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Report to the Congress

May 1989

# FINANCIAL AUDIT

# Federal Housing Administration Fund's 1987 Statement of Financial Position

GAO/AFMD-89-3

# GAO

United States
General Accounting Office
Washington, D.C. 20548

**Comptroller General of the United States**

B-206207

May 12, 1989

To the President of the Senate and the
Speaker of the House of Representatives

This report presents our opinion on the Federal Housing Administration Fund's consolidated statement of financial position as of September 30, 1987.

The Federal Housing Administration (FHA) was established in 1934 under authority granted to the President by the National Housing Act (Public Law 73-479) and became in 1948 a wholly owned government corporation for purposes of the Government Corporation Control Act (GCCA). FHA and its functions were transferred to the U.S. Department of Housing and Urban Development (HUD) in 1965. The GCCA now provides that the Secretary of HUD, when carrying out duties and powers related to the FHA Fund, is subject to the provisions of the GCCA.[1] The basic purpose of FHA programs is to encourage improvements in housing standards and conditions, provide an adequate home financing system through mortgage insurance, and exert a stabilizing influence on the mortgage market. To carry out this purpose, the Secretary of HUD administers FHA through four separate funds for its various mortgage insurance programs. As of September 30, 1987, FHA had $277 billion of insurance-in-force and government equity of $1.2 billion.

Under the provisions of 31 U.S.C. 9105, we are required to audit FHA at least once every 3 years. We were unable to perform an audit of FHA's fiscal year 1981 financial statements due to significant accounting and reporting changes needed (GAO/AFMD-83-66, June 10, 1983). In 1985, we terminated our audit work on FHA's fiscal year 1984 financial statements due to numerous deficiencies in FHA's accounting systems and financial records and changes in agency systems and staff.

Since 1984, FHA has made substantial improvements in agency systems, staffing, and management to permit an audit of its statement of financial position as of September 30, 1987. To fulfill our audit responsibility, we contracted with the independent certified public accounting firm of Price Waterhouse to conduct a financial audit of FHA. Due to the magnitude of accounting and reporting changes needed, as noted in prior year audits, it was not practical to audit FHA's consolidated statements of

[1] Herein, the FHA Fund, and the Secretary's administration of it, will be referred to simply as FHA.

its highest rate of claims in the second and third year after the insurance is written. These claims gradually decrease and level off to a constant rate after the 10th year of the policy.

Exacerbating the current cash flow situation is the timing of premium collection versus claim payment, and the manner in which prior year excess funds affected the federal budget deficit. In 1984, FHA began collecting, up front, the entire premium for virtually all of the MMI Fund insurance. This will initially generate substantial excess funds since the up-front premium is meant to cover claim payments that will probably not reach significant levels until the second and third year after the premium is collected. However, eventually the insurance that generated the significant cash inflow from the up-front premium will lead to claim payments. At a time when new insurance is declining, cash outflows from claim payments emanating from insurance written in prior years may well exceed cash inflows from up-front premium collections.

When FHA generates excess funds, they are invested in Treasury securities. However, when FHA has a net cash outflow and must redeem securities with which to fund it, the federal deficit increases because the needed funds are obtained, in effect, through additional borrowings from the public. Through August 12, 1988, to help meet its fiscal year 1988 cash needs, FHA had to redeem $643 million of Treasury securities ahead of their planned maturity schedules. In a future GAO report, we will discuss FHA's financial condition and the Treasury cash flow impact.

During the audit, Price Waterhouse proposed various audit adjustments which, in the aggregate, reduced FHA's equity from $3.1 billion to $1.2 billion, primarily in the general insurance and special risk insurance funds. The largest adjustment of $1.1 billion resulted from a more timely recording of insurance losses so that FHA's financial statements would conform with generally accepted accounting principles and the accounting practices followed by private mortgage insurers. Other major adjustments reduced FHA equity by $172 million for additional estimated losses in disposing of foreclosed properties and $178 million for additional losses and discounts on single and multifamily mortgage loans.

In our opinion, and consistent with the opinion of Price Waterhouse, the Federal Housing Administration Fund's consolidated statement of financial position is fairly presented as of September 30, 1987, in conformity with generally accepted accounting principles.

# Financial Statements

## Consolidated Statement of Financial Position

**SEPTEMBER 30, 1987**

**(Dollars in Thousands)**

| | |
|---|---|
| **ASSETS:** | |
| Fund Balance with Treasury | $ 175,331 |
| Investments in U.S. Government Securities, principally non-marketable (Note 3) | 6,651,427 |
| Foreclosed Property Held for Sale, Net | 1,432,116 |
| Mortgage Notes Receivable, Net (Note 5) | 2,808,597 |
| Appropriations Receivable (Note 6) | 400,586 |
| Other Assets and Receivables | 437,629 |
| Total Assets | $ 11,905,686 |
| **LIABILITIES AND GOVERNMENT EQUITY:** | |
| Claims Payable | $ 525,759 |
| Loss Reserves (Note 7) | 2,047,392 |
| Unearned Premiums | 3,983,749 |
| Debentures issued to Claimants (Note 9) | 175,743 |
| Accounts Payable, Accrued Expenses and Other Liabilities | 302,775 |
| Participations and Premium Refunds Payable | 150,158 |
| Borrowings from the U.S. Treasury (Note 8) | 3,531,434 |
| Total Liabilities | 10,717,010 |
| Commitments and Contingencies (Note 11) | |
| Government Equity: (Note 10) | |
| Mutual Funds Equity | 3,375,571 |
| Subsidized Funds Cumulative Losses | (7,117,649) |
| Appropriated Capital | 4,930,754 |
| Total Government Equity | 1,188,676 |
| Total Liabilities and Government Equity | $ 11,905,686 |

**The accompanying notes are an integral part of the Statement of Financial Position.**

**NOTE 1. Summary of Mission and Significant Accounting Policies (Continued):**

**B. Basis of Accounting:**

The Consolidated Statement of Financial Position has been prepared in accordance with generally accepted accounting principles. All intra-fund balances and transactions have been eliminated.

**C. Fund Balance With U.S. Treasury:**

Substantially all of FHA's receipts and disbursements are processed by the U.S. Treasury which, in effect, maintains FHA's bank accounts.

**D. Investment in U.S. Government Securities:**

The National Housing Act, as amended, limits FHA's investments to non-marketable Treasury interest bearing obligations (i.e., investments not sold in public markets). The market value and interest rates established for such investments are the same as those for similar Treasury issues which are publicly marketed.

Unlike private sector entities, FHA's investment decisions are limited by Treasury policy which (1) only allows FHA to invest in notes and bonds with maturities of six months or more (although FHA may invest in Treasury bills with maturities of less than six months), and (2) prohibits FHA from engaging in practices that result in "windfall" gains and profits such as security day-trading and full scale restructuring of portfolios in order to take advantage of interest rate fluctuations.

Investments in U.S. Government securities are reported at cost, net of amortized premiums or discounts. FHA's intent is to hold investments to maturity, unless they are needed to finance mortgage insurance claims or otherwise sustain the operations of the fund. No provision is made for unrealized gains or losses on these securities because, in the majority of cases, they are held to maturity.

**E. Mortgage Notes Receivable:**

Mortgage notes receivable consist of mortgage notes received in claim settlements and purchase money mortgages issued to buyers of FHA's foreclosed properties. Under certain conditions prescribed by regulation, FHA will assume insured mortgages which are in default rather than acquire the properties through foreclosure. Generally, mortgages will be assumed where the mortgagor has defaulted due to certain "temporary hardship" conditions beyond the control of the mortgagor, and where, in management's judgment, it is likely that the mortgage can be brought current in the future. However, the majority of FHA

**NOTE 1. Summary of Mission and Significant Accounting Policies (Continued):**

**H. Appropriations and Funds Received from other HUD programs:**

Appropriations to cover losses for the GI and SRI funds are recorded as restoration of capital at the time property and notes are sold rather than at the time losses are initially incurred. These appropriations, which are typically not received until two years after the receivable is established, do not cover interest incurred on Treasury borrowings which are necessary to fund losses during the intervening period between the initial request and ultimate receipt of funds.

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

**I. Distributions to Policyholders:**

As mutual funds, MMI and CMHI distribute, from time to time, excess revenues to policyholders at the discretion of the Secretary of HUD. Such distributions are determined based on MMI's and CMHI's financial position and their projected revenues and costs.

**NOTE 2. Intragovernmental Financial Activities:**

FHA is an integral part of the operations of HUD, and is thus subject to financial decisions and management controls of the Secretary of HUD. Similarly, FHA is also subject to financial decisions and management controls of the Office of Management and Budget(OMB). As a result of its relationship with HUD and OMB, FHA's operations may not be conducted nor its financial position reported as they would if FHA were a separate entity.

**Interest Subsidies, Rental Supplements and Other Assistance**

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

**NOTE 2. Intragovernmental Financial Activities (Continued):**

**Administrative Expenses Reimbursed to HUD (Continued):**

benefits or of the unfunded pension liability, since these amounts are reported in total by the Office of Personnel Management.

**Insurance Provided to Other Federal Entities:**

FHA provides mortgage insurance to individuals employed by other Federal entities. These Federal entities bear the premium cost of the insurance provided by FHA. Individuals covered include servicemen in the Armed Forces (Department of Defense), servicemen in the United States Coast Guard (Department of Transportation), and servicemen in the National Oceanic and Atmospheric Administration (Department of Commerce). As of September 30, 1987, there was approximately $849 million in insurance in force outstanding for individuals employed by these Federal entities.

**NOTE 3. Investment in U.S. Government Securities:**

Investments in U.S. Government securities as of September 30, 1987 are as follows (dollars in thousands):

| Maturity | Description | Amortized Cost | Market Value |
|---|---|---|---|
| Less Than one Year | Treasury Bills, and Notes, and GNMA Certificates | $ 522,361 | $ 522,127 |
| One to Five Years | Treasury Notes and Bonds | 1,948,751 | 1,949,614 |
| Five to Ten Years | Treasury Notes and Bonds | 2,338,157 | 2,221,421 |
| Ten to Fifteen Years | Treasury Notes and Bonds | 898,905 | 819,985 |
| Over Fifteen Years | Treasury Bonds | 943,253 | 863,700 |
| Total Investments | | $ 6,651,427 | $ 6,376,847 |

**NOTE 5. Purchase Money Mortgages and Mortgage Notes Assigned to FHA:**

Purchase Money Mortgages (PMM) and Mortgage Notes Assigned (MNA) to FHA comprise the following at September 30, 1987:

| Description | PMM | MNA | Total |
|---|---|---|---|
| | (dollars in thousands) | | |
| Single Family | $ 169,753 | $ 1,284,993 | $ 1,454,746 |
| Multifamily | 164,233 | 2,367,000 | 2,531,233 |
| Mobile Homes and Home Improvements (Title I) | -- | 267,689 | 267,689 |
| | 333,986 | 3,919,682 | 4,253,668 |
| Unearned discounts | ( 32,500) | ( 311,500) | ( 344,000) |
| Allowance for losses | ( 108,725) | ( 992,346) | (1,101,071) |
| Mortgages, net | $ 192,761 | $ 2,615,836 | $ 2,808,597 |

Mortgages on which the accrual of interest has been discontinued or reduced, are estimated to be approximately $189 million for PMMs and $ 2.44 billion for assigned notes at September 30, 1987.

**NOTE 6. Appropriations Receivable:**

Appropriations Receivable at September 30, 1987 comprise the following (dollars in thousands):

| Relating to: | GI | SRI | Total |
|---|---|---|---|
| Losses on property sales in fiscal year 1986, to be received in fiscal year 1988 | $ 113,520 | $ 49,346 | $ 162,866 |
| Losses on property sales in fiscal year 1987, to be received in fiscal year 1989 | 161,133 | 76,587 | 237,720 |
| Total | $ 274,653 | $ 125,933 | $ 400,586 |

The fiscal year 1988 appropriation (relating to certain 1986 losses) has been approved pursuant to P.L. 100-202. The fiscal year 1989 appropriation (relating to certain 1987 losses) has also been approved pursuant to P.L. 100-404.

**NOTE 8. Borrowings from U.S. Treasury (Continued):**

Outstanding borrowings from the U.S. Treasury at September 30, 1987 is as follows (dollars in thousands):

Borrowings from the U.S. Treasury; interest payable on June 30 and December 31; interest rates ranging from 6.75 % to 14.5 %.

| | |
|---|---|
| Current Portion | $ 218,166 |
| Long-term Portion | 3,313,268 |
| Total | $ 3,531,434 |

Projected principal payments for next five fiscal years and thereafter are: $ 218,166 in 1988, $ 431,000 in 1989, $ 693,268 in 1990, $ 965,000 in 1991, $ 130,000 in 1992, and $ 1,094,000 thereafter.

**NOTE 9. Debentures Issued to Claimants:**

The National Housing Act authorizes FHA to, in certain cases, issue debentures, in lieu of cash, to pay claims. FHA-issued debentures bear interest rates established by Treasury. They may be redeemed by mortgagees prior to maturity to pay mortgage insurance premiums to FHA.

On January 1, 1988, the Federal Housing Commissioner called General Insurance Fund debentures (MM series) outstanding as of September 30, 1987 with coupon rates of 8.25 percent or higher. Government and public debentures redeemed totalled $20 million and $72 million, respectively. The remaining debentures, substantially all of which mature after fiscal year 1992, bear interest at rates ranging from 2.5 to 8 percent.

**NOTE 10. Government Equity:**

As required by the National Housing Act, the equity of MMI and CMHI are maintained in two separate accounts; the general surplus account and the participating reserve account. The general surplus account is generally available for operating purposes while the participating reserve account is generally used to pay distributive shares to policyholders, although it may also be used for operating purposes if required. Cumulative results of operations is allocated to these two accounts based on actuarially determined operating requirements of the Funds. Cumulative losses of the GI and SRI fund are partially offset by capital appropriated to these two funds by Congress.

**NOTE 11. Commitments and Contingencies (Continued):**

**Section 221(g)4 Program Contingent Liability:**

Mortgages insured under Section 221(g)4 of the National Housing Act may be assigned to FHA (GI Fund) by mortgagees in exchange for FHA debentures bearing current interest rates. The assignment of these mortgages to FHA may result in a liability if Treasury established debenture rates exceed the mortgage interest rates since, in those circumstances, interest paid on the debentures will exceed interest received on the mortgages.

Eligible mortgagees must elect to assign their mortgages to FHA during the 20th year of the mortgage. The fiscal year in which outstanding mortgages under the Section 221(g)4 program reach their 20th year, and thus may become liabilities are presented below for the next five fiscal years and thereafter:

| Fiscal Year | Projected Principal Balance- Year 20 (dollars in thousands) | Average Mortgage Interest Rate |
|---|---|---|
| 1988 | $ 61,295 | 6.30 % |
| 1989 | 156,871 | 7.14 |
| 1990 | 198,459 | 8.00 |
| 1991 | 314,057 | 7.62 |
| 1992 | 327,344 | 6.99 |
| Thereafter | 1,837,986 | 8.91 |
| Total | $ 2,896,012 | 8.14 % |

The current Treasury-established debenture rate is 8.625 %. To the extent Section 221(g)4 mortgages have already been assigned to FHA and have remained current, a discount has been recorded for the difference between the mortgage interest rates and prevailing market interest rates as of the dates of assignment.

HUD's actuary has estimated that the cost to the GI fund from the 221(g)4 assignment option will be $432 million. However, the difficulty of predicting future interest rates creates a potential for large deviations in this estimate. Therefore the contingent liability, if any, resulting from the 221(g)4 program has not yet been recorded in the consolidated Statement of Financial Position.

## Schedule of Assets, Liabilities, and Government Equity (Deficiency) By Activity

SEPTEMBER 30, 1987

(Dollars in Thousands)

| | MMI | CMHI | GI | SRI | COMBINED |
|---|---|---|---|---|---|
| **ASSETS:** | | | | | |
| Fund Balance with Treasury | $ 71,714 | $ 2,391 | $ 61,585 | $ 39,641 | $ 175,331 |
| Investments in U.S. Government Securities, principally non-marketable | 6,617,117 | 13,087 | 21,223 | 0 | 6,651,427 |
| Foreclosed Property Held for Sale, Net | 1,257,596 | 0 | 144,617 | 29,903 | 1,432,116 |
| Mortgage Notes Receivable, Net | 1,015,855 | 4,610 | 1,294,882 | 493,250 | 2,523,897 |
| Appropriations Receivable | 0 | 0 | 274,653 | 125,933 | 400,586 |
| Other Assets and Receivables | 249,435 | 1,728 | 139,051 | 47,415 | 437,629 |
| Total Assets | $ 9,211,717 | $ 21,816 | $ 1,936,011 | $ 736,142 | $ 11,905,686 |
| **LIABILITIES AND GOVERNMENT EQUITY:** | | | | | |
| Liabilities: | | | | | |
| Claims Payable | $ 310,299 | $ 0 | $ 198,517 | $ 16,943 | $ 525,759 |
| Loss Reserves | 1,417,489 | 0 | 557,217 | 72,686 | 2,047,392 |
| Unearned Premiums | 3,837,536 | 1,544 | 124,388 | 20,281 | 3,983,749 |
| Debentures issued to Claimants | 38 | 1,389 | 174,316 | 0 | 175,743 |
| Accounts Payable, Accrued Expenses and Other Liabilities | 120,392 | 308 | 82,229 | 99,846 | 302,775 |
| Participation and Premium Refunds Payable | 150,158 | 0 | 0 | 0 | 150,158 |
| Borrowings from the U.S. Treasury | 0 | 0 | 1,596,268 | 1,935,166 | 3,531,434 |
| Total Liabilities | 5,835,912 | 3,241 | 2,732,935 | 2,144,922 | 10,717,010 |
| Government Equity: | | | | | |
| Mutual Funds Equity | 3,356,996 | 18,575 | 0 | 0 | 3,375,571 |
| Subsidized Funds Cumulative Losses | | 0 | ( 3,784,187) | ( 3,333,462) | ( 7,117,649) |
| Appropriated Capital | 18,809 | 0 | 2,987,263 | 1,924,682 | 4,930,754 |
| Total Government Equity (Deficiency) | 3,375,805 | 18,575 | ( 796,924) | ( 1,408,780) | 1,188,676 |
| Total Liabilities and Government Equity | $ 9,211,717 | $ 21,816 | $ 1,936,011 | $ 736,142 | $ 11,905,686 |

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**NOTE 11. Commitments and Contingencies (Continued):**

**Lawsuits and Other:**

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 position.

**NOTE 10. Government Equity (Continued):**

Following is the composition of government equity for each of FHA's funds as of September 30, 1987 (dollars in thousands):

| | MMI | CMHI | GI | SRI | Total |
|---|---|---|---|---|---|
| General Surplus | $ 1,030,506 | $ 16,734 | $ | $ | $ 1,047,240 |
| Participating Reserve | 2,326,490 | 1,841 | | | 2,328,331 |
| Cumulative Results of Operations | -- | -- | (3,784,187) | (3,333,462) | (7,117,649) |
| Appropriated Capital | 18,809 | -- | 2,987,263 | 1,924,682 | 4,930,754 |
| | $ 3,375,805 | $ 18,575 | $( 796,924) | $(1,408,780) | $ 1,188,676 |

Cumulative results (losses) of operations for the GI and SRI funds exceed appropriated capital even though the National Housing Act, as amended, authorizes appropriations to restore losses. This is because appropriations to restore such losses are neither requested nor received until well after loss recognition. Under generally accepted accounting principles, losses are recognized upon default while for budgetary purposes, related appropriated capital is not recorded until underlying assets are sold at a loss. Furthermore, the appropriations do not cover interest expense incurred on borrowings necessary to sustain the funds' operations until appropriations are received.

**NOTE 11. Commitments and Contingencies:**

**Insurance in Force:**

Total outstanding insurance in force is as follows as of September 30, 1987 (in thousands):

| Fund | Single Family | Multifamily | Title I | Total |
|---|---|---|---|---|
| MMI | $ 204,590,330 | $ -- | $ -- | $ 204,590,330 |
| CMHI | -- | 541,036 | -- | 541,036 |
| GI | 15,160,335 | 36,532,703 | 7,000,000 * | 58,693,038 |
| SRI | 7,129,278 | 6,014,375 | -- | 13,143,653 |
| Total | $ 226,879,943 | $ 43,088,114 | $ 7,000,000 | $ 276,968,057 |

* - Actuary's estimate of Title I insurance in force

**NOTE 7. Loss Reserves:**

Loss reserves, which comprise claims loss reserves and Loss Adjustment Expense (LAE) reserves were as follows as of September 30, 1987 (in thousands):

| Fund | Claims Loss Reserve | LAE Reserve | Total |
|---|---|---|---|
| MMI | $ 1,358,500 | $ 58,989 | $ 1,417,489 |
| CMHI | -- | -- | -- |
| GI | 514,055 | 43,162 | 557,217 |
| SRI | 64,496 | 8,190 | 72,686 |
| Total | $ 1,937,051 | $ 110,341 | $ 2,047,392 |

The claims loss reserve is provided for estimated losses incurred by FHA to pay claims on insured mortgages where defaults have taken place, but where claims have not yet been filed. The reserve is estimated based on historical claim and loss experience data, adjusted for judgments concerning current economic factors.

The loss expense reserve is provided for estimated administrative expenses of settling filed claims and reported defaults.

**NOTE 8. Borrowings from the U.S. Treasury:**

The National Housing Act, as amended, allows FHA's GI and SRI funds to borrow cash from the U.S. Treasury at Treasury's established lending rates for Federal departments and agencies. Borrowings from Treasury cannot exceed the total amount of claims paid by FHA. They typically have a 15 year term, but may be repaid prior to maturity at the discretion of FHA. However, such borrowings must be repaid in the sequence in which they were borrowed from Treasury.

Borrowings outstanding at September 30, 1987 are payable from the GI and SRI funds. Given the losses experienced by these funds in the past and those expected for the foreseeable future, management believes that repayment can only be accomplished through new borrowings, or through rescheduling maturity dates.

**NOTE 3. Investment in U.S. Government Securities (Continued):**

Through August 12, 1988, FHA redeemed (before maturity) investments that were owned as of September 30, 1987 with a carrying value of $642,585,000 and recorded a gain on sale of $12,237,000. If investments owned at September 30, 1987 had been held as of August 12, 1988, their market value would have been approximately $ 6.46 billion.

**NOTE 4. Proposed Loan Sales:**

During fiscal year 1988, HUD has been attempting to sell certain multi-family loans that were held by FHA as of September 30, 1987 under the Federal government's loan asset sale program. That program requires that loans be sold without recourse provisions. The subject loans were originally offered for sale, without recourse, in May 1987. However, that sale was challenged in court (Walker, et al. v. Pierce, 665 F. Supp. 831 (N.D. Cal. 1987)) on the grounds that sale of the mortgages on a non-insured basis would terminate the regulatory agreements between HUD and the project mortgagors and that termination of the regulatory agreements would deprive the tenants of a number of benefits and protections available to insured projects.

In May 1988, a Settlement Agreement was entered into by HUD and the plaintiffs whereby HUD can sell the cash flows from approximately 160 of the FHA multifamily mortgages, but must retain "bare legal title" and continue as the mortgagee of record. FHA is now attempting to sell 140 of these loans which have an aggregate carrying value of approximately $255 million.

As of November 15, 1988, HUD has been unable to structure the loan sale in a manner that would allow their sale without recourse, and there is doubt whether the loans can be so structured. Accordingly, the loans have not been classified as Mortgages Held for Sale in FHA's Statement of Financial Position

**NOTE 2. Intragovernmental Financial Activities (Continued):**

**Interest Subsidies, Rental Supplements and Other Assistance (Continued):**

During fiscal year 1987, FHA received directly the following interest subsidy, rental supplement and other assistance payments from HUD:

| Description | Amount (dollars in thousands) |
|---|---|
| Single Family Notes - Interest Subsidy | $ 2,211 |
| Multifamily Notes - Interest Subsidy | 42,943 |
| Rent Supplements for low income individuals occupying Multi-Family properties | 854 |
| Rent Supplements for low and very low income families living in multifamily properties | 7,005 |
| Payments for acquired homes utilized for Urban Homesteading | 5,942 |
| Total | $ 58,955 |

To the extent FHA-insured mortgagors receive interest subsidy and/or rental supplement payments, FHA benefits indirectly since these assistance payments will reduce the risk of the mortgagors' failing to repay the FHA-insured loans. The amount of HUD assistance to FHA-insured mortgagors or to occupants of multi-family property financed through FHA-insured mortgages is not presently determinable. Amounts receivable from HUD as of September 30, 1987 for the above assistance programs are not material.

**Administrative Expenses Reimbursed to HUD:**

HUD is reimbursed by FHA for personnel, property and equipment, and administrative services costs since all FHA operations are performed by HUD personnel. These annual reimbursements are budgeted amounts approved by Congress each fiscal year. They are based on the estimated staff levels to carry out FHA activities, not the time actually worked by HUD personnel on those activities. Since HUD does not calculate or record accrued annual leave, FHA's records do not reflect such an accrual.

Allocated personnel costs for which FHA reimburses HUD include matching contributions to the Civil Service Retirement System (CSRS) and the Federal Employees Retirement System (FERS). FERS went into effect for all HUD employees on January 1, 1987 pursuant to Public Law 99-335. FHA does not report its portion of the CSRS or FERS actuarial present value of accumulated

**NOTE 1. Summary of Mission and Significant Accounting Policies (Continued):**

claims do not result in the assumption of notes. Purchase money mortgages were previously issued, in certain circumstances, to buyers of FHA-owned property acquired in the settlement of insurance claims. Under current policies, however, FHA no longer issues purchase money mortgages to sell foreclosed property.

Both mortgage notes received in claim settlement and purchase money mortgages are recorded at the lower of cost or fair value. Fair value is based on prevailing market interest rates at dates of mortgage issue or assumption, as applicable. When fair value is less than cost, discounts are recorded and amortized to interest income over the initial or remaining terms of the mortgages. Interest income is recognized as income when earned. 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. Purchase money mortgages and notes received in claim settlement are reported net of the allowance for loss and any unamortized discount.

**F. Foreclosed Property Held for Sale:**

Foreclosed properties held for sale are reported net of an allowance for loss, which is established to reduce the property carrying value to the estimated net realizable value -- the amount FHA expects to receive in cash upon sale of the property.

**G. Premiums and Unearned Revenue:**

FHA's largest activity, the insurance of single family mortgages by MMI, charges a one-time premium upon insurance initiation. Such premiums are recorded as unearned revenue upon collection and then recognized as revenue over the historical loss period as determined by HUD's actuaries. Mortgagors may finance payment of the one-time premium by adding it to the mortgage principal. The one-time premium went into effect in fiscal year 1984. FHA's other activities, including most of those conducted through the GI and SRI funds, charge periodic premiums over the mortgage insurance term.

## Notes to Statement of Financial Position

**SEPTEMBER 30, 1987**

**NOTE 1. Description of Entity and Significant Accounting Policies**

**A. Entity and Mission**

The Federal Housing Administration (FHA) was established in 1934 and became a wholly owned government corporation in 1948 subject to the Government Corporation Control Act, as amended. FHA administers some 40 active mortgage insurance programs, thereby making mortgage financing more readily accessible to the home buying public. Its programs are designed primarily to serve first-time, inner city, and rural home buyers; and to provide affordable multifamily housing.

The FHA programs are organized into four major activities as follows: (1) The Mutual Mortgage Insurance Fund (MMI), which provides basic single family mortgage insurance. It is a mutual fund whereby mortgagors, upon non-claim termination of their mortgages, share surplus premiums paid into the fund that are not required for operating expenses and losses; (2) The Cooperative Management Housing Insurance Fund (CMHI), also a mutual fund, which provides mortgage insurance for management-type cooperatives authorized by Section 213 of the National Housing Act, as amended; (3) The General Insurance Fund (GI), which provides for a large number of specialized mortgage insurance programs, including insurance of loans for property improvements as well as for 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. SRI also provides insurance for high-risk mortgagors who normally would not be eligible for mortgage insurance.

The National Housing Act, as amended, authorizes appropriations to restore certain losses sustained from mortgage insurance operations of the GI and SRI funds, which contain subsidized activities.

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. FHA no longer has separate staff or facilities. Instead, FHA 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 activities are included in the Housing section of the HUD budget.

# Auditor's Opinion

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*Price Waterhouse*

To the Secretary
Department of Housing and Urban Development

We have examined the consolidated Statement of Financial Position of the Federal Housing Administration (FHA) as of September 30, 1987. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Under the provisions of 31 U.S.C. 9105, the U.S. General Accounting Office (GAO) is required to audit FHA every three years. For fiscal years 1981 and 1984, GAO concluded that FHA's financial statements could not be audited due to significant accounting and reporting changes needed, and due to deficiencies in FHA's accounting systems and financial records. For the fiscal year 1987 audit, ongoing improvements to financial and accounting systems and the implementation of new accounting policies allowed us to audit FHA's consolidated Statement of Financial Position as of September 30, 1987. However, because of past problems noted by GAO, it was not practical for us to examine the consolidated Statements of Operations and Changes in Financial Position for the fiscal year ended September 30, 1987. Accordingly, our opinion is limited to the consolidated Statement of Financial Position as of September 30, 1987.

In our opinion, the accompanying consolidated Statement of Financial Position presents fairly the financial position of the Federal Housing Administration as of September 30, 1987 in accordance with generally accepted accounting principles.

Our examination was made for the purpose of forming an opinion on the consolidated Statement of Financial Position taken as a whole. The supplemental schedule is presented for purposes of additional analysis and is not a required part of the basic financial statements. However, the supplemental schedule has been subjected to the auditing procedures applied in the examination of the consolidated Statement of Financial Position. In our opinion the supplemental schedule of assets, liabilities and government equity by activity is fairly presented in all material respects in relation to the consolidated Statement of Financial Position taken as a whole.

Price Waterhouse

August 12, 1988,
except for Note 4,
for which the date
is November 15, 1988

# Contents



**Abbreviations**

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| FHA | Federal Housing Administration Fund |
| GCCA | Government Corporation Control Act |
| HUD | Department of Housing and Urban Development |
| MMI | Mutual Mortgage Insurance |

During the course of its examination, Price Waterhouse also identified several matters which, although not material to the statement of financial position, are being communicated for FHA's consideration in a separate management letter.

We are sending copies of this report to the Director of the Office of Management and Budget; the Secretary of the Treasury; the Secretary of the Department of Housing and Urban Development; HUD's Assistant Secretary for Housing, who serves as the Federal Housing Commissioner; and HUD's Assistant Secretary for Administration.

for Charles A. Bowsher
Comptroller General
of the United States

operations and changes in financial position for the year ended September 30, 1987. For these reasons, we restricted the scope of Price Waterhouse's work and did not require reports on internal accounting controls and compliance with laws and regulations. However, we are planning a full financial statement audit for fiscal year 1988. We did determine the scope of the audit work, monitor its progress at all key points, review the working papers of the certified public accountant, and perform other procedures as we deemed necessary. Except for the scope restriction previously discussed, the examination was conducted in accordance with generally accepted government auditing standards.

An important objective of the financial audit was to assess the conclusions reached by HUD's actuary and others about FHA's financial condition as an actuarially sound insurance program. A key to this assessment was to review the methodologies and assumptions used by HUD's actuary to determine their reasonableness and to review the results of an economic stress test[2] of the Mutual Mortgage Insurance (MMI) Fund, FHA's largest insurance program, conducted by a HUD independent contractor. HUD's actuary had concluded that FHA is in sound financial condition despite significant losses incurred in economically stressed areas, most notably Texas, Oklahoma, Colorado, and Louisiana. HUD's independent contractor also concluded that as of December 31, 1987, the MMI Fund was in a strong financial position relative to future performance under probable future economic conditions. However, the HUD independent contractor cautions that the MMI Fund would barely survive under more severe regional stress and would not survive under conditions of national stress without U.S. Treasury support. Nothing came to the attention of Price Waterhouse during the course of its audit, nor to us during our review thereof, to indicate that these methodologies, assumptions, and conclusions are unreasonable.

Subsequent to September 30, 1987, the MMI fund began experiencing a net outflow of cash. This resulted principally from a decline in premium collections compared to 1987 and an increase in claim payments. One reason for the increase in claim payments is that the high levels of insurance written in 1986 and 1987 are now entering their historically high claim period. Like many private mortgage insurers, FHA experiences

[2]An economic stress test evaluates the ability of an entity to remain solvent under various future distress conditions. It involves forecasting future cash flows assuming various future economic conditions which can include home appreciation, mortgage default frequency, loss ratios, and interest rates.