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1988 Financial Audit: Federal Housing Administration

Statement of
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Comptroller General of the United States

Before the
Subcommittee on Housing and Urban Affairs
Committee on Banking, Housing and Urban Affairs
U.S. Senate

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Mr. Chairman and Members of the Subcommittee:

We are pleased to appear today to discuss the results of the 1988 financial statement audit of the Federal Housing Administration (FHA). On August 1, 1989, I appeared before this subcommittee and presented testimony on the history of our financial statement audits at FHA. At that time, I stated that we had contracted with the independent certified public accounting firm of Price Waterhouse to assist us in auditing FHA's financial statements for fiscal year 1988.

The fiscal year 1988 financial audit has just been completed. FHA's financial statements show losses of $4.2 billion in fiscal year 1988 and that the government's equity sunk to a deficit of $2.9 billion at the end of the fiscal year. The information provided by that audit gives cause for substantial concern. In summary,

-- FHA's Mutual Mortgage Insurance Fund, its largest fund, incurred a loss of $1.4 billion in 1988, causing its equity to diminish to $1.8 billion, and

-- FHA's General Insurance Fund, its second largest fund, incurred a loss of $2.6 billion in 1988, causing its already negative equity to further deteriorate to a deficit of $3.1 billion, even after an appropriation of $300 million.

The GI Fund situation is particularly troubling because of basic weaknesses in the coinsurance program and the potential for defaults in the hospital mortgage insurance program. It is clear that substantial appropriations will be needed to restore the solvency of the GI Fund.

Basic management weaknesses must be corrected if future losses are to be brought under control. The audit disclosed several problem areas:

-- There has been a lack of effective monitoring of those program activities delegated to the private sector,

-- Financial information needed to properly manage FHA's programs has not been available,

-- Important internal controls are not effective, particularly with regard to cash management and the processing of multifamily insurance claims,

-- Essential accounting functions have not been performed adequately, and

-- Management has not been diligent in correcting the weaknesses identified in earlier reviews.

We are unable to express an opinion on FHA's financial statements. There are uncertainties over the amount of losses that may result from (1) the extent of the diversion of property sales proceeds, (2) the extent to which foreclosed property reflected in FHA's financial statements may be misstated, and (3) the effect that the outcome of other investigations might have on FHA's financial statements. Numerous investigations of alleged fraud, embezzlement, and other illegal acts are currently underway and it is not possible to determine the extent of losses that could ultimately be sustained by FHA as a result of these alleged improprieties. As a result, the losses may be greater than those reported in the financial statements. (See attachment III)

Before I get into the details of the financial statement audit, let me spend a few minutes discussing some background related to FHA.

BACKGROUND

FHA was established in 1934 under authority granted to the President by the National Housing Act (Public Law 73-479). In 1948, FHA became a wholly owned government corporation subject to the Government Corporation Control Act, as amended. FHA and its functions were transferred to the Department of Housing and Urban Development (HUD) in 1965. After the transfer, FHA no longer had separate staff or facilities; its operations have been conducted, along with other housing activities, by HUD organizations.

The basic purpose of FHA programs is to encourage improvement in housing standards and conditions, provide an adequate home financing system through mortgage insurance, and exert a stabilizing influence on the mortgage market. To carry out this purpose, the Secretary of HUD administers FHA through four separate funds for its various mortgage insurance programs -- the Mutual Mortgage Insurance (MMI) Fund, the Cooperative Management Housing Insurance (CMHI) Fund, the General Insurance (GI) Fund, and the Special Risk Insurance (SRI) Fund.

FHA'S 1988 FINANCIAL STATEMENTS

As I have already stated, FHA, with $303 billion of insurance in force, lost $4.2 billion in fiscal year 1988, thereby converting the government's equity in FHA from a surplus at the beginning of fiscal year 1988, to a deficit of $2.9 billion at the end of fiscal year 1988. The majority of losses occurred in the MMI and GI Funds--FHA's two largest.

As shown in Attachment I to this statement, the MMI Fund, FHA's largest fund with $229 billion of insurance in force as of September 30, 1988, had a loss of $1.4 billion in fiscal year 1988. This loss caused the government's equity in this fund to fall to $1.8 billion at the end of the fiscal year. The MMI Fund provides basic single family mortgage insurance and is intended to be self-sustaining.

In addition, the General Insurance (GI) Fund, FHA's second largest fund, with $62 billion of insurance in force as of September 30, 1988, had a loss of $2.6 billion in fiscal year 1988, causing the government's already negative equity position in this fund to fall to a deficit of $3.1 billion at the end of the fiscal year. The GI Fund provides insurance on loans for cooperatives, condominiums, housing for the elderly, and non-profit hospitals, and is subsidized by appropriations to restore certain losses sustained from its mortgage insurance operations.

Let's look at why these funds are losing money.

Mutual Mortgage Insurance Fund

The $1.4 billion loss in the MMI Fund for fiscal year 1988 is mainly attributable to a $1.2 billion increase in its loss reserves. These reserves are necessary to account for losses on defaults which will eventually lead to claims.

Two major factors contribute to the MMI Fund's increase in loss reserves. First, the record high single family mortgage insurance endorsements from 1986 and 1987 are entering their historically high claim period and thus defaults have remained at a high level. Like many private mortgage insurers, FHA, and particularly the MMI Fund, experiences its highest rate of claims in the second and third year after the insurance is written. The rate gradually decreases after

the third year and levels off after the tenth year of the policy. Given the significant level of insurance written by the MMI Fund in 1986 and 1987, defaults are likely to continue at a relatively high level, at least in the near term.

The other factor contributing to the increase in loss reserves in the MMI Fund is the persistently high default and foreclosure rates in economically stressed regions, particularly the Rocky Mountain and Southwest regions. While the percentage of insurance written in these regions to total MMI insurance in force has remained relatively stable, claim rates, and thus losses, have been substantial in these stressed regions.

The MMI Fund's results were also affected by increasing losses when foreclosed property was eventually sold. While some losses on the sale of foreclosed properties should be expected, losses in distressed regions, particularly the Rocky Mountains, increased by 10 percent.

General Insurance Fund

The $2.6 billion loss in the GI Fund for fiscal year 1988 is mainly attributable to a $2.1 billion increase in its loss reserves. The GI Fund's premium and other revenues are not sufficient to cover its losses, leaving it dependent on Treasury borrowings and appropriations to offset the losses.

Loss reserves in the GI Fund 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 the loan).

In September 1988, DRG Funding Corp., a major FHA lender/coinsurer, was declared in default of its obligations. Subsequent to September 1988, two more large FHA lender/coinsurers were declared in default. Substantially all the losses will be borne by FHA. A loss provision of $960 million has been recorded in 1988 for estimated losses resulting from these and other probable defaults in the multifamily coinsurance programs. Because of basic weaknesses in the multifamily coinsurance programs, involving inadequate levels of capital and deficient coinsurer monitoring, it is possible that still more coinsurer defaults may occur and cause additional losses of unknown magnitude.

Another factor contributing to the increase in loss reserves in the GI Fund relates to probable defaults of FHA-insured hospital mortgages. A provision of $275 million has been recorded for these probable defaults. Changes in external conditions which affect occupancy rates are partially responsible for defaults of these

mortgages and could cause additional defaults in the future. Even a few defaults of these large mortgages could place a serious financial burden on the GI Fund.

Actuarial Soundness

HUD's actuary has determined that the MMI Fund's future income will exceed future expenses for insurance in force as of September 30, 1988. Nevertheless, we are studying other aspects of the MMI Fund to determine whether there are fundamental weaknesses that must be addressed.

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 borrowings from the U.S. Treasury and appropriations to sustain its operations.

FINANCIAL MANAGEMENT PROBLEMS

The audit noted a number of financial management problems that HUD and FHA top management need to address. These are the same fundamental accounting and financial management problems that GAO and the Inspector General have been reporting on since the early 1980s.

Monitoring Needs to be More Effective

In terms of its direct effect on FHA's financial condition, the most critical weakness was in HUD's monitoring of functions involving large amounts of money delegated to third parties.

We noted deficiencies in the following broad categories of functions delegated to third parties:

1. HUD's delegation of authority to certain eligible lenders to underwrite FHA mortgage insurance, particularly single family mortgage insurance.

2. HUD's delegation of authority to Area Management Brokers to maintain, manage and sell properties that FHA obtained in foreclosure.

3. HUD's delegation of authority to private closing agents to handle the collection of property sale proceeds, including their deposit in HUD's account at the U.S. Treasury. Marilyn Harrell, who has become known as "Robin HUD," was one of these private closing agent.

Oversight of the private underwriters suffered from a lack of coordination between the various parts of HUD that have information important to the oversight functions. Also, there's a lack of up-to-

date default information to identify the causes of excessive insurance losses.

Oversight of Area Management Brokers and private closing agents suffered, at least partially, from a lack of experienced staff to handle the large number of foreclosed properties that came to HUD in economically stressed regions. For example because of a lack of oversight one broker was allowed to manage over 1,000 properties, well in excess of the HUD-mandated limit of 100. Allowing brokers to manage excessive numbers of properties exposes FHA to excessive losses should one or more of the large brokers decide not to follow HUD rules.

Better Financial Management Systems Needed

Many of FHA's problems can be attributed to not having accurate financial information that is needed to properly manage FHA's programs.

For example, at present, managers at FHA do not have sufficient program level financial information to determine which programs are self-sustaining and which are not. FHA's four major funds encompass over 40 programs, each with its own unique purpose and each with unique financial attributes. Financial information is periodically produced only for each of its four major funds. FHA, therefore, does not have accurate information to promptly determine financial

results on a program-by-program or region-by-region basis; losses can only be attributed to major activities and cannot be pinpointed with any degree of precision to a particular program or region. This lack of adequate information prevents identifying the causes for losses, such as whether excessive losses are caused by external conditions or by mismanagement.

Another example of the lack of proper financial information is the use of different, overlapping systems used by the groups administering the programs and the groups performing finance and accounting functions. For example, two separate systems are currently used to manage and account for FHA-owned foreclosed properties - 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 responsible for property management and sale, only contains information on the number of properties but no dollar information. 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 explain these differences. Collectively, the problems with the property systems cause uncertainties about the number and dollar value of the properties FHA actually owns and raises questions about how property can be properly managed and sold with questionable information about its value.

Internal Controls Need to be Improved

HUD's internal controls over cash management and claims processing 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, and that claims for insurance benefits are being paid timely and only after proper review and examination.

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 ("Robin HUD") has admitted to embezzling a sizable amount of sale proceeds without prompt detection.

Our review of HUD's multifamily claim payments process showed that HUD has a large backlog of claim cases where the mortgagee has complied with all HUD requirements but which have simply not been paid because of delays in final processing. We estimate that HUD has incurred additional interest costs ranging from $6 million to $10

million as a result of these delays.

In addition, HUD does not verify all financial data provided in mortgagee claim submissions. For example, in one instance where a mortgagee failed to disclose information about a special escrow account when submitting a claim for payment, the claim examiner did not verify the escrow account balance and reduce the claim accordingly. As a result, the claim was overpaid by some $2.8 million.

Better Performance of Accounting Functions Needed

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. HUD staff have been deficient in performing these very basic routine accounting functions:

-- Documentation supporting several account balances was missing or incomplete.

-- Reconciliations of general ledger balances to supporting

records were not performed timely, and in many cases not at all.

-- Some payments were made without proper support or justification.

-- 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.

-- Escrow accounts maintained by HUD to fund repairs on HUD owned properties were not properly accounted for.

More Diligent Follow-Up of Findings Needed

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 responsible for FHA activities have generally responded to recommendations by GAO and the Inspector General and the weaknesses disclosed in the FMFIA reports, resolution of the findings has often been delayed and some findings are not addressed at all. In addition, in some cases, there are no follow-up reviews to determine if proposed procedures in fact cured the cited problems.

For example, HUD's 1987 FMFIA report 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. However, this same weakness was noted during the 1988 audit. The lack of follow-up and implementation unnecessarily exposes FHA to the risk of waste, loss, unauthorized use, or misappropriation of government funds, property, and other assets.

EXCESSIVE CONCENTRATION AND INADEQUATE CAPITAL REQUIREMENTS IN THE COINSURANCE PROGRAM

FHA's multifamily coinsurance programs incurred significant losses during 1988. We have a number of concerns about how these programs are structured and administered. Our concerns relate to whether the levels of capital required of coinsuring lenders are sufficient, and whether the controls designed to reduce portfolio risk and to monitor coinsuring lenders are effective.

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 percent of the mortgage amount, thereby assuming responsibility for a portion of any insurance losses resulting from defaulted mortgages. If there is

also an absence of adequate surveillance and monitoring, as we found to be the case, there is a temptation to grow without regard to the quality of that growth.

Under FHA's present capital requirements, one large coinsurer, before it defaulted, had capital of about $5 million in relation to its coinsured portion of $203 million of mortgages--a capital leveraging of 40 to 1. It is estimated that FHA may lose at least $540 million on the mortgages underwritten by this defaulting coinsurer.

As the graph on Attachment II shows, the coinsurance programs were heavily concentrated among two large coinsurers who accounted for 55 percent of the risk. The five largest coinsurers accounted for 73 percent of the risk. This is particularly alarming considering the excessive exposure the largest coinsurers have in relation to their capital investment.

We believe that: (1) capital requirements should be established at such a level that coinsuring lenders will be induced to make sound loans; (2) criteria should be established that will deter the concentration of loans (and thus risk) among too few lenders; and (3) that delegated responsibilities should be continually and thoroughly monitored. The importance of these controls becomes apparent when bearing in mind that if coinsurers mismanage their 20 percent risk, that means they have mismanaged HUD's 80 percent risk as well. In

fact, HUD has had to pay off 100 percent of many of these coinsured loans. There are many similarities between this situation and the government's deposit insurance exposure in the savings and loan crisis.

We understand that based on what has been happening with the coinsurer program, HUD is conducting a review of participating coinsurers. We plan to review the results of HUD's efforts.

COMPLIANCE WITH LAWS AND REGULATIONS

The audit also disclosed a condition believed to be a material instance of noncompliance with laws and regulations. This was noncompliance with the Debt Collection Act of 1982 by failing to establish a receivable and to collect for amounts owed from mortgagees caused by a shortfall between the payoff of their defaulted mortgage and the amount realized from the sale of their foreclosed property.

IMPACT OF PROPOSED CHANGES TO THE MUTUAL MORTGAGE INSURANCE FUND

I would now like to direct my comments for a few moments from the audit of FHA's financial statements to the ongoing work we are performing to prepare a forecast analysis of FHA's Mutual Mortgage Insurance Fund (MMI Fund). This work is being done at the request of

Congressman Gerald Kleczka and this subcommittee expressed interest in our analysis when we testified in August. Specifically, we are analyzing policy options that include:

-- increasing the FHA mortgage insurance limit to 95 percent of a geographic region's median single-family home price;

-- reducing the required down payment on loans guaranteed by FHA; and

-- raising the interest rate caps on FHA-insured adjustable rate mortgages.

Since testifying on FHA before this subcommittee in August, we have obtained preliminary results in both our analysis of loan characteristics and estimation of claim and loss rates. The initial results tend to be consistent with our expectations based on prior studies and economic theory. For example:

-- Claim rates tend to peak in the second and third year after loan origination and then decline in subsequent years.

-- Claim rates increase for loans with higher loan-to-value ratios.

-- Current FHA higher valued mortgages (within current FHA loan

limits) tend to have lower claim rates.

-- Claim rates decline as a homeowner's equity increases through pay back of the mortgage or through home price appreciation.

While we have obtained preliminary results in both our analysis of loan characteristics and estimation of claim and loss rates, we also have identified unforeseen problems and inconsistencies in the FHA database of insurance-in-force loans, primarily related to identifying claim dates in years prior to 1984. We believe that the source of the missing dates is associated with transferring data to a new computer system for the MMI Fund, installed at the end of fiscal year 1982. We believe that we can correct the problems we have identified and complete our work by early November. This analysis will establish a better understanding of loan performance and the likely impacts of various policy options on the solvency of the MMI Fund.

Even without the benefit of our forecast analysis, a number of relationships can be established regarding the probable impacts that the proposed changes would have on the MMI Fund. These relationships are based on what is generally known about the Fund's performance and historical claim and loss rates. For example, available data suggests that two of the proposals--lowering down payment requirements and raising interest rate caps on adjustable rate

mortgages--would be likely to increase FHA's claims and losses. The probable impact of raising the loan ceiling to 95 percent of the median home sales price, however, is not so clear.

We believe that raising the ceiling would be the most significant factor in increasing FHA's business. Data collected on 80 metropolitan areas by the National Association of Realtors shows that 14, or about 17 percent, have median home sale prices well above the current FHA loan limit. Overall, we believe a 20 percent increase in FHA business is possible if the 95 percent of median price proposal is adopted.

Based on our past work, we also believe that raising the loan ceiling could result in overall lower claim rates and, consequently, could help to boost FHA net revenues. However, the following two factors, which we are currently analyzing, could work against this scenario:

-- Analysis of FHA's database indicates that higher value loans within present FHA limits have lower claim rates, partly because these loans have had higher down payments associated with them. However, it can be anticipated that, as the ceiling amount of the loan is raised in high cost areas, many new borrowers will either not desire or not be able to make correspondingly higher down payments. Therefore, to the extent this happens, the potential risk associated with these

loans will increase.

-- When higher value loans default, losses might be higher than they are on lower value loans. Private mortgage insurers contend that loss rates rise with loan size. For example, in a weakened market, a $150,000 house might decline to $120,000, or 20 percent, while a $100,000 house might decline only to $90,000, or 10 percent.

As I mentioned earlier, we plan to complete our forecast analysis in early November by projecting, under various economic scenarios (current trend, optimistic, and pessimistic,) the status of the MMI Fund based on new loans over the next 10 years, assuming that the proposed changes are enacted. To provide a baseline for our analysis, we will also forecast the status of the Fund over the next 10 years, assuming that no changes are made to the program.

CURRENT FHA INITIATIVES

The new management at HUD under Secretary Kemp has started to address various deficiencies to strengthen FHA's financial position. In his August 1, 1989 letter to you, Mr. Chairman, Secretary Kemp outlined various initiatives he would take, including:

-- Stepping up monitoring and enforcement activities,

-- Redirecting FHA's accounting and computer systems,

-- Performing an independent actuarial analysis of the MMI and GI Funds,

-- Publishing annual audited financial statements,

-- Complying with recommendations resulting from the financial audit,

-- Reviewing the steps necessary to ensure full compliance with the Federal Managers' Financial Integrity Act, and

-- Reviewing lender requirements to ensure that only responsible and soundly capitalized firms participate in FHA programs.

I have met with Secretary Kemp and his management team and discussed our concerns with HUD's financial management problems. The Secretary has stated his strong desire to improve HUD's financial management problems and we look forward to working with him.

CONCLUSIONS

As we have stated, the 1988 financial audit reveals that FHA has sustained substantial losses, particularly in the MMI and GI Funds. These losses are directly attributable to rising defaults in

economically stressed regions, losses from sales of foreclosed properties, and the failure of several large coinsurers. The extent of losses attributable to program fraud and abuse is not yet known.

There are, however, a number of serious problems in the financial management of FHA which contribute to its losses. These problems are exemplified in the serious lack of monitoring of responsibilities delegated to the private sector, the poor quality of financial information available to management, the weak financial management systems and internal control procedures, the shoddy performance of essential accounting functions, and management's inattention to weaknesses identified by GAO, the Inspector General, and its own FMFIA reports. We are also concerned about the level of capital required for the GI multifamily coinsurance program.

These financial management problems open FHA to mismanagement and an unnecessary risk that fraud and abuse will occur and not be detected. They also impair management's ability to assess the level of risk arising from normal insurance operations. Accurate and timely financial information for each program and location are essential to effectively manage FHA's insurance programs.

FHA's accounting and financial management problems have been long-standing and well documented. Correction of these problems will require multiyear solutions and a long-term commitment by top management. I strongly believe that top management needs to develop

an action plan with milestones addressing the improvements needed in FHA/HUD's accounting and financial management systems. The plan should also provide for better accountability and discipline in financial reporting and the continued performance of annual financial audits.

I believe that an important part of the solution to HUD/FHA's problems is to establish a Chief Financial Officer within HUD and a corresponding Comptroller within FHA. A Chief Financial Officer would be responsible for setting accounting and financial reporting policies, directing the development and operation of financial management systems, and ensuring the maintenance of a sound internal control structure. The FHA Comptroller would share the same responsibilities as the HUD Chief Financial Officer, but within FHA. Both of these individuals should also be held responsible for implementation and monitoring of the corrective action plan.

Mr. Chairman, I would like to point out that it is because FHA has begun to prepare financial statements and, most importantly, that these statements have been independently audited, that we are now able to see the magnitude of FHA's problems. Regular audits of these statements are necessary to give the Congress an objective assessment of how management has been performing. FHA's fiscal year 1988 results, as reported by HUD, showed a loss of only $858 million, which is far less serious than the $4.2 billion loss as determined by the independent audit.

In order for the Congress to deal appropriately with this program, or any other program, it must have financial information it can rely on. To aid in its oversight role, I believe Congress should monitor HUD's progress through an annual oversight hearing on the annual report from the Secretary which should include financial statements, the independent auditor's opinion, reports on internal controls and compliance, and management's report required by the Federal Managers' Financial Integrity Act.

This concludes my statement, Mr. Chairman. We will be pleased to respond to any questions you or members of the Committee may have.

ATTACHMENT I

SUMMARY OF FY 88 RESULTS OF OPERATIONS

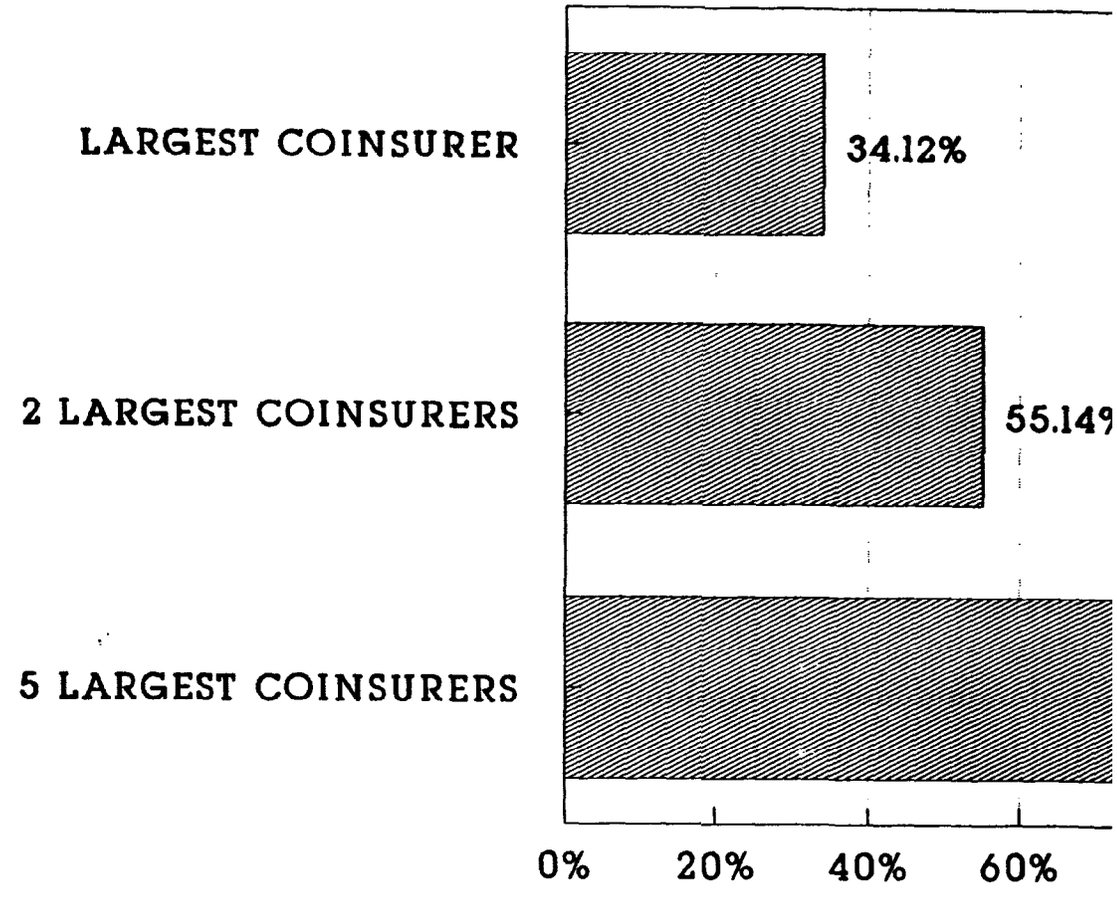
	Self-Sustaining		Subsidized		
	MMI Fund	CMHI Fund	GI Fund	SRI Fund	FHA Total[1]
	in billions				
Insurance-in-force	$229	$0.5	$62	$12	$303
REVENUE:					
Premiums earned	**1.5**	*	**0.3**	*	1.9
Interest and other	0.6	*	0.1	*	0.8
Total revenue	2.1	*	0.4	0.1	2.7
EXPENSES:					
Increase in loss reserves	**(1.2)**	(0)	**(2.1)**	(*)	(3.4)
Losses on property sales	**(1.7)**	(0)	**(0.3)**	(0.1)	(2.1)
Interest and other	(0.6)	(*)	(0.6)	(0.2)	(1.4)
Total expenses	(3.5)	(*)	(3.0)	(0.4)	(6.9)
RESULTS OF OPERATIONS	**(1.4)**	*	**(2.6)**	(0.3)	**(4.2)**
GOVERNMENT EQUITY, 1987	3.4	*	(0.8)	(1.4)	1.2
Appropriations	0	0	0.3	0.1	0.3
Distributions	(0.2)	(*)	0	0	(0.2)
GOVERNMENT EQUITY, 1988	**1.8**	*	**(3.1)**	(1.6)	**(2.9)**

*Less than $100 million

[1]Totals do not add due to rounding.

CONCENTRATION OF RISK AMONG THE LARGEST COINSURE1

PERCENT INSURED WITH:



ACTIONS NEEDED TO ADDRESS FHA PROBLEMS

- Develop a management action plan with milestones that corrects reported weaknesses and achieves monitoring of FHA operations

- Evaluate coinsurance capitalization requirements

- Establish Chief Financial Officer at HUD and a Comptroller at FHA to
  - monitor action plan
  - set accounting and financial reporting policies
  - oversee financial management systems
  - develop adequate internal controls

- Issue annual audited financial statements

- Improve Congressional oversight

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ATTACHMENT IV

Price Waterhouse

September 15, 1989

To the Secretary
Department 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 yet been made. We have been unable to apply other auditing procedures to satisfy ourselves regarding the alleged improper diversions of property sale 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-coinsured multifamily mortgages, declared a major FHA lender/coinsurer in

default of its GNMA obligations. Subsequent to September 1988, GNMA similarly declared two 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 dependant on the U.S. Treasury and on budget appropriations to sustain their operations.

In our report dated August 12, 1988 expect 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

FEDERAL HOUSING ADMINISTRATION
(A FUND OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
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.

FEDERAL HOUSING ADMINISTRATION
(A FUND OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
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.

FEDERAL HOUSING ADMINISTRATION
(A FUND OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
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.

FEDERAL HOUSING ADMINISTRATION

(A FUND OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 assume insured mortgages which are in default rather than acquire the properties through foreclosure. Generally, mortgages will be assumed where the mortgagor has defaulted due to certain "temporary hardship" conditions beyond the control of the mortgagor, and where, in management's judgment, it is likely that the mortgage can be brought current in the future. However, the majority of FHA claims do not result in the assumption of notes. Purchase money mortgages were previously issued, in certain circumstances, to buyers of FHA owned property acquired in the settlement of insurance claims. Under current policies, however, FHA 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 as 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. Accordingly, efforts to sell the subject loans have now been terminated.

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 assumes notes when defaults result from temporary hardship conditions. Many of the notes FHA assumes 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	(48,199)	(375,915)	(424,114)	(344,000)
Allowances for Losses	(31,378)	(1,250,989)	(1,282,367)	(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	$ 1,655,952	$ 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, 1987 and 1988 (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 oustanding 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:

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

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

FEDERAL HOUSING ADMINISTRATION
(A FUND OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
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)

FEDERAL HOUSING ADMINISTRATION
(A FUND OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
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

FEDERAL HOUSING ADMINISTRATION
(A FUND OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
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)