities

Under current legislation FHA may invest available funds in excess of current needs in non-marketable market-based U.S. Treasury securities for the MMI/CMHI liquidating account. These Treasury securities may not be sold on public securities exchanges, but do reflect prices and interest rates of marketable Treasury securities. The valuation of these investments is at acquisition cost net of unamortized premium or discount. Amortization is recognized on a straight line basis.

Credit Program Receivables and Related Foreclosed Property

Credit program receivables arise from two sources. Prior to April 1996, under certain conditions prescribed by law, FHA would take assignment of insured single family loans that were in default for direct collection rather than acquire the related properties through foreclosure. Single family loans were assigned to FHA when the mortgagor defaulted due to certain "temporary hardship" conditions beyond the control of the mortgagor and when, in FHA management's judgment, the loan could be brought current in the future. During fiscal year 1998, FHA continued to take single family assignments on those defaulted notes that were in process at the time the assignment program was terminated.

Secondly, multifamily loans are assigned when lenders file mortgage insurance claims to FHA for defaulted notes. In addition, multifamily and single family performing notes insured pursuant to Section 221(g)(4) of the National Housing Act may be assigned automatically to FHA at a pre-determined point.

Credit program receivables for direct loan programs and defaulted guaranteed loans assigned for direct collection are valued differently based on the direct loan obligation or loan guarantee commitment date. These valuations are in accordance with the Federal Credit Reform Act of 1990 and SFFAS No. 2, "Accounting for Direct Loans and Loan Guarantees" (see Note 5). Those obligated or committed on or after October 1, 1991 (post-Credit Reform) are valued at the net present value of expected cash flows from the related receivables.

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

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

General Property, Plant and Equipment

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

Liability for Loan Guarantees

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

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

Unearned Premiums

Premiums charged by FHA for single family mortgage insurance provided by its MMI/CMHI Fund include up-front and annual risk based premiums. Pre-Credit Reform up-front risk based premiums are recorded as unearned revenue upon collection and are recognized as revenue over the period in which losses and insurance costs are expected to occur. Annual risk based premiums are recognized as revenue on a straight-line basis throughout the year. FHA's other activities charge periodic insurance premiums over the mortgage insurance term. Premiums on annual installment policies are recognized for the liquidating accounts on a straight-line basis throughout the year.

Premiums associated with Credit Reform loan guarantees are included in the calculation of the LLG and are not included in the unearned premium amount reported on the Consolidated Balance Sheet, since the LLG represents the net present value of future cash flows.

Appropriations and Monies Received from Other HUD Programs

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

Monies received from other HUD programs, such as interest subsidies and rent supplements, are recorded as revenue for the liquidating accounts when services are rendered. Monies received for the financing accounts are recorded as an addition to the liability for loan guarantees when collected.

Full Cost Reporting

SFFAS No. 4 requires that full costing of program outputs be included in Federal agency financial statements beginning in fiscal year 1998. Full cost reporting includes all direct, indirect, and inter-entity costs. For purposes of the consolidated department financial statements, HUD identified each responsibility segment's share of the program costs or resources provided by HUD or other Federal agencies. As a responsibility segment of HUD, these costs are included in the FHA financial statements and are treated as imputed cost for the Consolidated Statement of Net Cost, and imputed financing for the Consolidated Statement of Changes in Net Position and the Combined Statement of Financing. A separate survey of all Housing operational managers was conducted to determine FHA's direct cost associated with the Salaries and Expenses (S&E) transfer to HUD and to allocate imputed costs by program, unsubsidized and subsidized.

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 2). Although the capitalization requirements were met at September 30, 1998, no distributive shares were declared. The National Affordable Housing Act does not affect distributions from the CMHI Fund.

Liabilities Covered by Budgetary Resources

Liabilities have been classified as those covered and not covered by budgetary resources, as defined by OMB, and in accordance with SFFAS No. 1, "Selected Assets and Liabilities" as of the Consolidated Balance Sheet date. In the event that available resources are insufficient to cover liabilities due at a point in time, FHA has authority to borrow monies from the Treasury or to draw on permanent indefinite appropriations to satisfy the liabilities. Thus, all liabilities are considered covered by budgetary resources.

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

Substantially all of FHA's cash transactions are processed by Treasury. Fund balances with the U.S. Treasury at September 30, 1998 were composed of the following (dollars in millions):

Entity Assets	
Intragovernmental Assets:	
Appropriated Funds	$ 1,704
Revolving Funds	4,770
Fund Balances with the U.S. Treasury	$ 6,474
Non-Entity Assets	
Intragovernmental Assets:	
Escrow Funds	$ 134
Fund Balances with the U.S. Treasury	$ 134
Total Fund Balances with the US Treasury	**$ 6,608**

Appropriated Funds

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

Revolving Funds

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

Escrow Funds

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

Timing Differences with Treasury

A difference exists between FHA's recorded fund balances with Treasury and the Treasury's records. Treasury has $156 million more in deposits than FHA's general ledger due to differences related to processing time of the various accounting systems.

(dollars in millions)	
Timing Difference with Treasury as of September 30, 1998, attributable to:	
Single Family Premiums	$(18)
Single Family Claims	(122)
Multifamily Property	(10)
Single Family Property	(9)
Other	3
Disbursement schedules prepared, but not disbursed	$(156)
Treasury SF2108	$6,764
FHA Fund Balances with Treasury	$6,608

Note 3. Investments in U.S. Government Securities

As discussed in Note 1, all investments are in non-marketable, market-based securities issued by the Treasury and, hence, are intragovernmental. The cost, net unamortized discount, investment, net, and market values as of September 30, 1998 were as follows:

(dollars in millions)

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

Note 4. Other Assets

Other Entity Assets (dollars in millions)

Intragovernmental Assets:	
HUD Section 312 Rehabilitation Loan Program Receivables	$ 4
Receivables from Unapplied Disbursements Recorded by Treasury	213
Total	$ 217
Assets With the Public:	
Receivables Related to Asset Sales	$ 32
Receivables Related to Credit Program Assets	77
Equity Interest in Multifamily Mortgage Trust 1996	60
Premiums Receivable	25
Total	$194

Receivables Related to Asset Sales

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

Receivables Related to Credit Program Assets

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

Equity Interest in Multifamily Mortgage Trust 1996

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

Premiums Receivable

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

Allowance for Loss

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

Other Non-Entity Assets (dollars in millions)	
Intragovernmental Assets:	
Mortgagor Reserves for Replacement	$6
Assets With the Public:	
Mortgagor Reserves for Replacement	$64

Mortgagor Reserves for Replacement

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

Note 5. Credit Program Assets and Liability for Loan Guarantees

An analysis of credit program assets, loan guarantees, and the liability for loan guarantees are provided in the following tables as of September 30, 1998 (dollars in millions):

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

	Loans Receivable, Gross	Interest Receivable	Allowance For Loan & Interest Losses	Foreclosed Property	Value of Assets Related to Direct Loans
Total Direct Loan Programs	$88	$13	$(76)	-	$25

Direct Loans Obligated After Fiscal Year 1991:

	Loans Receivable, Gross	Interest Receivable	Allowance For Subsidy Cost (Present Value)	Foreclosed Property	Value of Assets Related to Direct Loans
Total Direct Loan Programs	$6	-	-	-	$6

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

	Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Allowance For Loan & Interest Losses	Foreclosed Property, Net	Defaulted Guaranteed Loans Receivable, Net
Total Loan Guarantee Programs	$2,690	$640	$(2,460)	$560	$1,430

Defaulted Guaranteed Loans from Post-1991 Guarantees:

	Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Allowance For Subsidy Cost (Present Value)	Foreclosed Property, Gross	Value of Assets Related to Defaulted Guaranteed Loans Receivable
Total Loan Guarantee Programs	$614	$21	$(1,315)	$2,352	$1,672

Total Credit Program Receivables and related foreclosed property, net $3,133

Guaranteed Loans Outstanding:

	Outstanding Principal, Guaranteed Loans, Face Value	Amount of Outstanding Principal Guaranteed
Total Loan Guarantee Programs	$518,069	$475,236

	Liabilities for Losses on Pre-1992 Guarantees, Estimated Future Default Claims	Liabilities for Loan Guarantees For Post-1991 Guarantees (Present Value)	Total Liabilities For Loan Guarantees
Total Loan Guarantee Progra	$7,473	$1,931	$9,404

Foreclosed Property

The average holding period of single family properties is approximately 6 months while the average holding period of multifamily properties is 8 years. Additional requirements are usually attached to FHA's foreclosed property to restrict future use or disposal of those assets. The following table is a summary of FHA's foreclosed properties resulting from loans and loan guarantees of September 30, 1998:

	Pre-1992		Post-1991	
(*number of property)*	**Single Family**	**Multifamily**	**Single Family**	**Multifamily**
Foreclosed Property	13,828	50	25,542	0

The following tables summarize the dollar amount and number of FHA's foreclosure proceedings in process as of September 30, 1998 (dollars in millions):

	Pre-1992		Post-1991	
	Single Family	**Multifamily**	**Single Family**	**Multifamily**
Outstanding Principal	$2	$111	$1	$13

	Pre-1992		Post-1991	
	Single Family	**Multifamily**	**Single Family**	**Multifamily**
Number of Properties	40	45	8	5

Direct Loan Obligations and Loan Guarantee Commitments

Direct loan obligations or loan guarantee commitments made prior to fiscal year 1992 and the resulting direct loans or defaulted guaranteed loans, are reported net of allowance for estimated uncollectible loans or estimated losses.

Direct loan obligations or loan guarantee commitments made after fiscal year 1991, and the resulting direct loans or defaulted guaranteed loans are governed by the Federal Credit Reform Act of 1990 and are recorded at the net present value of the associated estimated cash flows (i.e., interest rate differentials, interest subsidies, estimated delinquencies and defaults, fee offsets, and other cash flows.)

Pre-Credit Reform Valuation Methodology

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

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

FHA records the loss estimates for multifamily program when defaults are considered probable but have not yet been reported as such to FHA. The loss estimate is based on case-by-case analysis of approximately 78 percent of all the multifamily cases and is further adjusted by management for factors such as administrative expenses, projects already in default, and potential disaster. The recovery rate is based on actual notes sales and property dispositions over the most recent three years.

A separate analysis was conducted to adjust the loan loss estimate for planned reductions in project-based Section 8 rental assistance subsidy. All projects that submitted annual financial statements, received Section 8 assistance, and had rents in excess of the fair market value were included in the analysis. The gross rent for these projects was reduced by the amount necessary to reduce the rent for assisted units to 100 percent of fair market value. Then projects were then grouped into the following three categories:

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

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

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

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

Credit Reform Valuation Methodology

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

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

Significant Assumptions

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

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

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

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

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

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

- Economic assumptions: Forecasts of economic conditions used in conjunction with loan-level data to generate single family claim and prepayment rates were obtained from McGraw-Hill/DRI forecasts of U.S. annual economic figures from August, 1998. Had FHA used more recent economic forecasts, its estimate of the net present value of loan guarantee liabilities would likely change. Other economic assumptions used, such as discount rates, are provided by OMB.

- Reliance on historical performance: FHA relies on the average historical performance of its insured multifamily portfolio to forecast future performance of that portfolio. Changes in legislation, subsidy programs, tax treatment and economic factors all have impacts on loan performance. FHA assumes that similar events may occur during the remaining life of existing mortgage guarantees, which can be as long as 40 years, and affect loan performance accordingly. A smoothing methodology is used to dampen the effects of extreme events.

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

- Single family allowance for subsidy: Significant estimates used in calculating the single family allowance for subsidy include the proceeds from notes sold through asset sales and the cost of asset sales. Both of these are taken from actual experience based on the last two single family notes sales, held in 1997.

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

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

Note 6. Debt

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

(dollars in millions)		
Agency Debt:		
Debentures Issued to Public – Par Value	$	166
Other Debt:		
Borrowings From U.S. Treasury		6,579
Total Debt	$	6,745
Classification of Debt:		
Intragovernmental Debt	$	6,579
Debt with the Public		166
Total Debt	$	6,745

Debentures Issued to Public

The National Housing Act authorizes FHA, in certain cases, to issue debentures in lieu of cash to settle claims. FHA-issued debentures bear interest at rates established by Treasury. Interest rates related to the outstanding debentures range from 4 percent to 12.88 percent. They may be redeemed by lenders prior to maturity to pay mortgage insurance premiums to FHA, or they may be called with the approval of the Secretary of the Treasury.

The par value of debentures outstanding at September 30, 1998, was $166 million. The fair value based on original maturity dates was $211 million.

Borrowings From U.S. Treasury

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

FHA's Treasury borrowings carry interest ranging from 5.57 percent to 7.59 percent. Maturity dates occur from September 2000 – September 2017. Loans may be repaid in whole or in part without penalty at any time prior to maturity.

Note 7. Other Liabilities

Other Liabilities Covered by Budgetary Resources (dollars in millions)

Intragovernmental Liabilities:	**Current**	**Non-Current**	**Total**
HUD-Section 312 Rehabilitation Program Payable	$ 4	$ -	$ 4
Payable to Other Government Agencies	23	-	23
Payable from Unapplied Receipts Recorded by Treasury	183	-	183
Total	$ 210	$ -	$ 210

Liabilities with the Public:

Escrow Funds Related to Mortgage Notes	$ 204	$ -	$204
Earnest Money Held Pending Completion of Property Sales	25	-	25
Interest Enhancement - Multifamily Mortgage Auctions	13	-	13
Certificates of Claims Payable	12	-	12
Amounts Withheld from Claims Paid for Foreclosure Costs	-	14	14
Interest payable on Debentures and Outstanding Claims	19	-	19
Trust and Deposits related to Coinsurance Program	13	-	13
Miscellaneous Undistributed Credits and Other Payables	18	-	18
Total	$304	$14	$318

Note 8. Contingencies

Litigation

FHA is party in various legal actions and claims brought by or against it. In the opinion of management and general counsel, the ultimate resolution of these legal actions and claims will not materially affect FHA's financial statements as of, and for, the fiscal year ended September 30, 1998.

Note 9. Unexpended Appropriations

Unexpended Appropriations (dollars in millions)

Unobligated:	
Available	$ 43
Unavailable	1,636
Undelivered Orders	25
Total	$1,704

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

Undelivered orders for FHA's subsidized funds represent subsidy obligations for guaranteed loans committed but not disbursed by lenders and direct loans obligated but not disbursed by FHA at the consolidated balance sheet date. Undelivered orders for FHA's unsubsidized funds represent obligations for goods or services which have been ordered, but not received at the end of the fiscal year.

Note 10. Exchange Revenue

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

Up-front Premiums

The up-front premium rate is used to calculate the up-front premium paid by borrowers. Rates, which are set by legislation, vary according to the mortgage type and the year of origination. Single Family up-front premiums are recorded as unearned revenue upon collection and are recognized as revenue over the period in which losses and insurance costs are expected to occur. The Multifamily up-front premium is treated much like a periodic premium, and is amortized 1/12 per month for the first full year.

Up-front Premium Rates

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

In accordance with Section 203(c)(1) of the National Housing Act, reductions to premium charges are at the discretion of the Secretary of Housing. In fiscal year 1998, in cases where the Single Family first-time homebuyer received housing counseling, the borrower was subject to an up-front premium of 1.75 percent, regardless of the mortgage term.

Periodic Premiums

The periodic premium rate is used to calculate monthly or annual premium receipts. These rates, which are legislated, vary by mortgage type and program. Periodic premiums can be calculated on an amortized or unamortized basis depending on the Fund. Currently, the periodic premium rate for Single Family and Multifamily are:

Periodic Premium Rates

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

Pre-Credit Reform insurance premiums earned during the fiscal year totaled $ 776 million. Pre-Credit Reform income on sale of mortgage notes during the fiscal year totaled $ 130 million. In accordance with the Credit Reform Act, all Post-Credit Reform revenues have been posted to the LLG. All Pre-Credit Reform interest income and the Post-Credit Reform interest income on uninvested funds equals $ 2,348 million. Other revenues totaled $ 71 million for the fiscal year.

Note 11. Subsidy Expense Generated by New Endorsements

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

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

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

Note 12. Subsidy Expense for Re-estimate

The cash flow models and financial data used to calculate the fiscal year 1998 subsidy expense re-estimate are substantially different from the models used to calculate the fiscal year 1997 re-estimate. These differences primarily resulted from additional refinements in the calculation process, cash flow assumptions and models, as well as additional information about the actual performance of outstanding loan guarantees.

The initial September 30, 1997 subsidy expense re-estimate was $2,005 million. This re-estimate was based on the best available information and cash flow models at the time. This re-estimate, if calculated based upon revised models and financial data developed during fiscal year 1998, would result in a revised fiscal year 1997 re-estimate of $3,391 million, an increase of $1,386 million in the fiscal year 1997 re-estimate. As the fiscal year 1997 re-estimate would have been $1,386 million higher, the fiscal year 1998 re-estimate would have been lower by that amount.

Note 13. Gross Cost and Earned Revenue by Budget Functional Classification

All cost and earned revenue reported on the Statement of Net Cost is categorized under the budget functional classification (BFC) for Commerce and Housing Credit (370). All of the FHA Treasury account symbols found under the department code "86" for Department of Housing and Urban Development appear with the Commerce and Housing Credit BFC, therefore no breakout is necessary.

Note 14. Status of Budgetary Resources

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

The Statement of Budgetary Resources has been prepared as a combining statement and as such, intra-entity transactions have not been eliminated.

Budget authority is the authorization provided by law to enter into obligations to carry out the guaranteed and direct loan programs and their associated administrative costs which would result in immediate or future outlays of federal funds. FHA's budgetary resources include current budgetary authority (i.e., appropriations and borrowing authority) and unobligated balances brought forward from multi-year and no-year budget authority received in prior years, and recoveries of prior year obligations. Budgetary resources also include spending authority from offsetting collections credited to an appropriation of fund account.

Pursuant to Public Law 101-510, unobligated balances associated with appropriations that expire at the end of the fiscal year remain available for obligation adjustments, but not for new obligations, until that account is canceled. When accounts are canceled, five years after they expire, amounts are not available for obligations or expenditure for any purpose.

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

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

FHA funds its programs through borrowings from the U.S. Treasury and the public. These borrowings are authorized through an indefinite permanent authority at interest rates set each year by the U.S. Treasury and the prevailing market rates. Financing sources for repayments are from premiums earned and maturity dates are generally 20 years or more. Funded borrowings and repayments at September 30, 1998 were:

(dollars in millions)	From the Public	From U.S. Treasury	Total
Total borrowing, beginning of the year	$ 68	$ 3,639	$ 3,707
New borrowing	126	3,365	3,491
Repayments	(28)	(425)	(453)
Total borrowing, ending of the year	$ 166	$ 6,579	$ 6,745

Note 15. Financing Sources Yet to be ProvidedFootnote Disclosure Related to the Statement of FinancingDisclosure Related to the Statement of FinancingDisclosure Related to the Statement of Financing

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

(dollars in millions)	
Liabilities not covered by budgetary resources	$ -
Financing sources yet to be provided:	
Credit program subsidy expense from upward re-estimates and positive subsidy related to loan guarantee endorsement	2,805
Interest expense from upward subsidy re-estimate	1,464
Total financing sources yet to be provided	$ 4,269

Appendix A

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