United States General Accounting Office

GAO

Report to the Congress

October 1990

FINANCIAL AUDIT

Government National Mortgage Association's 1989 Financial Statements

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

Comptroller General
of the United States

B-114828

October 30, 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 Government National Mortgage Association's (GNMA) financial statements as of September 30, 1989. Reports on GNMA's internal control structure and on its compliance with laws and regulations are also provided.

The Mortgage-Backed Securities Program is GNMA's primary activity whereby GNMA guarantees securities issued by private mortgage institutions that are backed by pools of home mortgages. Mortgages in these pools are insured by the Federal Housing Administration (FHA) or the Farmer's Home Administration (FmHA), or guaranteed by the Department of Veterans Affairs (VA).

For fiscal year 1989, GNMA operations resulted in income of $54 million, a decrease from fiscal year 1988 income of $206 million. The cause of this decrease was the additional provision for estimated losses due to (1) increased use by VA of an option to limit its losses, (2) uninsured mortgages in the mortgage pools, (3) the failure of defaulted issuers to remit certain proceeds, and (4) unanticipated costs associated with increased levels of security issuer defaults.

The 1989 audit also disclosed two material internal control weaknesses which increase the risk of additional losses to GNMA. First, GNMA did not always coordinate with FHA and VA on the monitoring of issuers of GNMA mortgage-backed securities. FHA and VA insure or guarantee most of the mortgages. Second, some security issuers, primarily savings and loan institutions, have been allowed to continue in GNMA's Mortgage-Backed Securities Program, even though they have violated GNMA requirements by including goodwill in their net worth calculations without specific approval.

Background

GNMA is a wholly-owned government corporation within the Department of Housing and Urban Development (HUD). GNMA administers the Mortgage-Backed Securities Program which operates in the mortgage-financing market to provide secondary-market financing for most FHA, VA, and some FmHA home loans. GNMA guarantees timely payment of principal and interest on privately issued securities backed by pools of government insured (FHA and FmHA) or guaranteed (VA) mortgages. For an annual fee of up to 6 basis points (0.06 percent) of the outstanding loan amount, GNMA will guarantee to provide scheduled payments to security holders should the security issuers fail to do so. Security issuers are fully responsible for acquiring, originating, servicing, marketing, and administering the securities.

Opinion on Financial Statements

We are required to conduct an audit of GNMA at least once every 3 years under the provisions of 31 U.S.C. 9105. To fulfill our responsibility, we contracted with the independent certified public accounting firm of Price Waterhouse to conduct a financial audit of GNMA for the year ended September 30, 1989. We determined the scope of the audit work, monitored its progress at key points, reviewed the working papers of the certified public accountants, and performed other procedures as we deemed necessary. The 1989 audit was conducted in accordance with generally accepted government auditing standards. Our prior financial audit of GNMA was conducted for the year ended September 30, 1986 (GAO/AFMD-87-55). GNMA contracted with Price Waterhouse for financial audits of its 1987 and 1988 financial statements.

In our opinion, and consistent with the opinion of Price Waterhouse, the Government National Mortgage Association's financial statements present fairly its financial position as of September 30, 1989, and the results of its operations and its cash flows for the fiscal year then ended, in conformity with generally accepted accounting principles.

Material Internal Control Weaknesses Exist

Price Waterhouse's report on internal control structure, with which we concur, discloses two reportable conditions that are material weaknesses and could result in additional losses to GNMA. These weaknesses were considered during the audit and do not affect the opinion expressed on the fair presentation of GNMA's financial statements.

Lack of Coordination With FHA and VA

GNMA did not coordinate with FHA and VA in all instances in which it identified a security issuer who was not in compliance with essential terms of the Mortgage-Backed Securities Program, which allowed noncompliant issuers to remain in the program. Noncompliance includes instances where the issuer did not meet capital requirements, filed inaccurate reports, failed to obtain an annual audit, or experienced high delinquency rates. When issuers defaulted, FHA and VA bore the majority of losses, with GNMA absorbing the amounts not covered by insurance or guarantees.

In its 1988 report on internal controls, Price Waterhouse identified lack of coordination as a material weakness. HUD also reported it as a material weakness in its 1989 Federal Manager's Financial Integrity Act report. GNMA has targeted this problem for correction by December 1990. As a first step, it has formed a task force of GNMA, FHA, and VA representatives to facilitate better coordination and information sharing.

Exceptions to GNMA Capital Requirements

GNMA did not always take action when security issuers failed to meet GNMA's capital requirements. GNMA allowed some security issuers to continue in the Mortgage-Backed Securities Program even though they included goodwill in their net worth calculations without approval.

Since goodwill represents an intangible amount in excess of the assets of a business, it does not add strength to an issuer's capital base. Thus, GNMA guidelines prohibit issuers from including goodwill to meet the capital requirements of the Mortgage-Backed Securities Program without GNMA's written approval. In cases in which GNMA does allow issuers to include goodwill to meet their capital requirements, there is increased risk that GNMA will experience losses that capital requirements are intended to prevent.

This issue was also identified as a material weakness in the 1988 Price Waterhouse report on internal accounting controls. GNMA has targeted this problem for correction by December 1990. GNMA is currently working with the Office of Thrift Supervision and the Resolution Trust Corporation on approaches for dealing with GNMA security issuers who do not meet the new capital requirements of the Financial Institutions Reform, Recovery and Enforcement Act of 1989.

Compliance With Laws and Regulations

Price Waterhouse's report on compliance with laws and regulations, with which we concur, disclosed nothing to indicate that GNMA had not complied with applicable laws and regulations that could have a material effect on the financial statements.

Reserve for Losses

In fiscal year 1989, GNMA increased its reserve for losses on the Mortgage-Backed Securities Program to $629 million, from $506 million in fiscal year 1988. This loss reserve is established to cover probable losses that will result in future cash payments arising from defaults by issuers of GNMA securities.

Loss provisions are added to the reserve when defaults of security issuers become probable. Thus, if GNMA believes more security issuers will default, it increases its loss reserve. In most cases, GNMA places an issuer in default when the issuer fails to make timely principal and interest payments to security holders. If the mortgages held by the issuer to back the security are also in default, GNMA relies on FHA, or VA, as the insurer or guarantor to absorb the majority of any resulting losses. However, other costs and expenses associated with a security issuer default, not covered by federal insurance or guarantee, are borne by GNMA. Some of the reasons why the loss reserve has increased include the following:

- VA's use of its "no bid"[1] option to limit its losses on defaulted mortgages to a specified percentage. When VA determines that it is more cost beneficial to pay only the guaranteed portion of the mortgage, losses over and above the VA guarantee are paid by the GNMA security issuer, or by GNMA if the issuer is in default. There is a greater probability of losses to GNMA in economically distressed areas, where declining property values may induce VA to use its no-bid option more extensively. As of September 30, 1989, GNMA estimated that it would incur $151 million in losses due to VA no bids, based upon its overall exposure on VA loans.
- Mortgage pools of defaulted security issuers contain uninsured mortgages. Uninsured mortgages are included in the mortgage pools when issuers fail to remit insurance premiums, thus causing the mortgage insurance to lapse. Without insurance on the mortgages backing the GNMA securities, GNMA, rather than FHA or VA, becomes responsible for losses associated with the mortgage default. As of September 30, 1989, GNMA estimated that it would incur $47 million in losses from these uninsured loans.
- Defaulted issuers fail to remit proceeds from early mortgage payoffs or from claim settlements to security holders. Principal and interest payments on mortgages backing GNMA securities are supposed to be passed through to security holders. When they are not, the mortgage principal balance is less than the security principal balance. If an issuer is later placed in default, then GNMA becomes responsible for making up this shortfall when the security is liquidated. Losses for these shortfalls are included in a contingency pool for security issuer defaults.
- Unanticipated costs caused by security issuer defaults. When security issuers default and GNMA becomes responsible for servicing the security

[1]In cases of default, VA has the option to pay the full amount of a defaulted mortgage to the mortgage holder and acquire the property or to pay only the guaranteed portion of the mortgage value and leave the property with the holder. The latter action is referred to as the VA "no bid" option.

portfolio, a number of unreimbursable costs are incurred. These costs are largely due to administrative and legal expenses and, recently, to missing escrow funds that GNMA must make whole. GNMA and others have initiated investigations into these missing escrow funds and missing passthroughs of other proceeds to security holders. As of September 30, 1989, GNMA estimated that it would incur $278 million in losses due to these unanticipated costs.

GNMA's Mortgage-Backed Securities reserve is established to cover estimated losses resulting from the above situations, less the guarantee fees received. On a present value basis, GNMA has reserved $285 million for single-family mortgages and $51 million for multifamily mortgages as of September 30, 1989. These reserves, when added to the $293 million reserve established in prior years for mobile home losses, result in GNMA's total loss reserve of $629 million as of September 30, 1989.

The Potential for Greater Losses

In recent years, GNMA has significantly increased its Mortgage-Backed Securities loss reserve because a number of security issuers have been placed in default. While the majority of costs associated with issuer defaults result from defaulted mortgages and are thus reimbursed by FHA or VA, GNMA's most significant exposure to losses occurs when the number of issuers defaulting on their GNMA obligations increases.

First, VA's increasing use of its no-bid option can cause more issuer defaults. Losses not covered by VA as a result of exercising its guarantee limitation must be borne by the security issuers, thus reducing their capital. A reduced capital level, coupled with the need for more cash to make principal and interest payments to security holders, increases the probability that issuers will default on their security payments, thus increasing GNMA's losses.

Second, the number of defaults by single family issuers increases GNMA's risk. In June 1989, GNMA placed New York Guardian Mortgage Corporation in default. Guardian is a major single-family issuer with $6.9 billion in GNMA mortgage-backed securities. Ten other single-family security issuers were placed in default in fiscal year 1989, up from five in fiscal year 1988. As of September 30, 1989, GNMA had $10.3 billion in mortgage-backed securities outstanding that had been issued by defaulted single-family issuers. Because GNMA experiences a loss when issuers fail to make timely principal and interest payments to security holders, the prospect of increased failures of security issuers directly increases the risk of loss to GNMA.

Finally, the number of defaults of multifamily issuers also increases GNMA's risk. Structural and administrative flaws in the multifamily coinsurance program have led to the default of GNMA's two largest multifamily security issuers. In September 1988, GNMA placed in default DRG Funding, a major security issuer with $1.1 billion in GNMA securities backed by coinsured multifamily mortgages. It placed two additional multifamily issuers in default during fiscal year 1989. As of July 1990, GNMA had placed four more multifamily issuers in default, including its largest coinsurer, York Associates, Inc., with more than $2 billion in outstanding GNMA securities. These defaults prompted the Secretary of HUD, in January 1990, to cancel new issuer participation in the coinsurance program. As with single-family issuers, GNMA's risk of loss directly increases as multifamily security issuers fail to pay security holders.

GNMA's loss reserve is adequate at this time to cover the recent increase in issuer defaults. However, GNMA, like FHA and VA, is susceptible to greater losses in the event economic conditions worsen, causing more issuers to default.

Comments of Cognizant Officials

We provided a draft of this report to responsible Association officials for comment. They concurred with the contents and indicated their commitment to correct the problems noted.

During the course of its audit, Price Waterhouse also identified several matters which, although not material to the financial statements, are being communicated to GNMA separately.

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 Housing and Urban Development, the President of the Government National Mortgage Association, HUD's Assistant Secretary for Administration, and the Chairman of the Oversight Board of the Resolution Trust Corporation.

Donald H Chapin
for

Charles A. Bowsher
Comptroller General
of the United States

Contents

Abbreviations

FHA	Federal Housing Administration
FmHA	Farmer's Home Administration
GNMA	Government National Mortgage Association
HUD	Housing and Urban Development
VA	Department of Veterans Affairs

Auditors' Opinion

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

Telepnone 202 296 0800

Price Waterhouse

To the Comptroller General
of the United States

and the Executive Vice President,
Government National Mortgage Association:

We have audited the accompanying balance sheets of the Government National Mortgage Association (GNMA) as of September 30, 1989 and 1988, and the related statements of revenues and expenses and investment of the U.S. Government, and of cash flows for the fiscal years then ended. These financial statements are the responsibility of GNMA's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards and Government Auditing Standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Government National Mortgage Association at September 30, 1989 and 1988, and the results of its operations and its cash flows for the fiscal years then ended in conformity with generally accepted accounting principles.

GNMA has exposure to losses because of limitations to the guarantee provided by the Department of Veterans Affairs (VA), as discussed in Note E. VA, at its option, can limit its losses by not bidding on foreclosed property if the subsequent sale of the property will lead to losses greater than payment of the guaranteed portion of the mortgage. However, in the event an issuer of GNMA securities backed by VA-guaranteed loans goes into default, losses resulting from the limitations of the VA guarantee are borne by GNMA.

To the Comptroller General of the United States
and the Executive Vice President,
Government National Mortgage Association
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As a result of VA's policy, and because of other limitations to the default costs that GNMA can recover, loss reserves of $629.0 million in fiscal 1989 and $506.4 million in fiscal 1988 have been recorded in the financial statements. GNMA management believes that as of September 30, 1989, these reserves are sufficient to cover losses from probable defaults of issuers of GNMA securities.

Price Waterhouse

February 28, 1990

Auditors' Report on Internal Control Structure

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 Executive Vice President,
Government National Mortgage Association:

We have audited the financial statements of the Government National Mortgage Association (GNMA) as of and for the year ended September 30, 1989, and have issued our report thereon dated February 28, 1990. We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

GNMA's management 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 incurred 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 GNMA's internal control structure in the following categories:

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- o Treasury/Investments
- o Mortgage-Backed Securities Program
- o Subservicing of GNMA portfolios
- o Purchases/Disbursements

For all categories listed above, we obtained an understanding of the design of relevant policies and procedures which comprise the control structure, 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. Our study and evaluation disclosed the following conditions which we believe could result in material losses to GNMA and to the Department of Housing and Urban Development (HUD) as a whole.

GNMA SHOULD CONTINUE ITS EFFORT TO COORDINATE ISSUER MONITORING WITH FHA AND VA.

GNMA continues to experience significant losses in its Mortgage Backed Securities (MBS) program, primarily because of issuer defaults. The cost to HUD as a whole of defaults under this program is significant. In cases where an issuer is not in compliance with the significant terms of the MBS Guide, such as through failing the minimum net worth requirement, filing inaccurate reports, lack of audited financial statements, or through having high delinquency rates, GNMA should be able to take swift action to curb excessive losses that will result from that issuer's potential default.

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This issue was first raised in our internal control report for fiscal year 1988. HUD reported it as a material weakness in its 1989 report issued pursuant to the Federal Managers' Financial Integrity Act, and targeted December 1990 for its correction. Since initially reported, GNMA has made progress in more quickly identifying problem issuers, and in withholding commitments from issuers who have violated MBS program requirements.

However, there continue to be situations where disciplinary action could be better coordinated with the Federal Housing Administration (FHA) and the Department of Veterans Affairs (VA). Coordination among GNMA, FHA and VA is important, because withholding the GNMA commitment after FHA insurance or VA guarantees are endorsed might unduly expose FHA and VA to additional losses. Similarly, if FHA and VA continue to issue insurance and guarantees to issuers who have violated GNMA guidelines, then GNMA has increased exposure to loss. Therefore, disciplinary action must be a coordinated effort among all interested agencies. If GNMA identifies lender/issuers who have violated or are about to violate its program requirements, FHA and VA should be promptly informed so that they can determine if lenders should be disciplined before additional insurance or guarantees are allowed.

We understand that task forces, which include representatives from FHA, VA and GNMA, have been established to facilitate better coordination among these agencies. We encourage this cooperative effort and also recommend that GNMA continue its efforts to promptly inform FHA and VA when issuers fail to meet MBS guidelines, and then help coordinate sanctions and/or other disciplinary actions before new loans are insured or guaranteed by the subject issuers. In this regard, GNMA's issuer monitoring system provides information about potential violations of MBS guidelines that should be shared with and analyzed by FHA and VA, after which GNMA should request action to prevent further endorsement by an issuer who is not in compliance. Similarly, FHA information with regard to excessive defaults by individual issuers, and loans for which no premium has been received, should be shared with GNMA. Information exchanges such as those just mentioned should also be arranged with VA. Where VA and FHA do not act on a timely basis to discipline potential problem issuers in their programs, then GNMA should suspend further commitment to those issuers under its regulatory authority.

PROVIDE WRITTEN JUSTIFICATION FOR ALLOWING SAVINGS AND LOAN INSTITUTIONS TO CONTINUE ISSUING GNMA SECURITIES WHEN THEY ARE IN VIOLATION OF NET WORTH OR CAPITAL REQUIREMENTS.

We continue to note instances where certain Savings and Loan institutions were allowed to continue as issuers of GNMA securities despite being in technical violation of GNMA's net worth requirements. We understand that these

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institutions were allowed to continue because, after including goodwill in the net worth calculation, the institutions met GNMA requirements. However, GNMA guidelines specifically exclude goodwill from the net worth requirement. While we were informed that exceptions to the minimum net worth requirements were granted in these cases, there was no written evidence of this.

As with the capital standards for Savings and Loan institutions, GNMA's minimum net worth requirement is designed to protect GNMA from losses which occur when issuers default. In its simplest sense, capital or net worth is the total investment of a company in itself and can be measured by subtracting the liabilities of a company from its assets. At times this measure of capital is insufficient because certain assets do not fulfill capital's purpose of protecting against loss. For instance, goodwill, the amount paid in excess of the book value of an institution upon its purchase, does not provide any cover against losses. If issuers with capital or net worth that is insufficient to cover losses are allowed to continue in the MBS program, then GNMA may be exposing itself to additional loss.

It is possible that some of the Savings and Loan institutions which have violated GNMA net worth requirements, but which have been allowed to continue in the MBS program, might also have violated the new capital standards of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA). These institutions may be awaiting decisions by the Office of Thrift Supervision (OTS) that would allow them to continue operations, or resolution by the Resolution Trust Corporation (RTC). Where GNMA, to coordinate policy with the OTS and RTC, has been asked to waive net worth requirements, the reasons therefor should be properly documented in writing. In all cases involving a Savings and Loan Institution that is in technical violation of GNMA's net worth requirements, the OTS and/or RTC should be contacted to determine the current status of the institution (i.e., whether the institution is in violation of the new capital rules and is in either conservatorship or receivership) and to determine how GNMA's interests can best be protected.

With respect to Savings and Loan institutions currently under resolution, GNMA has begun to coordinate its actions with those of the RTC. We believe similar coordination of effort is necessary for those Savings and Loan institutions (which are GNMA security issuers) that are still operating but are awaiting decisions by the OTS, FDIC or RTC. It is particularly important to identify those institutions that have failed FIRREA capital requirements but have not yet been passed to the RTC for resolution. In both cases, we recommend that (1) any decisions made to allow Savings and Loan institutions to continue in the MBS program after they have violated GNMA net worth requirements, or FIRREA capital requirements, be coordinated with actions being taken or to be taken by the OTS, FDIC, or RTC, wherein GNMA's interests are appropriately considered, and (2) that all decisions to grant

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exceptions to the net worth requirements be accompanied by written explanations demonstrating that GNMA's interests were adequately considered and protected when the exceptions were granted.

* * * *

Except for the conditions described above, our study and evaluation disclosed no other conditions which we considered to be material to the financial statements of GNMA taken as a whole. We considered the above conditions in determining the nature, timing, and extent of our audit tests. We concluded that they do not affect our opinion on the financial statements of GNMA for the year ended September 30, 1989.

Our study and evaluation did, however, reveal areas with potential for improvement in internal controls. These areas and our recommendations for improvement are included in a separate letter to GNMA management.

Price Waterhouse

February 28, 1990

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 Executive Vice President,
Government National Mortgage Association:

We have audited the financial statements of the Government National Mortgage Association (GNMA) for the fiscal year ended September 30, 1989 and have issued our report thereon dated February 28, 1990. We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of GNMA is responsible for compliance with laws and regulations. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of GNMA'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.

The results of our tests indicate that, with respect to the items tested, GNMA complied in all material respects with the provisions referred to in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that GNMA had not complied, in all material respects, with such provisions.

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

Price Waterhouse

February 28, 1990

Financial Statements

Balance Sheet

	September 30 1989	September 30 1988
	(Dollars In Thousands)	
Assets:		
Funds in U.S. Treasury	$ 600	$ 700
U.S. Government securities - Note B	1,730,300	1,711,700
Mortgages held for sale, net - Note C	21,700	50,600
Properties held for sale, net - Note D	41,300	29,700
Accrued interest and other receivables	59,500	55,100
Advances against defaulted Mortgage-Backed Security pools	162,000	52,800
Claims against HUD/FHA and VA	15,400	5,200
Equipment	100	100
Total Assets	**$2,030,900**	**$1,905,900**
Liabilities and Investment of U.S. Government		
Liabilities:		
Reserve for loss on Mortgage-Backed Securities Program - Note E	$629,000	$506,400
Trust and deposit liabilities	45,900	48,000
Accounts payable and accrued liabilities	9,500	6,300
Total Liabilities	**684,400**	560,700
Commitments and Contingencies - Note F		
Investment of U.S. Government	**1,346,500**	**1,345,200**
	$2,030,900	**$1,905,900**

See notes to financial statements.

Statement of Revenues and Expenses and Investment of U.S. Government

	For the year ended September 30 1989	1988
	(Dollars In Thousands)	
Revenues:		
Interest income..........................	$ 159,300	$ 195,000
Mortgage-Backed Securities Program income.............................	244,100	231,000
Gain (loss) on investment in mortgages..	400	(34,400)
Other income...........................	7,000	9,400
Net Revenues	410,800	401,000
Expenses:		
Provision for loss on Mortgage-Backed Securities Program - Note E..........	$ 289,700	$ 146,000
Interest expense.......................	0	12,200
Mortgage-Backed Securities Program expenses............................	50,000	30,500
Administrative and other expenses......	16,700	6,700
Total Expenses.........................	356,400	195,400
Excess of Revenue Over Expenses........	$ 54,400	$ 205,600
Investment of U.S. Government at Beginning of Year............................	$1,345,200	$1,602,600
Excess of revenue over expenses........	54,400	205,600
Returned to U.S. Treasury	(53,100)	(463,000)
Investment of U.S. Government at End of Year.........................	$1,346,500	$1,345,200

See notes to financial statements.

Statement of Cash Flows

Increase (Decrease) in Cash

	For the year ended September 30 1989	1988
	(Dollars In Thousands)	
Cash flows from operating activities:		
Interest received......................	$164,400	$181,200
Mortgage-Backed Securities Program fees	243,000	231,000
Advances against defaulted Mortgage-Backed Security pools................	(249,500)	(149,200)
Mortgage-Backed Securities Program expenses............................	(62,700)	(31,900)
Other income received..................	62,800	17,600
Administrative expenses................	(49,800)	(7,400)
Net cash provided by operating activities	108,200	241,300
Cash flows from investing activities:		
Proceeds from sale of mortgages........	$ 25,900	$209,200
Principal repayments on mortgages......	3,400	37,600
Purchase of mortgages..................	(1,400)	(29,200)
Purchase of properties held for sale...	(140,600)	(125,400)
Proceeds from sale of properties.......	48,100	13,700
Recoveries from FHA and VA.............	28,000	15,800
Purchase of U.S. Treasury Securities, net......................	(18,600)	(38,000)
Net cash (used) provided by investing activities............................	(55,200)	83,700
Cash flows from financing activities:		
Cash returned to U.S. Treasury.........	(53,100)	(463,000)
Cash inflows from trust activities.....	0	126,700
Net cash used in financing activities	(53,100)	(336,300)
Net decrease in cash....................	(100)	(11,300)
Cash at beginning of year................	700	12,000
Cash at end of year......................	$ 600	$ 700

See notes to financial statements.

Reconciliation of Net Excess of Revenue Over Expenses to Net Cash Provided by Operating Activities

	For the year ended September 30 1989	1988
	(Dollars In Thousands)	
Net excess of revenue over expenses.........	$ 54,400	$205,600
Adjustments to reconcile net excess of revenue over expenses to net cash provided by operating activities:		
Provision for losses on Mortgage-Backed Securities Program..............	289,700	146,000
(Gain) loss on investment in mortgages...	(400)	34,400
(Increase) decrease in accrued interest and other receivables..................	(14,600)	8,600
(Increase) in advances against defaulted Mortgage-Backed Security pools.........	(109,200)	(43,100)
(Decrease) increase in trust and deposit liabilities...........................	(2,100)	11,100
Increase (decrease) in accounts payable and accrued liabilities................	3,200	(600)
Net income from trust activities.........	0	(13,500)
Decrease in Mortgage-Backed Securities reserve relating to operating activities............................	(112,800)	(107,200)
Total adjustments....................	53,800	35,700
Net cash provided by operating activities..	$108,200	$241,300

See notes to financial statements.

Notes to the Financial Statements

NOTE A--ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Government National Mortgage Association (GNMA) was created in 1968 through amendment of Title III of the National Housing Act as a Government corporation within the Department of Housing and Urban Development (HUD) to administer mortgage support programs which could not be carried out in the private market.

The Mortgage-Backed Securities (MBS) Program is GNMA's primary ongoing activity. The purpose of the program is to increase liquidity in the secondary mortgage market and attract new sources of capital for residential loans. Through the program, GNMA guarantees the timely payment of principal and interest on securities backed by pools of mortgages issued by private mortgage institutions. The guaranty is backed by the full faith and credit of the United States Government. GNMA requires that the mortgages be insured by the Federal Housing Administration (FHA) or the Farmer's Home Administration (FmHA) or guaranteed by the Department of Veterans Affairs (VA).

For several years until 1988, GNMA was also responsible for managing and liquidating a portfolio of mortgages, loans and other obligations that were acquired under various programs over several years. In addition, GNMA acted as trustee for two Federal trusts.

U.S. Government Securities: U.S. Government securities are recorded at cost, net of unamortized discount or premiums. Discounts and premiums are amortized over the life of the security. Federal Housing Administration (FHA) debentures are recorded at cost and are either held until maturity or used to pay FHA insurance premiums. GNMA's intent is to hold the securities until maturity.

Mortgages and Properties Held for Sale: Mortgages and properties held for sale are reported on the Balance Sheet net of the allowance for loss on recovery or resale. The allowance for loss is established to reduce the carrying value of mortgages and properties held for sale to their estimated net realizable value, i.e. the amount GNMA expects to realize in cash upon sale of the mortgages and property or upon collection on the mortgages.

Advances Against Defaulted Mortgage-Backed Security Pools: Advances against defaulted mortgage-backed security pools represent payments made to fulfill GNMA's guaranty of timely principal and interest payment to MBS holders.

Claims Against HUD/FHA and VA: Claims against HUD/FHA and VA represent amounts receivable for recovery under FHA's insurance and VA's guarantee on defaulted mortgages backing GNMA securities.

<u>Recognition of Revenues and Expenses</u>: Fees received for GNMA's guaranty of mortgage-backed securities are recognized as earned on an accrual basis. Fees received for commitments to subsequently guarantee mortgage-backed securities and commitments to fund mortgage loans are recognized when received. Losses on assets acquired through liquidation and claims against HUD/FHA and VA are recognized when they occur.

<u>Reserve for Loss on MBS Program</u>: In the operation of its MBS Programs, GNMA periodically monitors the financial condition and the operating results and statistics of issuers. As a result of these procedures, reserves are established to the extent management believes issuer defaults are probable, and Federal insurance and guarantees are insufficient to recoup GNMA advances.

<u>Funds in U.S. Treasury</u>: All of GNMA's receipts and disbursements are processed by the U.S. Treasury which, in effect, maintains GNMA's bank accounts. For purposes of the Statement of Cash Flows, Funds in U.S. Treasury are considered cash.

NOTE B—U.S. GOVERNMENT SECURITIES

The U.S. Government securities and FHA debentures are nonmarketable securities. Interest rates are established by U.S. Treasury and range from 5.5% to 12.75% annually. U.S. Government securities and FHA debentures at September 30 were as follows (dollars in thousands):

Maturity	1989	1988
Less than one year	$808,800	$750,800
One to two years	445,700	444,000
Three to five years	345,900	452,800
More than five years	137,000	77,000
	1,737,400	1,724,600
Less: unamortized discounts	(7,100)	(12,900)
Total U.S. Government securities	$1,730,300	$1,711,700

NOTE C—MORTGAGES HELD FOR SALE

GNMA acquires certain mortgages in order to protect the interests of GNMA security holders. Mortgages held for sale were as follows (dollars in thousands):

At September 30,	1989	1988
Unpaid principal balance	$ 23,600	$ 62,300
Allowance for doubtful recoveries	(1,900)	(11,700)
Mortgages, net	$ 21,700	$ 50,600

NOTE D--PROPERTIES HELD FOR SALE

GNMA, from time to time, acquires residential properties by foreclosure in order to protect the interests of GNMA security holders. Properties held for sale were as follows (dollars in thousands):

At September 30,	1989	1988
Cost of properties	$ 69,800	$ 81,500
Allowance for doubtful recoveries	(28,500)	(51,800)
Properties, net	$ 41,300	$ 29,700

NOTE E--RESERVE FOR LOSSES ON MBS PROGRAM

GNMA management believes that its reserves of $629.0 million at September 30, 1989 and $506.4 million at September 30, 1988 are adequate to cover probable losses from defaults by issuers of GNMA securities. The reserves at September 30 comprise the following (dollars in thousands):

MBS Program	1989	1988
Single Family	$285,200	$120,000
Multifamily	50,500	6,000
Mobile Home	293,300	380,400
Total	$629,000	$506,400

Changes in the reserve for the year ended September 30, 1989 were as follows (dollars in thousands):

	Single Family	Multi-Family	Mobile Homes	Total
Balance, beginning of year	$120,000	$6,000	$380,400	$506,400
Realized losses on security liquidation	(68,700)	(11,300)	(87,100)	(167,100)
Provision	233,900	55,800	-0-	289,700
Balance, end of year	$285,200	$50,500	$293,300	$629,000

As a result of limitations to the VA guarantee, GNMA is exposed to additional losses from securities backed by VA-guaranteed single family mortgages. GNMA management has estimated that losses approximating $285.2 million will probably result from defaulted issuers. Accordingly, GNMA has established a single family MBS reserve.

In the past management believed its losses from defaults by single family mortgage-backed securities issuers would be minimal because mortgages backing the securities were either fully insured by FHA or because the VA guarantee effectively covered virtually all default losses. However, in recent years VA began to use an optional settlement whereby VA does not bid on foreclosed property if the subsequent sale of the property will lead to losses greater than the guaranteed portion of the mortgages (i.e., "VA no bids"). Unlike FHA insurance, which generally covers 100% of the defaulted single family mortgage, the VA guarantee is limited to a specified percentage of the mortgage. VA's use of this optional settlement policy exposes GNMA to additional losses when issuers of securities backed by VA-guaranteed mortgages default, particularly in regional areas experiencing economic stress. GNMA estimates that between 30% and 40% of its $350 billion of single family mortgage-backed securities involve mortgages guaranteed by VA.

GNMA has placed several major issuers of GNMA multifamily mortgage-backed securities in default. The multifamily mortgages backing the securities were coinsured by FHA and the issuers. In the opinion of management, and pursuant to an agreement between GNMA and FHA, GNMA will be indemnified by FHA for substantially all losses resulting from the default of these issuers. However, a reserve of $50.5 million has been recorded to cover administrative and other costs.

The mobile home MBS reserve is for remaining payments to be made on losses from defaulted issuers of GNMA mobile home mortgage-backed securities. Substantially all of the estimated losses on mobile home mortgage-backed securities were accrued in 1987 as a result of actual or probable issuer defaults that took place in or prior to that year.

NOTE F--COMMITMENTS AND CONTINGENCIES

GNMA is contingently liable for timely principal and interest payments to mortgage-backed securities holders under its guarantee. The securities are backed by pools of FHA-insured, FmHA-insured, and VA-guaranteed mortgage loans. The total amount of securities outstanding at September 30, 1989 was approximately $361 billion, however GNMA's contingent liability is considerably less because of the FHA and FmHA insurance and VA guarantee.

Under its MBS guarantee, GNMA advanced $511.7 million in fiscal year ended 1989 and $385.5 million in 1988 against defaulted mortgage-backed security pools to facilitate timely pass-through payments, of which $262.2 million and $236.3 million respectively, was recovered. GNMA paid $140.6 million in 1989 and $125.4 million in 1988 to purchase foreclosed properties and $29.2 million in 1988 to purchase mortgages in order to buy out the securities that were backed by those properties and mortgages, for the protection of the security holders.

Prior to incurring a contingent liability as guarantor of mortgage-backed securities, GNMA accepts commitment applications from securities issuers. The commitment ends when the mortgage-backed securities are issued or when the commitment period expires. Outstanding commitments, as of September 30, 1989 were $29 billion.

GNMA has certain claims and lawsuits pending against it. Where claims are expected to result in payments, appropriate provision has been included in the financial statements. In the opinion of management and counsel, the resolution of other claims and lawsuits will not materially affect the financial position or operation of GNMA.

NOTE G—RELATED PARTIES

GNMA is subject to controls established by government corporation control laws (32 U.S.C. 9101 through 9109) and management controls by the Secretary of HUD and the Director of the Office of Management and Budget. Such controls could affect GNMA's financial position or operating results in a manner that differs from those that might have been obtained if GNMA were autonomous.

HUD provides GNMA, without charge, use of space and equipment. Administrative expenses are allocated to GNMA by HUD. All GNMA operations are performed by HUD personnel. HUD is reimbursed by GNMA for payroll and payroll related costs and other administrative services. Allocations of these costs to GNMA are primarily based on projected staff hours required to carry out GNMA operations, as a percentage of total projected staff hours for HUD.

Allocated payroll related costs for which GNMA reimburses HUD include matching contributions to the Civil Service Retirement System (CSRS) and the Federal Employees Retirement System (FERS). FERS went into effect for all HUD employees on January 1, 1987 pursuant to Public Law 99-335. GNMA does not report its portion of the CSRS or FERS actuarial present value of accumulated benefits or unfunded pension liability, since these amounts are reported in total by the Office of Personnel Management.

Cash receipts, disbursements and investment activities are processed by the U.S. Treasury. Funds in the U.S. Treasury represent cash currently available to finance purchase commitments and pay current liabilities. GNMA has an outstanding authority to borrow up to $1.5 billion from the U.S. Treasury to finance its operations in lieu of appropriations if necessary.

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