United States General Accounting Office

GAO

Report to the Congress

February 1990

FINANCIAL AUDIT

Federal Housing Administration Fund's 1988 Financial Statements

GAO/AFMD-90-36

GAO

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

Comptroller General
of the United States

B-206207

February 9, 1990

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

This report presents the results of our audit of the Federal Housing Administration Fund's consolidated financial statements as of September 30, 1988. Reports on the Fund's internal accounting controls and on its compliance with laws and regulations are also provided.

As a result of the 1988 financial audit, the Federal Housing Administration (FHA) adjusted its financial statements from a loss of $858 million to a loss of $4.2 billion, which reduced its government equity to a cumulative deficit of $2.9 billion. The 1988 losses resulted from rising defaults in economically stressed regions, sales of foreclosed properties at less than carrying values, the failure of several large coinsurers, and program fraud and abuse. The full extent of losses attributable to program fraud and abuse through September 30, 1988, is not yet known.

We and Price Waterhouse have declined to express an opinion on FHA's 1988 financial statements because of an inability to ascertain the extent of losses due to fraud and abuse and because of the lack of an accurate inventory of foreclosed property. We are also concerned about large potential future losses in FHA's General Insurance (GI) Fund. The audit also revealed serious internal accounting control weaknesses in third-party monitoring, financial management systems, insurance program design, controls over cost and claims settlement, and the performance of basic accounting functions. In addition, the audit showed that FHA did not fully comply with the Debt Collection Act of 1982.

Background

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 the 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

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

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, 1988, FHA had $303 billion of insurance-in-force.

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 a number of improvements in agency systems, staffing, and management, which we considered sufficient, to permit an audit of its statement of financial position as of September 30, 1987.

The 1987 and 1988 Audits

To fulfill our audit responsibility, we contracted with the independent certified public accounting firm of Price Waterhouse to conduct financial audits of FHA for 1987 and 1988. 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 operations and cash flows for the year ended September 30, 1987. For these reasons, it was deemed necessary to restrict the scope of Price Waterhouse's work to the audit of FHA's September 30, 1987, statement of financial position to establish opening balances, and we did not require reports on internal accounting controls and compliance with laws and regulations (GAO/AFMD-89-3, May 12, 1989). However, these reports are presented as part of the consolidated financial statement audit for fiscal year 1988.

We determined the scope of the audit work, monitored its progress at all key points, reviewed the working papers of the certified public accountant, and performed other procedures as we deemed necessary. The audits were conducted in accordance with generally accepted government auditing standards, except for the previously discussed scope restriction on the 1987 audit.

Disclaimer of Opinion

Price Waterhouse has disclaimed expressing an opinion on FHA's 1988 and 1987 financial statements because it was unable to ascertain the amount of potential losses involved in alleged improper diversions of property sales proceeds by certain private closing agents contracted by

HUD to sell HUD-owned properties and other alleged improprieties and because FHA did not maintain an accurate inventory of foreclosed properties. We concur with Price Waterhouse's disclaimer.

As of September 30, 1988, FHA had $3.1 billion of foreclosed property held for sale ($2.5 billion in 1987) less an estimated allowance for losses of $1.4 billion ($1.1 billion in 1987). The alleged diversions resulted, in part, from internal accounting control weaknesses involving HUD's inability to properly monitor both the collection and the prompt deposit of property sales proceeds. As of September 15, 1989, the amount of the losses that will ultimately be incurred because of the alleged diversions had not been determined. Further, the amount of losses applicable to FHA's 1988 and 1987 financial statements is not ascertainable and could have a significant impact on FHA's financial position, results of operations, and cash flows. HUD investigations into this matter are currently pending.

Price Waterhouse's audit of FHA's financial statements also disclosed a material uncertainty with respect to FHA's General Insurance (GI) Fund, which has incurred substantial losses due to the default of several coinsuring lenders. Because of insufficient levels of capital required of coinsuring lenders and the lack of FHA program monitoring, additional losses may result. A provision of $960 million has been recorded in the 1988 consolidated statement of operations for the amount of estimated losses resulting from existing and probable defaults in the multifamily coinsurance programs. An additional provision of $275 million has also been recorded for probable defaults of FHA-insured hospital mortgages, based upon unfavorable financial conditions involving several hospital mortgages. HUD's actuary has determined that, in the aggregate, the GI Fund premiums are insufficient to cover its losses, and the Fund must depend on borrowings from the U.S. Treasury and appropriations to sustain its operations. However, given the probability that additional losses will take place, FHA cannot presently estimate the amount of premium deficiency or the level of support it will ultimately require from the U.S. Treasury.

Additionally, Price Waterhouse's report emphasized that FHA's Mutual Mortgage Insurance (MMI) Fund is operated as a mutual fund and is required to be "actuarially sound," so that over the life of the fund, premiums are sufficient to pay claims and expenses. The MMI Fund, FHA's largest, with $229 billion of a total $303 billion of insurance-in-force, incurred 1988 losses of $1.4 billion, reducing its equity to $1.8 billion as of September 30, 1988. Despite this current loss, HUD's actuary has estimated that future revenue will exceed future claims and expenses for the MMI Fund. However, actuarial studies are currently underway to determine whether there are structural or design weaknesses in the MMI fund that could cause material losses.

The 1988 unaudited financial statement amounts released by FHA and reported to the U.S. Treasury in December 1988 disclosed a loss of $858 million for all four FHA funds. During the audit, Price Waterhouse proposed, and FHA recorded, over 100 adjustments to correct FHA's accounts which, in the aggregate, reduced government equity by $3.4 billion and resulted in a cumulative deficit of $2.9 billion. The $3.4 billion of audit adjustments were primarily the result of net increases in accruals for claims not yet reported. FHA must report to the U.S. Treasury financial results for the fiscal year ended September 30 by December 31 of each year, requiring estimates of incurred but not reported and probable future claims. Audit work by Price Waterhouse disclosed the need to report additional claims based upon actual experience and the recognition of losses at the time of default rather than at the time of foreclosure—an average lag of 15 months.

Serious Internal Accounting Control Weaknesses Exist

The report by Price Waterhouse on internal accounting controls disclosed six conditions believed to be material weaknesses and made a number of suggestions to address those weaknesses. Those weaknesses are as follows:

- Monitoring of underwriting, property management, and collection of property sales proceeds delegated to private sector third parties is ineffective.
- Financial management systems do not provide timely and accurate information on programs, nor do they hold managers accountable for program results and effectiveness.
- Structural or design flaws exist in the multifamily coinsurance program, due to insufficient levels of capital required of coinsuring lenders, and in the hospital mortgage insurance program, due to uncoordinated underwriting practices.
- The system for foreclosed property inventory cannot account for acquired properties and their value, and the cash management system does not ensure that proceeds collected by third parties on sales of foreclosed property are promptly deposited in FHA's Treasury accounts.

- Controls over cost are inadequate, multifamily insurance claims benefits are not being paid promptly, and controls are inadequate to detect misrepresentations by mortgagees and lenders.
- Routine and basic accounting functions, such as reconciling accounts to supporting records, providing support to justify payments, controlling funds held on behalf of others, and properly recording transactions, are not being performed.

Problems Are Longstanding

Most of these fundamental accounting and financial reporting problems are the same ones that GAO and the HUD Inspector General have been reporting since the early 1980s. HUD has not been diligent in correcting problems cited by auditors or in its own Federal Managers' Financial Integrity Act (FMFIA) reports. While HUD staff members responsible for FHA activities have generally responded to GAO and Inspector General recommendations and to the weaknesses disclosed in the FMFIA reports, resolution of the findings has often been delayed and some findings have not been addressed at all. In addition, in some cases, there were no follow-up reviews to determine if proposed procedures had, in fact, resolved the cited problems.

For example, HUD's 1987 and 1988 FMFIA reports disclosed that inadequate controls existed which provided the potential for private closing agents to manipulate or otherwise take funds for their own use or to delay the transfer of such funds to HUD. This same weakness was noted during the 1988 audit. Subsequently, a private closing agent, known as "Robin HUD," admitted to embezzling $5.5 million of HUD funds during this period.

These weaknesses, findings with which we concur based upon our review of the auditors' working papers, are discussed in detail in the accompanying report on internal accounting controls.

Noncompliance With the Debt Collection Act

The report by Price Waterhouse on compliance with laws and regulations disclosed an instance of noncompliance, which could impact FHA's ability to effectively collect money it is owed. FHA did not fully implement the Debt Collection Act of 1982 because it failed to take collection action after foreclosed property was acquired. The noncompliance with the Debt Collection Act of 1982, a finding with which we concur based upon (1) our review of the auditors' working papers and (2) the actions that should be taken to fully implement the act, are discussed in detail in the accompanying report on compliance with laws and regulations. In addition, the report notes that there are a number of investigations currently underway regarding alleged improprieties in HUD's administration of FHA. These investigations may reveal other violations of laws and regulations.

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

Current FHA Initiatives

FHA's accounting and financial management problems are long-standing and well-documented. Correction of these problems will require multi-year solutions and a long-term commitment by top management. The new management at HUD has started to address various deficiencies to strengthen FHA, which include:

- announcing that the Secretary will appoint a Chief Financial Officer at HUD and a Controller at FHA;
- establishing a task force to gather data, assess problems, and develop an action plan with milestones addressing the improvements needed in accounting and financial management systems;
- increasing monitoring and enforcement activities of private sector third parties;
- redirecting FHA's accounting and computer systems to generate timely and accurate data for financial and program management;
- performing an independent actuarial analysis of the MMI and GI Funds;
- reviewing controls over programs, particularly where abuses have occurred, to correct weaknesses or terminate ineffective programs;
- publishing annual audited financial statements; and
- implementing recommendations resulting from audits.

Conclusions

There are a number of serious financial management problems at FHA which contribute to its losses. These problems are exemplified in the lack of monitoring of responsibilities delegated to private sector third parties; the poor quality of financial information available to management; the weak financial management systems and internal control procedures; design flaws in the multifamily coinsurance and hospital mortgage insurance programs; the substandard performance of essential accounting functions; and management's inattention to weaknesses identified by GAO, the Inspector General, and FHA's own FMFIA reports.

As a result of these financial management problems, FHA is susceptible to mismanagement and the unnecessary risk that fraud and abuse will occur and not be detected. Such conditions also impede management from assessing the level of risk arising from normal insurance operations. Accurate and timely financial information for each program and location is essential to effectively manage FHA's insurance programs.

It is because FHA has begun to prepare financial statements and, most importantly, that these statements have been independently audited, that the magnitude of FHA's problems is becoming evident. Annual audits of financial statements would provide the Congress and the public an objective assessment of management's performance. Additionally, financial reporting can provide a measurement tool for effective congressional oversight.

We believe that the initiatives discussed above, if properly implemented, should address the problems cited in this report.

Recommendation to the Congress

We recommend that the Congress, through its appropriation, authorization, and oversight committees, hold annual hearings on the actions of FHA to ensure that FHA resolves the financial management problems identified, including evaluating its systems, correcting the material weaknesses identified, and ensuring that similar problems do not occur in the future. To assist in its oversight role, we believe the Congress should require the Secretary to provide audited financial statements, reports on internal accounting controls and compliance, and management's report required by the Federal Managers' Financial Integrity Act.

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.

Charles A. Bowsher

Charles A. Bowsher
Comptroller General
of the United States

Contents

Letter		1
Independent Auditors' Report		10
Auditors' Report on Internal Accounting Controls		13
Auditors' Report on Compliance With Laws and Regulations		26
Financial Statements		29
	Consolidated Statement of Financial Position	29
	Consolidated Statement of Operations and Government Equity (Deficiency)	30
	Consolidated Statement of Cash Flows	31
	Notes to Consolidated Financial Statements	32
Supplemental Information		48
	Consolidating Statement of Financial Position	48
	Consolidating Statement of Operations and Government Equity (Deficiency)	49
	Consolidating Statement of Cash Flows	50

Abbreviations

CMHI	Cooperative Management Housing Insurance
FHA	Federal Housing Administration
GI	General Insurance
GCCA	Government Corporation Control Act
HUD	Housing and Urban Development
MMI	Mutual Mortgage Insurance
SRI	Special Risk Insurance

Independent Auditors' Report

Office of Government Services
1801 K Street N W
Washington DC 20006

Telephone 202 296 0800

Price Waterhouse

To the Comptroller General
of the United States

and the Secretary
of Housing and Urban Development

We were engaged to audit the accompanying consolidated statements of financial position of the Federal Housing Administration (FHA), a fund of the Department of Housing and Urban Development (HUD), as of September 30, 1988 and 1987, and the related consolidated statements of operations and government equity (deficiency), and of cash flows for the fiscal year ended September 30, 1988. These financial statements are the responsibility of FHA's management.

Allegations have been made about improper diversions of property sales proceeds by certain private closing agents contracted by HUD to sell HUD-owned property. This property is reported in the FHA financial statements. The alleged diversions resulted, in part, from internal control weaknesses involving HUD's inability to properly monitor the collection and prompt deposit of property sales proceeds, or to maintain an accurate inventory of foreclosed properties. The Inspector General has estimated that such improper diversions may lead to substantial losses, but to date, the amount of the losses that will ultimately be incurred by HUD has not been determined, nor is HUD able to ascertain how much, if any, of these losses are already reflected in the 1988 financial statements. Further, ongoing investigations into this matter have not yet been completed. There are a number of other investigations currently being conducted about other alleged improprieties involving HUD's administration of FHA. These investigations could reveal violations of laws and regulations, but to date, a final determination about such violations has not been made. We have been unable to apply other auditing procedures to satisfy ourselves regarding the alleged improper diversions of property sales proceeds or the extent to which the inventory of foreclosed property reflected in the accompanying financial statements may be misstated, nor were we able to determine the possible impact on the financial statements of other investigations currently being conducted. These matters could have a significant impact on FHA's financial position, results of operations and cash flows.

As discussed in Note 8, FHA's General Insurance (GI) Fund has incurred substantial losses primarily relating to its multifamily coinsurance programs, and to a lesser degree, to its insurance of hospital mortgages. In September 1988, the Government National Mortgage Association (GNMA), a government corporation operated by HUD which guarantees securities backed by FHA-

To the Comptroller General of the United States
and the Secretary of Housing and Urban Development
Page 2

coinsured multifamily mortgages, declared a major FHA lender/coinsurer in default of its GNMA obligations. Subsequent to September 1988, GNMA similarly declared three more large FHA lender/coinsurers in default. Because FHA insures the mortgages underlying the GNMA securities, substantially all losses relating to these defaulted lender/coinsurers will be borne by FHA. A provision of $960 million has been recorded in the fiscal year 1988 consolidated statement of operations for estimated losses resulting from these and other probable defaults in the multifamily coinsurance programs. However, because of weaknesses in the multifamily coinsurance programs involving required levels of capital and coinsurer monitoring, it is possible that more lender/coinsurers will default and cause substantial additional losses in the GI Fund. Also, a provision of $275 million has been recorded in the consolidated statement of operations for probable defaults of FHA-insured hospital mortgages. Even a limited number of defaults of these large mortgages could place a serious financial burden on the GI Fund, and could render the hospital insurance premiums insufficient to cover related losses. HUD's actuary has determined that, in the aggregate, the GI Fund's premiums are insufficient to cover its losses, and the Fund is dependent on the U.S. Treasury and on budget appropriations to sustain its operations. However, given the probability that additional losses will take place, FHA cannot presently estimate the degree of its premium insufficiency or the level of support it will ultimately require from Treasury. The accompanying financial statements do not include any adjustments for these uncertainties which, if known, could be material in relation to FHA's financial position and results of operations.

As discussed in Note 1, FHA comprises four major activities, the MMI, CMHI, GI and SRI Funds. The MMI and CMHI Funds are operated as mutual insurance funds and are required to be "actuarially sound". The largest FHA activity is the MMI Fund, a fund which insures single family home mortgages and which comprises $228.5 billion of FHA's $303.4 billion of insurance in force. Although the MMI Fund incurred, on an accrual basis, losses of $1.4 billion for fiscal year 1988, it still reports government equity of $1.8 billion. Despite its current losses, HUD's actuary has estimated that the MMI Fund's future revenue will exceed its future expenses. However, there are studies currently underway to determine whether there are structural weaknesses in the MMI Fund that must be addressed. For fiscal year 1988, the CMHI Fund, FHA's smallest activity, paid no claims, reported an excess of revenues over expenses, and showed positive government equity. The GI and SRI Funds are not mutual insurance funds, have no requirement that they be actuarially sound, and contain programs that have had continuing losses. Neither the GI Fund's nor the SRI Fund's premiums are sufficient to cover their losses leaving them dependent on the U.S. Treasury and on budget appropriations to sustain their operations.

To the Comptroller General of the United States
and the Secretary of Housing and Urban Development
Page 3

In our report dated August 12, 1988 except for Note 4, for which the date was November 15, 1988, we expressed an opinion that the consolidated statement of financial position at September 30, 1987 presented fairly the financial position of the Federal Housing Administration in conformity with generally accepted accounting principles. However, the allegations about the diversion of property sales proceeds, possible misstatements of the inventory of foreclosed properties, and the unknown outcome of other investigations referred to in the second paragraph of this report may have affected FHA's financial position at September 30, 1987. Accordingly, with respect to the September 30, 1987 consolidated statement of financial position, our report as presented herein, is different from that previously issued.

HUD has not yet determined (1) the extent of the diversion of property sales proceeds, (2) the extent to which foreclosed property reflected in the accompanying financial statements may be misstated, or (3) the effect that the outcome of other investigations might have on FHA's financial statements. Nor were we able to satisfy ourselves about the effect of these matters, which could have a significant impact on the accompanying financial statements. Therefore the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the accompanying financial statements.

We were engaged for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, and cash flows of FHA's major activities. For the reasons described in the preceding paragraph, we are unable to, and do not, express an opinion on whether the consolidating information is fairly stated, in all material respects, in relation to the consolidated financial statements taken as a whole.

Price Waterhouse

September 15, 1989,
except as to Note 14,
which is as of
December 20, 1989

Auditors' Report on Internal Accounting Controls

Office of Government Services
1801 K Street, N.W.
Washington, DC 20006
Telephone 202 296 0800

Price Waterhouse

To the Comptroller General
of the United States

and the Secretary
of Housing and Urban Development

We were engaged to audit the consolidated financial statements of the Federal Housing Administration (FHA), a fund of the Department of Housing and Urban Development (HUD), as of and for the year ended September 30, 1988, and have issued our report thereon dated September 15, 1989, except as to Note 14 to those financial statements, which is as of December 20, 1989.

In planning and performing our audit of FHA's financial statements for the year ended September 30, 1988, we considered its internal control structure in order to determine our auditing procedures.

The management of FHA is responsible for establishing and maintaining an internal control structure. 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 an internal control structure are to provide management with reasonable, but not absolute, assurance that (1) obligations and costs are in compliance with applicable laws, (2) funds, property, and assets are safeguarded against waste, loss, and unauthorized use or misappropriation, and (3) assets, liabilities, revenues, and expenses applicable to operations are properly recorded and accounted for to permit the preparation of reliable financial reports and to maintain accountability over the entity's assets. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For purposes of this report, we have classified the significant policies and procedures relative to FHA's internal control structure in the following categories:

- o General Ledger and Treasury Operations
- o Financial Reporting
- o Notes Receivable
- o Property Held for Sale
- o Claims Processing
- o Insurance-in-Force
- o Premiums, Premium Refunds, and Distributive Shares

Report on Internal Controls
Page 2

- o Field Office Operations
- o Actuarial Branch Operations
- o Administration and Other

For all the categories listed above, we obtained an understanding of the design of relevant policies and procedures, determined whether they have been placed in operation, and assessed control risk.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

A material weakness is a reportable condition in which the design or operation of specific elements of the internal control structure do not reduce to a relatively low level the risk that errors or irregularities, 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. We consider the following reportable conditions to be material weaknesses.

MONITORING OF DELEGATED FUNCTIONS MUST BE UPGRADED AND IMPROVED

Many of HUD's[1] important functions, including certain underwriting functions, property management, and collection of property sale proceeds, have been delegated to third parties. However, despite the importance of these delegated functions and the inherent need to closely watch over them, we found that HUD oversight and monitoring has not always been effective and must be improved to ensure delegated functions are carried out in the government's best interest.

The delegated functions in which we noted deficiencies can be broadly categorized in three ways. First is delegated underwriting whereby HUD allows certain eligible lenders to write FHA mortgage insurance without prior HUD approval. The largest and perhaps best known program for delegated underwriting is the direct endorsement of single family mortgage insurance by

[1] Hereinafter when HUD is referred to it pertains to HUD's administration of FHA activities.

FHA approved lenders (generally known as "mortgagees"). Second is the delegation of property management functions to third party agents. These agents are commonly known as Area Management Brokers (AMBs) who, on behalf of HUD, maintain, manage and sell properties that the FHA Fund obtained in foreclosure. And third is the delegation of property sale closing responsibilities to private closing agents. Among the private closing agents' most important, and from HUD's standpoint most risky, functions is collecting property sale proceeds and depositing them in HUD's account at the U.S. Treasury. Each of these areas had instances of flawed, deficient, or lackluster monitoring and oversight. Deficiencies in monitoring sales closing agents are discussed on page 9 of this report.

With regard to monitoring of mortgagees to whom underwriting has been delegated, HUD, on behalf of FHA, uses headquarters and regional staff to perform some oversight functions and to periodically conduct field reviews of selected mortgagees. However, their functions are often too narrow, rely on information of questionable veracity, and are not well coordinated. Moreover, field reviews generally focus on the same mortgagees year after year, and there are indications that they do not identify the causes of excessive insurance losses; specifically they do not always identify mortgagees and/or appraisers who have repeatedly overvalued properties. The system used to monitor mortgage defaults does not have up to date default information, does not always identify defaults that have been cured, and has shown differences of 100,000 cases or more with another system that summarizes similar information. Furthermore, there is little coordination of the oversight and monitoring functions being performed by various parts of HUD. For example GNMA has its own monitoring and field review system, yet rarely shares its findings and information with FHA. The result of the problems with mortgagee monitoring is a function that is, in an agency-wide sense, disjointed and which leaves unclear what an acceptable level of defaults and insurance losses is or should be.

HUD has been similarly deficient in monitoring area management brokers. Some AMBs have been allowed to manage excessive numbers of properties. In one instance a broker was managing over 1,000 properties; well in excess of the HUD-mandated limit of 100. Allowing a concentration of property management responsibilities to too few brokers unnecessarily exposes HUD to excessive losses should one or more of the large brokers decide to abuse HUD rules. This risk is further exacerbated by the fact that AMBs are paid a fee based on total properties they manage, and thus they have little incentive to promptly sell properties. In other instances, AMBs were allowed to incur expenses well in excess of HUD limits, yet they were still reimbursed for them. Property inspections to ensure repairs and maintenance were properly performed on AMB managed properties were also less than that required by HUD policy. Failure to perform either of these important monitoring functions at an acceptable level could cause HUD to incur improper or unreasonably high property expenses, or could lead to property being sold at less than its full value because it was inadequately maintained.

The causes of oversight and monitoring deficiencies result in part from a lack of appreciation of the financial impact of poor underwriting and of the need to closely coordinate all oversight activities. This is perhaps best exemplified by the fact field monitoring is largely case-based. There is a focus on the number of cases that have defaulted or have led to claims, but not so much on the dollar losses caused by those defaults and claims or on the causes of those losses, or on how they might be minimized in the future. AMB and private closing agent oversight suffered, at least partially, from a lack of experienced staff to handle the large number of foreclosed properties that came to HUD in economically distressed regions. But there was apparently no contingency plan to provide additional resources to those regions requiring them.

Resolving the deficiencies in oversight and monitoring will require a concerted effort on the part the agency. Therefore we suggest that the Secretary establish a task force comprised of individuals from the Office of Housing, Office of Administration, Government National Mortgage Association, and from the regions to: (1) identify and assess information currently gathered by the various HUD groups about mortgagees to whom underwriting has been delegated to determine whether it is adequate, timely and useful, (2) identify other information that might be needed to effect better monitoring, (3) assess all field monitoring functions to determine whether they are frequent enough, are properly identifying the causes for insurance losses and are effective in resolving problems that have caused persistent losses, (4) establish formal means of communicating review findings among the HUD groups, (5) establish a method of monitoring findings from field reviews and their subsequent resolution, and (6) develop, at least conceptually, an informational data base which can be used by all HUD groups involved with mortgagee oversight functions. With respect to oversight of area management brokers, the Secretary should reiterate to the regions HUD's policy regarding limitations on the number of properties individual brokers can manage, and require explanations and take appropriate remedial action where this policy was not followed. The Secretary should further initiate a study of regional staff capabilities to determine whether experience and staffing levels are proper in light of responsibilities and determine whether additional travel funds are needed to allow regions to properly carry out oversight and property inspection duties.

Report on Internal Controls
Page 5

ACCOUNTABILITY MUST BE ALIGNED WITH RESPONSIBILITY

While some of FHA's losses are attributable to specific shortcomings in particular procedures or processes, in a broader sense not holding responsible managers or personnel accountable for their actions provides a better explanation of how FHA's problems took place. It is difficult to hold anyone accountable in the organization when financial information is not available to do so. At present, managers do not know which programs are self sustaining and which are not because there are no program level financial statements or other reporting mechanisms that routinely produce information about program financial results and effectiveness. Decisions affecting staffing and administrative support for FHA operations are apparently made without regard to their financial impact on the FHA fund. And finally, financial systems which are presumably the basis for measuring how well FHA activities are carried out, have not adequately considered the needs of the managers who operate the FHA programs and who are accountable for them.

Financial statements and other financial information are periodically produced only for each of FHA's four major activities (i.e., the MMI, GI, SRI and CMHI Funds). However, HUD cannot accurately and promptly determine financial results on a program-by-program or region-by-region basis, and thus there is a lack of information about program and region effectiveness. The significance of this is that losses can only be attributed to major activities and cannot be pinpointed with any degree of precision to a particular program or region. The four major activities encompass some 40 active mortgage insurance programs, each with its own unique purpose and each with unique financial attributes as well. It may be that some of these programs are or should be financially sound while others should not, but the absence of sufficiently detailed financial information prevents making this determination. This lack of accountability also prevents identifying the causes for losses and, therefore, it cannot be determined whether excessive losses are caused by external conditions or simply by mismanagement.

The manner in which staffing and administrative decisions relative to the operation of FHA are made provides another example of a split between responsibility and accountability. Salary and administrative expenditures incurred to operate the FHA programs are administered through a separate, appropriated fund, and management of this fund rests with a group separate from that which operates FHA. In many respects, the salary and expense fund is operated like an entity all its own rather than as a support function for the operation of the various HUD programs. There are indications of decisions being made to reduce salary and administrative expense that may have caused problems in the FHA Fund. For example, some of the regions have indicated that pressures to make staffing cuts, which may have provided salary expense savings on the one hand, may have also reduced the number of staff available to perform oversight and monitoring functions on the other. Similarly, restrictions on travel funds to produce small savings, may have prevented regional personnel from taking trips needed to conduct a sufficient number of property inspections. Decisions like this which lead to small savings in one fund but which may cause substantial losses in another, in our view, constitute a fundamental flaw in the management of the agency. In effect, the salary and administrative function has the responsibility to provide staff support and resources to operate FHA properly, but is not accountable for losses that would result in another fund from inadequate staff support or from providing insufficient resources.

There are instances where accounting systems have been developed which do not adequately address the needs of program managers. In some instances two systems with overlapping functions were implemented -- one for the group administering the program and another for the group performing finance and accounting functions. Furthermore, systems used by program managers are often case-based. That is, they contain information about the **number** of defaults or the **number** of properties on hand but little or no information on the dollar value of those cases. Some accounting systems that are used to report financial information and prepare financial statements, are not also used for program accountability. For example, systems with financial and accounting information on single family mortgages held by FHA and on property owned by FHA are not always used by program managers because their information needs were not appropriately addressed. Rather than integrate the accounting and programmatic needs, separate duplicate systems were implemented. To provide for proper accountability, factionalism that causes systems to be less than fully useful or which leads to the development of redundant systems must be eliminated. Individuals responsible for program accountability must be an integral part of financial and accounting systems development efforts because those systems are, after all, intended to provide a measure of program effectiveness.

The situations just discussed provide examples of how divisions between those responsible for program success and those responsible for financial reporting ultimately lead to inadequate accountability, or worse, mismanagement. Without any real steps to address and correct organizational issues that may have created these problems, they cannot finally be resolved. Moreover, without some consideration of changes in the way FHA is fundamentally managed, accountability problems could again occur. We therefore suggest that the Secretary initiate a thorough study of HUD's organization, and of its present and future information needs with the objective of determining how the agency can best be run to efficiently and effectively fulfill its mission.

SOME GENERAL INSURANCE PROGRAMS ARE STRUCTURALLY FLAWED

FHA's multifamily coinsurance programs and its hospital mortgage insurance programs recorded significant loss provisions during 1988 of $960 million and $275 million, respectively. These losses related, at least in part, to flaws in way the programs were structured and administered. In the case of the multifamily coinsurance programs, the flaws related to insufficient levels of capital required of coinsuring lenders, to other deficiencies in quantitative controls designed to reduce portfolio risk, and to inadequate qualitative controls notably involving ongoing monitoring of coinsuring lenders. The hospital mortgage insurance flaws pertain to a division of responsibility between the department performing underwriting functions, the Department of Health and Human Services (HHS), and the department which bears insurance losses resulting from poor underwriting, HUD. The multifamily coinsurance and hospital mortgage insurance programs are operated through FHA's General Insurance (GI) Fund, a fund which, as of September 30, 1988, had negative equity of some $3.1 billion.

Under the multifamily coinsurance programs, various loan functions are delegated to eligible lenders including underwriting, servicing, management and property disposition functions. The lenders then "coinsure" approximately 20% of the mortgage amount thereby assuming responsibility for a portion of any insurance losses resulting from defaulted mortgages. Because so many of HUD's functions are delegated for these programs, there is a particular need for proper quantitative controls, in the form of sound capital and leverage requirements, and effective qualitative controls, involving sufficient monitoring of program participants. Both GAO and OMB recognize the need for these types of controls. GAO's standards define internal controls as "...methods and procedures adopted by management to ensure..that resources are safeguarded against fraud, waste, and misuse..." Similarly, OMB requires the establishment of an appropriate level of "financial and other management controls." In applying these standards to the coinsurance programs, we believe they necessitate that: (1) capital requirements be established at such a level that coinsuring lenders will be induced to make sound loans; (2) criteria be established that will deter the concentration of loans (and thus risk) among too few lenders; and (3) that delegated responsibilities be continually and thoroughly monitored. The importance of these controls becomes apparent when bearing in mind that if coinsurers mismanage their 20% risk, that means they have mismanaged HUD's 80% risk as well.

During 1988, the combination of insufficient capital requirements, concentration of risk among a few large coinsuring lenders and the lack of an effective monitoring function led to loss levels that neither present lender capital requirements nor any other as yet imagined capital requirement would have been sufficient to cover, much less protect FHA from excessive losses. Furthermore, other quantitative controls that might have mitigated the losses were also missing. For example, there might have existed an overriding leverage limitation which would have begun to curtail the incentive for volume inherent in FHA's liberal capital accumulation formula, and which probably would have limited the concentration among a few large lenders. But because no such control existed, FHA suffered severe losses when a large coinsuring lender with a disproportionate share of the programs' coinsured mortgages defaulted. Without a reasonable leverage limitation or a large enough capital requirement, the temptation to expand an increasingly lucrative revenue stream in relation to capital-at-risk can be expected to become overwhelming. If there is also an absence of adequate surveillance and monitoring (as we found to be the case), the temptation to grow, without regard to the quality of that growth is unbounded. Such circumstances constitute a fundamental program flaw, the responsibility for which cannot be delegated, nor can it be blamed entirely on the existence of fraud.

FHA's hospital insurance program contains flaws of an organizational nature. Insurance in this program is not initiated by HUD. Instead, hospitals apply to HHS for mortgage insurance, who effectively make decisions about which mortgages should be insured, and HUD later provides that insurance. HHS is responsible for reviewing the underwriting of these loans, and is also primarily responsible for subsequent loan monitoring. Despite the fact that HHS determines which loans should be insured, it is HUD that has the risk of default, pays insurance claims and bears any losses. After claims are paid, HUD assumes added responsibility to perform loan servicing functions for defaulted hospital mortgages, since they are typically assigned to HUD rather than being foreclosed upon. The division of the underwriting and insuring activities effectively cuts the link between responsibility, which presumably belongs to HHS because of its involvement with the underwriting, and accountability which belongs to HUD because it reports resultant losses.

We understand that HUD has assessed capital deficiencies and shortcomings in monitoring for its multifamily coinsurance programs and will shortly be making program revisions to address these issues. These changes, if properly administered, should go a long way toward resolving the programs' structural flaws and we encourage their quick implementation. With respect to hospital mortgage insurance, we believe a decision must be made about which organization, HHS or HUD, should assume <u>full</u> responsibility. Once this decision is made, all mortgage insurance functions should be shifted to the responsible agency and staff necessary to conduct both insurance and finance functions should be hired and trained.

Report on Internal Controls
Page 9

CASH AND PROPERTY MANAGEMENT IS WEAK AND MUST BE IMPROVED

Apart from directly monitoring those individuals to whom property management and sales functions have been delegated, HUD's own internal property and cash management systems and procedures are weak and require improvement. HUD has not done enough, through the use of its own systems, to ensure that proceeds collected by third parties are promptly deposited in FHA's Treasury account, nor does HUD have enough information to allow for proper accountability over the management, maintenance and sale of foreclosed single-family properties. There are widely varying amounts, depending upon which system or set of records is used, on the number of properties FHA owns at any given time with the result that managers do not know, with precision, how much property they are responsible for or how much that property is really worth.

HUD has followed the policy of accepting sales packages and of recording sales before sales proceeds are actually deposited in its Treasury account. Follow-up of case-by-case situations where sales have been processed but where no cash has been received has been inconsistent across regions. Indeed, reports of sales for which proceeds have not yet been located contain over 8,000 cases, some dating back to 1983. One region, in particular, was so deficient in this regard that a private closing agent was allegedly able to embezzle a sizable amount of sale proceeds without prompt detection. This shortcoming provides a partial explanation of why embezzlements of the magnitude seen can take place yet not be detected for a long period of time. The reason this is only a partial explanation is that there are other controls HUD might have used, as fundamental as reconciling a monthly bank statement, which also would have detected missing cash. For example, if one were to note that a wire transfer or other promised deposits never in fact made it into their bank account, they would presumably seek an explanation and look for the missing funds. HUD has the ability to perform a similar reconciliation each month, albeit on a much larger scale, yet it has not consistently done so. And differences of as much as $6.2 million have remained unreconciled and unexplained.

Shortcomings in the cash management and control process are further hampered by weaknesses in the automated systems used to manage and account for FHA-owned foreclosed properties. Two separate systems are currently used to do so, one by the office of housing and another by the office of finance and administration. Apart from the complexities and redundancy introduced by using two systems to perform similar functions, the system used by the office of housing, the group really responsible for property management and sales contains little or no dollar information (i.e., it has information only on the number of properties). Property transactions do not become dollarized until they pass to the finance part of HUD. Furthermore, the two systems routinely show large differences in the number of properties FHA owns at any given time, and only recently have attempts been made to try to explain these differences. Collectively the problems with the property systems cause uncertainties about the number and dollar value of the properties FHA actually owns, leave questions about how property can be properly managed and sold with no information about its true value, and further exacerbates the cash management problems should properties not picked up by either system be sold without HUD's knowledge.

The cash management problems resulted, in our view, from a lack of appreciation for the need to closely control cash transactions, particularly those that have been delegated. Insufficient management emphasis on the need to perform very basic Treasury reconciliation functions thoroughly and timely was also a contributing factor. However proper control was also constrained by a split between responsibility for cash and property management functions and accountability over them. Moreover, the use of case level information by those primarily responsible for property management, and then later dollarizing property transactions when another group needed to report property transactions constitutes an unjustifiable split between those responsible for property management and sales and those whose job it is to report this information.

We understand that HUD is now implementing a new automated system which will eliminate the two redundant property systems and which will facilitate better cash control and more timely reconciliation to Treasury information. However, this new system will not be fully operational for several more months, and we believe that HUD must take some near term action to address the problems that still exist in cash and property management. Therefore, until the new system is fully operational we suggest that the Secretary direct FHA management to: (1) Perform a complete physical inventory, perhaps on a region by region basis, of FHA-owned single family properties. This will allow HUD to identify properties which should be in its inventory but are not, and will also facilitate the identification of properties which may have been sold without HUD's knowledge. Furthermore, obtaining an accurate property inventory is essential to ensuring that the new system will contain accurate property information; (2) Prepare a report on a quarterly basis of property held in inventory for longer than one year. The regional offices should then research each case to determine if the identified property has really been sold but not reported as such to HUD or, absent that, they should identify the problems causing the identified properties to remain in inventory for an excessively long period of time; and (3) Require headquarters management to prepare a monthly summary of properties sold for which no proceeds have been received, together with a summary actions being taken to recoup missing cash.

CONTROLS OVER MULTIFAMILY INSURANCE CLAIM PAYMENTS ARE INADEQUATE AND INEFFICIENT

Our review of the HUD's multifamily claim payments process indicated that multifamily claims for insurance benefits are not being paid in a timely manner and that the existing claim review and examination process is inadequate in detecting misrepresentations by mortgagees/lenders. Both GAO and OMB require that internal controls provide reasonable assurance that government resources are protected from fraud, waste and mismanagement.

With respect to payment delays there is a significant backlog of claims cases awaiting final settlement and payment. These are cases where the mortgagee has complied with all HUD filing requirements and for which legal clearance has been received from the Office of General Counsel but which have simply not been paid because of delays in final processing. Since the delays in processing are due to reasons not controllable by mortgagees, HUD has to pay interest on the claim. We have estimated that HUD has incurred additional interest costs ranging from $6 to $10 million as a result of these delays.

The inadequacies in claim review process pertain to the fact that HUD does not verify all fiscal data provided by mortgagees with the claim submission. For example, we noted an instance where a mortgagee failed to disclose information about a special escrow account when submitting the claim for insurance benefits. As a result, the claims examiners failed to reduce the claim amount by the remaining balance in this escrow account and the claim was eventually overpaid by some $2.8 million.

Delays in processing claims were caused by insufficient staffing levels, which were not quickly addressed and which caused the backlog of cases awaiting settlement to build to unacceptable levels. Shortcomings in the claims examination process were caused by a lack of diligence in verifying all submitted information. In the interest of saving time, some claim examiners did not verify all claim financial data to supporting documents submitted by mortgagees.

Some steps have been taken to address the staff shortages that caused the claim backlog. HUD is seeking to hire ten additional accountants to augment the claim payment staff and there have been organizational realignments to ensure better supervisory control over the process. In addition outside help is being sought to bolster the claims examination function. However, over the longer term, this problem can only be eliminated with improved financial information at the individual program level which would indicate (1) impending defaults which may require allocating more resources to the claim examination and payment functions, (2) excessive interest cost being incurred, and (3) unusual increases in claims costs relative to insurance in force.

Report on Internal Controls
Page 12

ROUTINE ACCOUNTING FUNCTIONS ARE NOT BEING PERFORMED

Any operation the size of FHA has a number of routine accounting functions that must be continually performed to ensure that financial statements and other financial reports are accurately produced. Routine accounting functions include very basic procedures -- reconciling accounts to supporting records, diligent record keeping, controlling funds held on behalf of others, and making sure transactions are properly recorded -- to name just a few. The need to perform these procedures would appear obvious and further, GAO's policy and procedures manual specifically requires that they be performed. However, HUD staff who perform FHA accounting functions have been deficient in performing many of these functions, and our audit identified nearly 100 adjustments that were necessary to correct resultant errors. More specifically, we noted that:

-- Documentation supporting several account balances was missing or incomplete. Among the many unsupported balances, for example, there was inadequate support for $10.8 million of interest payable balances and for $1.1 million of accounts payable to the public.

-- Reconciliations of general ledger balances to supporting records were not performed timely, and in some cases not at all. Virtually every account in the financial statements had transactions that were neither reconciled nor explained.

-- There was very poor accountability of distributive share payments. Payments were made without proper support or justification. In some cases payments were made with no evidence that the individuals receiving them had, in fact, insured their mortgages through FHA.

-- Forbearance agreements, agreements which restructure the terms of defaulted mortgages in the interest of providing some sort of work out, were not properly recorded in the loan system, thus misreporting mortgagor account balances.

-- Escrow accounts maintained by HUD to fund repairs on properties financed by HUD mortgages were not properly accounted for. Account balances shown by the banks holding the funds, recorded in the FHA's records, and reported to mortgagors on the yearly statement all differed without explanation.

It is unclear why these functions have not been performed. There was not enough emphasis placed on properly performing them in prior years, and now errors emanating from the past, and old, unexplained transactions have built

Report on Internal Controls
Page 13

up and will be difficult to correct. There was a similar lack of emphasis, in our view, on financial and accounting matters and on financial statements in general, and it is for this reason that we believe problems in performing very basic and fundamental accounting functions have persisted.

Normally shortcomings in some accounting functions would not necessarily cause significant problems, but because these shortcomings were so pervasive in FHA's case, they could cause material misstatements in financial reports. Moreover, in certain cases significant adjustments had to be made to reflect a more accurate situation. Performance of these procedures should be a continuous process, and attention to them should not just be devoted in anticipation of a financial audit.

To correct these problems, responsibilities for performing accounting functions must be firmly established. Supervisory reviews should then be initiated to ensure accounting functions are properly performed and on a timely basis. Year-end closing procedures should be enhanced to include developing specific requirements for the year end close out, with a subsequent supervisory review of the closing process to ensure all closing procedures have been properly carried out. All this should be done before financial reports are released to other Federal Agencies or to the public.

* * * * *

Our consideration of the internal control structure would not necessarily disclose all matters in the structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above.

We also noted other matters involving the internal control structure and its operation that we have reported to FHA's management in a separate letter.

This report is intended for the information of the Congress, the U.S. General Accounting Office and the management of the Department of Housing and Urban Development. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

Price Waterhouse

September 15, 1989

Auditors' Report on Compliance With Laws and Regulations

Office of Government Services
1801 K Street N W
Washington DC 20006

Telephone 202 296 0800

Price Waterhouse

To the Comptroller General
of the United States

and the Secretary
of Housing and Urban Development

We were engaged to audit the consolidated financial statements of the Federal Housing Administration (FHA), a fund of the Department of Housing and Urban Development (HUD), as of and for the year ended September 30, 1988, and have issued our report thereon dated September 15, 1989, except as to Note 14 to those financial statements, which is as of December 20, 1989.

Compliance with laws and regulations applicable to FHA is the responsibility of FHA's management. We performed tests of FHA's compliance with certain provisions of applicable laws and regulations. However, our objective was not to provide an opinion on overall compliance with such provisions.

Material instances of noncompliance are failures to follow requirements, or violations of prohibitions, contained in applicable laws and regulations that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the financial statements. While the following instance of noncompliance may not necessarily be material to the financial statements, it is, nevertheless, reported herein because it could significantly impact FHA's ability to effectively collect money it is owed.

FHA SHOULD PURSUE FULL IMPLEMENTATION OF THE DEBT COLLECTION ACT

During fiscal year 1988, FHA did not achieve full implementation of the Debt Collection Act of 1982 (Public Law 97-365) with respect to how it applies collection procedures to claims emanating from FHA-insured mortgage defaults. When FHA-insured mortgages default, claim payments are made for the unpaid principal balance plus any costs (principally unpaid interest) incurred by the insured mortgagee between the time of default and foreclosure. In most cases, the claim payment made by FHA exceeds the amount recovered when the foreclosed property is subsequently sold. However, the shortfall between claim payment and the amount ultimately recovered is not recorded in the accounting records as a claim of the U.S. Government, and thus very few collection efforts are made against mortgagors.

Report on Compliance with Laws and Regulations
Page 2

The Debt Collection Act requires that the head of an executive or legislative agency "shall try to collect a claim of the United States Government for money or property arising out of the activities of, or referred to, the agency." Claims are defined by the Act as including "amounts owing on account of loans insured or guaranteed by the government and other amounts due the government" (emphasis added). The Act further stipulates the types of collection procedures that should be applied to such claims including, among other things, administrative offset (such as against IRS refunds), assessing interest and penalties on delinquent amounts, and the use of collection agencies.

It has been HUD's general practice to effectively forgive the debt by not taking collection action after the foreclosed property is acquired. For example, HUD has not required mortgagees to obtain deficiency judgments in all cases, nor has HUD pursued such judgments on its own. We have been informed that HUD has initiated a new policy of pursuing deficiency judgments in certain circumstances, and where they are allowed to do so by applicable state law. To fully implement the Debt Collection Act, HUD should record the debts as claims in appropriate claims files and document any subsequent decisions to terminate collection action and forgive the debts. Where deficiency judgments have been obtained, the claims should be established as receivables in FHA's accounting records and the collection actions authorized by the Act should be taken. This may entail developing systemic means of accounting for numerous claims, but we encourage HUD to do so. Other agencies, most notably the Department of Veterans Affairs, have done so and have collected some portion of the claim, however small the amount. By not fully documenting the debts owed to it and the reasons for taking or not taking collection actions, and by not establishing receivables when deficiency judgments are obtained, FHA may be missing opportunities to take more effective collection action.

Therefore, we suggest that FHA develop a systemic means of documenting when collection actions are not being taken, of recording deficiency judgments as receivables, and of applying the collection provisions of the Act to such receivables.

* * * * *

The results of our tests indicate that, with respect to the items tested, FHA complied, in all material respects, with the provisions referred to in the second paragraph of this report. With respect to the items not tested, except as described below, nothing came to our attention that caused us to believe that FHA had not complied, in all material respects, with those provisions.

Report on Compliance with Laws and Regulations
Page 3

OTHER MATTERS UNDER INVESTIGATION

There are a number of investigations currently being conducted about alleged improprieties involving HUD's administration of FHA. These investigations could reveal other violations of laws and regulations, but to date, a final determination about such violations has not yet been made. The outcome of these investigations could have a material effect on FHA's financial statements, however HUD is not yet able to determine what the effect might be. Nor were we able to satisfy ourselves about the effect of the outcome of these investigations.

Price Waterhouse

September 15, 1989

Financial Statements

Consolidated Statement of Financial Position

SEPTEMBER 30, 1988 AND 1987
(Dollars in Thousands)

	September 30, 1988	September 30, 1987
ASSETS:		
Fund Balance with the U.S. Treasury	$ 113,108	$ 175,331
Investments in U.S. Government Securities Principally Non-marketable (Note 3)	6,208,004	6,651,427
Foreclosed Property Held for Sale, Net (Note 4)	1,696,364	1,432,116
Mortgage Notes Receivable, Net (Note 6)	2,913,127	2,808,597
Appropriations Receivable (Note 7)	587,813	400,586
Other Assets and Receivables	268,339	437,629
Total Assets	$ 11,786,755	$ 11,905,686
LIABILITIES AND GOVERNMENT EQUITY:		
Claims Payable	628,692	525,759
Loss Reserves (Note 8)	5,411,000	2,047,392
Unearned Premiums (Note 9)	3,994,668	3,983,749
Debentures Issued to Claimants (Note 10)	119,545	175,743
Accounts Payable, Accrued Expenses and Other Liabilities	351,472	302,775
Distributive Shares and Premium Refunds Payable	142,133	150,158
Borrowings from the U.S. Treasury (Note 11)	3,993,268	3,531,434
Total Liabilities	14,640,778	10,717,010
Government Equity (Deficiency) (Note 13):		
Mutual Funds Equity	1,806,811	3,375,571
Subsidized Funds Cumulative Losses	(9,941,681)	(7,117,649)
Appropriated Capital	5,280,847	4,930,754
Total Government Equity (Deficiency)	(2,854,023)	1,188,676
Commitments and Contingencies (Note 12)		
Total Liabilities and Government Equity	$ 11,786,755	$ 11,905,686

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

Consolidated Statement of Operations and Government Equity (Deficiency)

FOR THE YEAR ENDED SEPTEMBER 30, 1988
(Dollars in Thousands)

REVENUES:	
Premiums:	
Monthly Premiums	$ 431,196
Earned Portion of One–time and Annual Premiums	1,444,393
Net Premiums Earned	1,875,589
Interest Income	721,731
Other Revenues	67,194
Total Revenues	2,664,514
EXPENSES:	
Net Increase in Loss Reserves	3,363,608
Realized Losses on Sales of Properties	2,073,674
Provision for Losses on Properties Owned	271,806
Provision for Losses on Mortgage Notes Held	290,458
Salary and Administrative Expenses	455,213
Interest Expense	338,628
Other Expense	101,122
Total Expenses	6,894,509
Deficiency (Losses) of Revenues over Expenses	(4,229,995)
Government Equity, Beginning of Year	1,188,676
Appropriations	350,093
Distributive Shares Paid	(162,797)
Government (Deficiency), End of Year	$ (2,854,023)

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

Consolidated Statement of Cash Flows

FOR THE YEAR ENDED SEPTEMBER 30, 1988
(Dollars in Thousands)

Net Cash Flows from Operating Activities:	
Deficiency of Revenues over Expenses (Losses)	$ (4,229,995)
Non Cash Expenses, Revenues, Losses and Gains	
Included in Operations:	
Realized Losses on Sales of Properties	2,073,674
Net Increase in Loss Reserves	3,363,608
Premiums Earned	(1,444,393)
Increase in Loss Allowances on Properties and Mortgages	562,264
Decrease in Other Assets	169,292
Increase in Claims Payable and Other Liabilities	143,605
Amortization of Discounts on Investments and Notes	3,941
Assets Acquired in Claims Settlement	(6,506,494)
Collections of Principal on Notes Acquired in Claims Settlement	217,800
Proceeds from Disposition of Assets Acquired in Claims Settlement	3,084,869
Premiums Collected	1,588,811
Premiums Refunded	(133,499)
Net Cash Used by Operations	(1,106,517)
Cash Flows from Investing Activities:	
Purchase of Investment Securities	(3,180,905)
Proceeds from Sales of Investment Securities	3,622,328
Issuance of Purchase Money Mortgages	(3,428)
Collections of Principal on Purchase Money Mortgages	104,643
Proceeds from Disposal of Purchase Money Mortgages	95,944
Net Cash Provided by Investing Activities	638,582
Cash Flows from Financing Activities:	
Appropriations Received	162,866
Borrowings from the U.S. Treasury	680,000
Issuance of Debentures to Claimants	48,877
Payment of Borrowings to the U.S. Treasury	(218,166)
Payment of Debentures	(105,068)
Distributive Shares Paid	(162,797)
Net Cash Provided by Financing Activities	405,712
Net Decrease in Cash	$ (62,223)

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

SEPTEMBER 30, 1988

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 home buyers and to provide affordable multifamily housing.

The FHA programs are organized into four major activities. (1) the Mutual Mortgage Insurance Fund (MMI), FHA's largest activity, provides basic (principally 30 year) single family mortgage insurance. It is a mutual insurance 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, provides mortgage insurance for management-type cooperatives authorized by Section 213 of the National Housing Act, as amended; (3) the General Insurance Fund (GI), 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), 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.

Note 1. Description of Entity and Significant Accounting Policies (continued):

A. Entity and Mission (continued):

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.

B. Basis of Accounting:

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

C. Fund Balance with the 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. For purposes of the Consolidated Statement of Cash Flows, FHA's funds in the U.S. Treasury are considered cash.

D. Investments 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 daytrading 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 unamortized premiums or discounts. Premiums or discounts are amortized into interest income over the term of the investment. 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.

Note 1. Description of Entity and Significant Accounting Policies (continued):

E. Mortgage Notes Receivable:

Mortgage notes receivable consist of mortgage notes received in claims settlement and purchase money mortgages issued to buyers of FHA's foreclosed properties. Under certain conditions prescribed by regulation, FHA will take assignments of insured mortgages which are in default rather than acquire the properties through foreclosure. Single family mortgages can be assigned to FHA 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 single family claims do not result in the assignment of notes. Mortgagees holding defaulted multifamily mortgages may make mortgage insurance claims by assigning the mortgages to FHA, subject to a one percent reduction in the claim paid. 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 rarely issues purchase money mortgages to sell foreclosed property.

Both mortgage notes received in claims 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, an allowance for losses is recorded, 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 claims settlement are reported net of the allowance for loss and any unamortized discount.

F. Foreclosed Property Held for Sale:

Foreclosed property held for sale is 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. Loss Reserves:

Loss reserves, which comprise undiscounted claims loss reserves and loss adjustment expense reserves, are provided for estimated losses incurred by FHA to pay claims on insured mortgages when defaults have taken place, but where claims have not yet been filed.

Note 1. Description of Entity and Significant Accounting Policies (continued):

H. 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 actuary. 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. Premiums on annual installment policies are earned on a straight-line basis throughout the year. All other policies earn premiums on a monthly basis.

I. 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 services are rendered.

J. Distributive Shares:

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 and CMHI's financial positions 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 and unrelated entity.

Note 2. Intragovernmental Financial Activities (continued):

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.

During fiscal year 1988, FHA received directly the following interest subsidy, rental supplement and other assistance payments from HUD (dollars in thousands):

Single Family Notes – Interest Subsidy	$ 2,265
Multifamily Notes – Interest Subsidy	42,581
Rental Supplements for Low Income Individuals Occupying Multifamily Properties	794
Rental Supplements for Low and Very Low Income Families Living in Multifamily Properties	7,117
Payments for Acquired Homes Utilized for Urban Homesteading	11,344
Total	$ 64,101

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 multifamily property financed through FHA-insured mortgages is not presently determinable. Amounts receivable from HUD as of September 30, 1987 and 1988 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 the 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.

Allocated personnel costs for which FHA reimburses HUD include matching contributions to the Civil Service Retirement System (CSRS) and the Federal Employees Retirement Systems (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 benefits or of the unfunded pension liability, since these amounts are reported in total by the Office of Personnel Management.

Note 2. Intragovernmental Financial Activities (continued):

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 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). Insurance in force outstanding for individuals employed by these Federal entities was approximately $754 million as of September 30, 1988 and approximately $849 million as of September 30, 1987.

Note 3. Investments in U.S. Government Securities:

Investments in U.S. Government securities as of September 30, 1988 were as follows (dollars in thousands):

Maturity	Description	Amortized Cost	Market Value
Less than One Year	Treasury Bills and Notes	$ 820,037	$ 812,892
One to Five Years	Treasury Notes and Bonds	1,925,663	1,978,237
Five to Ten Years	Treasury Notes and Bonds	1,756,882	1,701,694
Ten to Fifteen Years	Treasury Bonds	783,991	751,730
Over Fifteen Years	Treasury Bonds	921,431	893,041
Total Investments		$ 6,208,004	$ 6,137,594

As of September 30, 1987, investments in U.S. Government securities were 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 3. Investments in U.S. Government Securities (continued):

During 1988 FHA's MMI Fund redeemed, before maturity, investments with a carrying value of $642.6 million and recorded a gain of $12.2 million. It is FHA's normal policy to hold investments to maturity unless otherwise needed to sustain operations. If investments owned as of September 30, 1988 had been held as of September 15, 1989, their market value would have been approximately $6.3 billion.

Note 4. Foreclosed Property Held for Sale:

Foreclosed property held for sale is obtained in claims settlement and was composed of the following classes of property at September 30, 1988 and 1987 (dollars in thousands):

Description	1988	1987
Single Family Homes	$ 2,870,401	$ 2,337,033
Multifamily Properties	195,328	192,642
Total Property	3,065,729	2,529,675
Allowance for Losses	(1,369,365)	(1,097,559)
Property, Net	$ 1,696,364	$ 1,432,116

The allowance for losses is recorded to reduce the property carrying value to the amount FHA expects to receive in cash when properties are sold. The allowance is necessary because historically FHA has not recovered the full value of its foreclosed property.

Note 5. Proposed Loan Sales:

During fiscal year 1988 and 1987, HUD attempted to sell certain multifamily loans that were held by FHA as of September 30, 1988 and 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 protection available to insured projects.

Note 5. Proposed Loan Sales (continued):

HUD had been attempting to sell 140 of these loans with a carrying value of approximately $255 million, but was unable to structure their sale without recourse provisions.

In a separate transaction during 1988, HUD sold, without recourse, $100.6 million of multifamily notes for $69.8 million. Also, under an option which offered discounts to single family mortgagors who prepaid their loans, FHA received $15.8 million on $17.8 million of single family mortgage notes.

Note 6. Purchase Money Mortgages and Mortgage Notes Assigned to FHA:

Most of the mortgage notes held were assigned to FHA when mortgagors defaulted (i.e. mortgage notes assigned, MNAs). FHA does not normally provide financing (through purchase money mortgages, PMMs) to sell foreclosed property. FHA takes assignment of single family notes when defaults result from temporary hardship conditions. Defaulted multifamily notes may be assigned to FHA without such restrictions, subject only to a one percent reduction of the claim amount. Many of the notes assigned to FHA are at interest rates below prevailing market rates at the time of assumption, hence, discounts are recorded. As discussed below, many others are either in default or are no longer generating interest income, and an allowance for losses is recorded on these notes.

PMMs and MNAs comprise the following at September 30, 1988 and 1987 (dollars in thousands):

Description	PMM	MNA	1988 Total	1987 Total
Single Family	$ 123,816	$ 1,411,004	$ 1,534,820	$ 1,454,746
Multifamily	145,494	2,648,549	2,794,043	2,531,233
Mobile Homes and Improvements (Title I)	0	290,745	290,745	267,689
	269,310	4,350,298	4,619,608	4,253,668
Unearned Discounts	(41,797)	(296,511)	(338,308)	(344,000)
Allowances for Losses	(37,780)	(1,330,393)	(1,368,173)	(1,101,071)
Mortgages, Net	$ 189,733	$ 2,723,394	$ 2,913,127	$ 2,808,597

Interest income for the year ended September 30, 1988 was $12.2 million on PMMs and $150.1 million on MNAs.

Note 6. Purchase Money Mortgages and Mortgage Notes Assigned to FHA (continued):

Mortgages on which the accrual of interest has been discontinued or reduced, are estimated to be approximately $96 million for PMMs and $2.62 billion for MNAs at September 30, 1988, and $189 million for PMMs and $2.44 billion for MNAs at September 30, 1987. If interest on those mortgages and notes had been accrued for the year ended September 30, 1988, that interest income would have approximated $10.7 million on PMMs and $198.2 million on MNAs.

Mortgages which are considered current but which are under forbearance agreements comprise approximately $10.4 million of PMMs and $754 million of MNAs.

Changes in the allowance for losses and unearned discounts on PMMs and MNAs for the year ended September 30, 1988, were (dollars in thousands):

	PMM	MNA	Total
Balance, Beginning of Year	$ 141,225	$ 1,303,846	$ 1,445,071
Change in Allowance Charged to Operations	(61,648)	352,106	290,458
Notes Written Off	0	(29,048)	(29,048)
Balance, End of Year	$ 79,577	$ 1,626,904	$ 1,706,481

Note 7. Appropriations Receivable:

Appropriations receivable at September 30, 1988 comprise the following (dollars in thousands):

	GI	SRI	1988 Total
Relating to:			
Losses on Property Sales in Fiscal Year 1987 to Be Received in Fiscal Year 1989	$ 161,133	$ 76,587	$ 237,720
Losses on Property Sales in Fiscal Year 1988 to Be Received in Fiscal Year 1990	257,128	92,965	350,093
Total	$ 418,261	$ 169,552	$ 587,813

The fiscal year 1989 appropriation (relating to certain 1987 losses) has been approved pursuant to P.L. 100-404. As of September 15, 1989 the fiscal year 1990 appropriation (relating to certain 1988 losses) had been reported on favorably by both the Senate and House Committees on Appropriations. Appropriations receivable were $400.6 million at September 30, 1987.

Note 8. Loss Reserves:

Loss reserves, which comprise undiscounted claims loss reserves and loss adjustment expense (LAE) reserves, were as follows as of September 30, 1988 and 1987 (dollars in thousands):

Fund	Claims Loss Reserve	LAE Reserve	1988 Total	1987 Total
MMI	$ 2,557,000	$ 107,000	$ 2,664,000	$ 1,417,489
CMHI	0	0	0	0
GI	2,537,000	73,000	2,610,000	557,217
SRI	125,000	12,000	137,000	72,686
Total	$ 5,219,000	$ 192,000	$ 5,411,000	$ 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 LAE reserve is provided for estimated administrative expenses of settling filed claims and reported defaults.

Loss reserves in the GI Fund were increased significantly during 1988 because of defaults in the Fund's multifamily coinsurance programs and, to a lesser degree, because of potential defaults of FHA insured hospital mortgages. Under the multifamily coinsurance programs, eligible lenders/coinsurers perform underwriting, servicing, management, and property disposition functions and assume responsibility for a portion of any insurance loss (up to a maximum of approximately 20 percent of the loan). Substantially all FHA coinsured multifamily mortgages are sold through the issuance of mortgage-backed securities that are fully guaranteed by the Government National Mortgage Association (GNMA), a government corporation operated by HUD.

In September 1988, GNMA declared a major FHA lender/coinsurer in default of its obligations for GNMA securities backed by multifamily coinsured mortgages. Subsequent to September 1988, GNMA similarly declared two more large FHA lender/coinsurers in default. FHA's losses on these coinsurer defaults will be substantial and are exacerbated by the fact that the coinsurer defaults will cause FHA to assume full insurance responsibility and bear 100 percent of any insurance losses. A provision of approximately $960 million has been recorded for these and other reported defaults in the coinsurance programs. However, because of structural weaknesses in the basic multifamily coinsurance programs, it is possible that still more coinsurer defaults may occur and cause substantial additional losses.

Note 8. Loss Reserves (continued):

A provision of $275 million has been recorded for probable defaults of FHA-insured hospital mortgages, a program which is part of the GI Fund. Changes in external conditions which affect occupancy rates are partly responsible for delinquencies and defaults of these mortgages, and could cause additional defaults in the future. Even a limited number of defaults of these large mortgages could place a serious financial burden on the GI Fund, and could quickly render its premiums insufficient to cover insurance losses.

In any case, aggregate premiums generated by the GI Fund's various programs will not be sufficient to cover the Fund's losses, nor to sustain its operations. Furthermore, given uncertainties about the level of additional losses that may occur, particularly in the coinsurance and hospital mortgage insurance programs, it is not currently possible to estimate how much the premium deficiency will be.

The severity of the GI Fund's losses and the insufficiency of its premiums leaves the Fund dependent on the U.S. Treasury to sustain its operations. The GI Fund will not, in the foreseeable future, be able to repay Treasury without the infusion of appropriated funds.

Activity under all of the SRI Fund's major categories has decreased substantially in recent years. The majority of the SRI Fund's losses have already occurred and are reflected in the Fund's equity balance. In addition, HUD's actuary now believes that the SRI Fund's future income will exceed its future expenses.

Note 9. Unearned Premiums:

The following shows the activity in unearned premiums during 1988 (dollars in thousands):

	MMI	CMHI	GI	SRI	Total
Balance, Beginning of Year	$ 3,837,536	$ 1,544	$ 124,388	$ 20,281	$ 3,983,749
Premiums Collected	1,345,513	2,267	208,420	32,611	1,588,811
Premiums Earned	(1,171,870)	(2,671)	(232,967)	(36,885)	(1,444,393)
Premium Refunds	(133,496)	0	(3)	0	(133,499)
Balance, End of Year	$ 3,877,683	$ 1,140	$ 99,838	$ 16,007	$ 3,994,668

Note 10. 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 at 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 GI 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 12.75 percent. Interest paid during the year ended September 30, 1988 on debentures was $17.9 million.

Note 11. 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, 1988 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.

Outstanding borrowings from the U.S. Treasury at September 30, 1988 and 1987 were as follows (dollars in thousands):

	1988	1987
Borrowings from the U.S. Treasury; Interest Payable on June 30 and December 31; Interest Rates Ranging from 6.875% to 14.5%.		
Current Portion	$ 431,000	$ 218,166
Long-term Portion	3,562,268	3,313,268
Total	$ 3,993,268	$ 3,531,434

Projected principal payments for the next five fiscal years and thereafter are (dollars in thousands): $431,000 in 1989, $693,268 in 1990, $965,000 in 1991, $325,000 in 1992, $311,000 in 1993 and $1,268,000 thereafter. Interest paid during the year ended September 30, 1988 on borrowings was $300.3 million.

Note 12. **Commitments and Contingencies:**

Insurance in Force:

Total outstanding insurance in force was as follows at September 30, 1988 (dollars in thousands):

Fund	Single Family	Multifamily	Title I	1988 Total
MMI	$ 228,520,354	$ 0	$ 0	$ 228,520,354
CMHI	0	516,171	0	516,171
GI	16,989,908	37,949,395	7,000,000 *	61,939,303
SRI	6,505,732	5,930,505	0	12,436,237
Total	$ 252,015,994	$ 44,396,071	$ 7,000,000	$ 303,412,065

* – Actuary's estimate of Title I insurance in force.

Insurance written by Fund during 1988 was $41.3 billion for MMI, $7.3 billion for GI, and $75 million for SRI. The CMHI Fund had no insurance written during 1988.

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

Current 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 year following the 20th anniversary after final endorsement of the mortgage. The fiscal year in which outstanding mortgages under the Section 221(g)(4) program reach their 20th anniversary, and thus may become liabilities are presented below for the next five fiscal years and thereafter (dollars in thousands):

Fiscal Year	Projected Principal Balance – Year 20	Average Mortgage Interest Rate
1989	$ 142,873	7.19%
1990	185,477	8.08
1991	293,789	7.62
1992	307,099	7.00
1993	205,254	7.06
Thereafter	1,497,856	9.47
Total	$ 2,632,348	8.56%

Note 12. Commitments and Contingencies (continued):

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

The current Treasury-established debenture rate is 8.625 percent. 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 total potential cost to the GI Fund from the Section 221(g)(4) assignment option will be $678 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 Section 221(g)(4) program has not yet been recorded in the Consolidated Statement of Financial Position.

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 at September 30, 1988.

Note 13. 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 are allocated to these two accounts based on actuarially determined operating requirements of the Funds. Cumulative losses of the GI and SRI Funds are partially offset by capital appropriated to these two Funds by Congress.

Note 13. Government Equity (continued):

Following is the composition of government equity for each of FHA's Funds as of September 30, 1988 (dollars in thousands):

	MMI	CMHI	GI	SRI	1988 Total
General (Deficiency) Surplus	$ (378,091)	$ 15,958	$ 0	$ 0	$ (362,133)
Participating Reserve	2,166,970	1,974	0	0	2,168,944
Cumulative Results of Operations	0	0	(6,355,047)	(3,586,634)	(9,941,681)
Appropriated Capital	18,809	0	3,244,391	2,017,647	5,280,847
Equity (Deficiency)	$ 1,807,688	$ 17,932	$ (3,110,656)	$ (1,568,987)	$ (2,854,023)

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	1987 Total
General Surplus	$ 1,030,506	$ 16,734	$ 0	$ 0	$ 1,047,240
Participating Reserve	2,326,490	1,841	0	0	2,328,331
Cumulative Results of Operations	0	0	(3,784,187)	(3,333,462)	(7,117,649)
Appropriated Capital	18,809	0	2,987,263	1,924,682	4,930,754
Equity (Deficiency)	$ 3,375,805	$ 18,575	$ (796,924)	$ (1,408,780)	$ 1,188,676

Cumulative results of operations (losses) 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, under generally accepted accounting principles, losses are recognized upon the default of insured mortgages while for budgetary purposes, related appropriated capital cannot be requested or received until assets acquired in claims settlement 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 14. Subsequent Event:

In December 1989, GNMA declared another FHA coinsurance lender in default of its obligations for GNMA securities backed by multifamily coinsured mortgages. This defaulted coinsurance lender had FHA-insured mortgages aggregating approximately $95 million. FHA will ultimately bear substantially all losses resulting from this default; but the amount of these losses has not yet been determined.

Consolidating Statement of Financial Position

SEPTEMBER 30, 1988
(Dollars in Thousands)

	MMI	CMHI	GI	SRI	CONSOL-IDATED
ASSETS:					
Fund Balance with the U.S. Treasury	$ 32,905	$ 1,398	$ 65,931	$ 12,874	$ 113,108
Investments in U.S. Government Securities					
Principally Non-marketable	6,193,987	14,017	0	0	6,208,004
Foreclosed Property Held for Sale, Net	1,489,080	0	173,786	33,498	1,696,364
Mortgage Notes Receivable, Net	1,037,511	4,193	1,429,530	441,893	2,913,127
Appropriations Receivable	0	0	418,261	169,552	587,813
Other Assets and Receivables	185,349	1,226	81,744	20	268,339
Total Assets	$ 8,938,832	$ 20,834	$ 2,169,252	$ 657,837	$ 11,786,755
LIABILITIES AND GOVERNMENT EQUITY:					
Claims Payable	363,395	0	251,652	13,645	628,692
Loss Reserves	2,664,000	0	2,610,000	137,000	5,411,000
Unearned Premiums	3,877,683	1,140	99,838	16,007	3,994,668
Debentures Issued to Claimants	31	1,389	118,125	0	119,545
Accounts Payable, Accrued Expenses					
and Other Liabilities	83,915	360	164,025	103,172	351,472
Distributive Shares and Premium Refunds Payable	142,120	13	0	0	142,133
Borrowings from the U.S. Treasury	0	0	2,056,268	1,937,000	3,993,268
Elimination of Interfund Balances	0	0	(20,000)	20,000	0
Total Liabilities	7,131,144	2,902	5,279,908	2,226,824	14,640,778
Government Equity (Deficiency):					
Mutual Funds Equity	1,788,879	17,932	0	0	1,806,811
Subsidized Funds Cumulative Losses	0	0	(6,355,047)	(3,586,634)	(9,941,681)
Appropriated Capital	18,809	0	3,244,391	2,017,647	5,280,847
Total Government Equity (Deficiency)	1,807,688	17,932	(3,110,656)	(1,568,987)	(2,854,023)
Total Liabilities and Government Equity	$ 8,938,832	$ 20,834	$ 2,169,252	$ 657,837	$ 11,786,755

Consolidating Statement of Operations and Government Equity (Deficiency)

FOR THE YEAR ENDED SEPTEMBER 30, 1988
(Dollars in Thousands)

	MMI	CMHI	GI	SRI	CONSOL-IDATED
REVENUES:					
Premiums:					
Monthly Premiums	$ 316,643	$ 0	$ 76,005	$ 38,548	$ 431,196
Earned Portion of One-time and Annual Premiums	1,171,870	2,671	232,967	36,885	1,444,393
Net Premiums Earned	1,488,513	2,671	308,972	75,433	1,875,589
Interest Income	588,386	1,249	102,485	29,611	721,731
Other Revenues	17,871	0	43,555	5,768	67,194
Total Revenues	2,094,770	3,920	455,012	110,812	2,664,514
EXPENSES:					
Net Increase in Loss Reserves	1,246,511	0	2,052,783	64,314	3,363,608
Realized Losses on Sales of Properties	1,692,275	0	279,016	102,383	2,073,674
Provision for Losses on Properties Owned	230,969	0	33,489	7,348	271,806
Provision for Losses on Mortgage Notes Held	61,809	0	228,898	(249)	290,458
Salary and Administrative Expenses	228,763	1,077	203,005	22,368	455,213
Interest Expense	0	19	174,178	164,431	338,628
Other Expense	43,039	191	54,503	3,389	101,122
Total Expenses	3,503,366	1,287	3,025,872	363,984	6,894,509
Excess (Deficiency/Losses) of Revenues over Expenses	(1,408,596)	2,633	(2,570,860)	(253,172)	(4,229,995)
Government Equity (Deficiency), Beginning of Year	3,375,805	18,575	(796,924)	(1,408,780)	1,188,676
Appropriations	0	0	257,128	92,965	350,093
Distributive Shares Paid	(159,521)	(3,276)	0	0	(162,797)
Government Equity (Deficiency), End of Year	$ 1,807,688	$ 17,932	$ (3,110,656)	$ (1,568,987)	$ (2,854,023)

Consolidating Statement of Cash Flows

SEPTEMBER 30, 1988
(Dollars in Thousands)

	MMI	CMHI	GI	SRI	CONSOL-IDATED
Net Cash Flows from Operating Activities:					
Excess (Deficiency/Losses) of Revenues over Expenses	$ (1,408,596)	$ 2,633	$ (2,570,860)	$ (253,172)	$ (4,229,995)
Non Cash Expenses, Revenues, Losses and Gains					
Included in Operations:					
Realized Losses on Sales of Properties	1,692,275	0	279,016	102,383	2,073,674
Net Increase in Loss Reserves	1,246,511	0	2,052,783	64,314	3,363,608
Premiums Earned	(1,171,870)	(2,671)	(232,967)	(36,885)	(1,444,393)
Increase in Loss Allowances on					
Properties and Mortgages	292,778	0	262,387	7,099	562,264
Decrease in Other Assets	64,087	503	57,287	47,415	169,292
Increase in Claims Payable and Other Liabilities	8,580	64	114,931	20,030	143,605
Amortization of Discounts on Investments and Notes	11,477	82	(7,767)	149	3,941
Assets Acquired in Claims Settlement	(5,164,237)	0	(1,140,929)	(201,328)	(6,506,494)
Collections of Principal on Notes Acquired in Claims Settlement	70,114	413	81,351	65,922	217,800
Proceeds from Disposition of Assets Acquired					
in Claims Settlement	2,824,494	0	190,248	70,127	3,084,869
Premiums Collected	1,345,513	2,267	208,420	32,611	1,588,811
Premiums Refunded	(133,496)	0	(3)	0	(133,499)
Net Cash (Used) Provided by Operations	(322,370)	3,291	(706,103)	(81,335)	(1,106,517)
Cash Flows from Investing Activities:					
Purchase of Investment Securities	(3,156,585)	(24,320)	0	0	(3,180,905)
Proceeds from Sales of Investment Securities	3,569,630	23,308	29,390	0	3,622,328
Issuance of Purchase Money Mortgages	0	0	0	(3,428)	(3,428)
Collections of Principal on Purchase Money Mortgages	30,038	2	67,767	6,836	104,643
Proceeds from Disposal of Purchase Money Mortgages	0	0	95,944	0	95,944
Net Cash Provided (Used) by Investing Activities	443,083	(1,010)	193,101	3,408	638,582
Cash Flows from Financing Activities:					
Appropriations Received	0	0	113,540	49,326	162,866
Borrowings from the U.S. Treasury	0	0	460,000	220,000	680,000
Issuance of Debentures to Claimants	0	0	48,877	0	48,877
Payment of Borrowings to the U.S. Treasury	0	0	0	(218,166)	(218,166)
Payment of Debentures	0	0	(105,068)	0	(105,068)
Distributive Shares Paid	(159,522)	(3,275)	0	0	(162,797)
Net Cash (Used) Provided by Financing Activities	(159,522)	(3,275)	517,349	51,160	405,712
Net Increase (Decrease) in Cash	$ (38,809)	$ (994)	$ 4,347	$ (26,767)	$ (62,223)