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**TO:** Brian D. Montgomery, Assistant Secretary for Housing-Federal Housing Commissioner, H

**FROM:** Robert McGriff, Director, Financial Audits Division, GAF

**SUBJECT:** Audit of the Federal Housing Administration's Financial Statements for Fiscal Years 2007 and 2006

In accordance with the Government Corporation Control Act as amended (31 U.S.C. 9105), the Office of Inspector General engaged the independent certified public accounting firm of Urbach Kahn and Werlin LLP (UKW) to audit the fiscal year 2007 and 2006 financial statements of the Federal Housing Administration (FHA). The contract required that the audit be performed according to Generally Accepted Government Auditing Standards (GAGAS).

UKW is responsible for the attached auditors' report dated October 29, 2007 and the conclusions expressed in the report. Accordingly, we do not express an opinion on FHA's financial statements or conclusions on FHA's internal controls or compliance with laws and regulations. Within 30 days of this report, UKW expects to issue a separate letter to management dated October 29, 2007 regarding other matters that came to its attention during the audit.

This report includes both the Independent Auditors' Report and FHA's principal financial statements. Under Federal Accounting Standards Advisory Board (FASAB) standards, a general-purpose federal financial report should include as required supplementary information a section devoted to Management's Discussion and Analysis (MD&A) of the financial statements and related information. The MD&A is not included with this report. FHA plans to separately publish an annual report for fiscal year 2007 that conforms to FASAB standards.

The report contains two material weaknesses and one significant deficiency in FHA's internal controls. The Department and FHA disagreed with UKW's assessment that these two weaknesses in internal controls over financial reporting were material weaknesses. The Department reported no material weaknesses for Federal Managers' Financial Integrity Act (FMFIA) reporting in its fiscal year 2007 PAR. In addition, FHA reported no material weaknesses in its fiscal year 2007 Annual Management Report's Annual Assurance Statement on Internal Controls over Financial Reporting.

This year's report contains 16 new recommendations. As part of the audit resolution process, we will record management's decisions for the 16 new recommendations in the Department's Audit Resolution and Corrective Action Tracking System (ARCATS).

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

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## INDEPENDENT AUDITORS' REPORT

Inspector General  
United States Department of Housing and Urban Development

Commissioner  
Federal Housing Administration

We have audited the accompanying consolidated balance sheets of the Federal Housing Administration (FHA), a wholly owned government corporation within the United States Department of Housing and Urban Development (HUD), as of September 30, 2007 and 2006, and the related consolidated statements of net cost, changes in net position, and the combined statements of budgetary resources (Principal Financial Statements) for the years then ended. The objective of our audits was to express an opinion on these financial statements. In connection with our audits, we also considered FHA's internal control over financial reporting and tested FHA's compliance with laws and regulations that could have a direct and material effect on its financial statements.

### Summary

We concluded that FHA's Principal Financial Statements are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

Our consideration of internal control over financial reporting resulted in the following matters being identified as significant deficiencies:

- A risk assessment and systems development plan are needed for FHA's Home Equity Conversion Mortgage systems and transaction controls
- HECM credit subsidy cash flow model needs improvement
- FHA system security controls need to be strengthened

We consider the first two findings to be material weaknesses. We found no reportable instances of noncompliance with laws and regulations.

This report (including Appendices A through D) discusses: (1) these conclusions and our conclusions relating to other information presented in the Annual Management Report, (2) management's responsibilities, (3) our objectives, scope and methodology, (4) management's response and our evaluation of their response, and (5) the current status of prior year findings and recommendations.

## INDEPENDENT AUDITORS' REPORT, CONTINUED

### Opinion on the Principal Financial Statements

In our opinion, the Principal Financial Statements referred to above present fairly, in all material respects, the financial position of FHA as of September 30, 2007 and 2006, and its net cost, changes in net position, and combined budgetary resources for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

### Consideration of Internal Control

In planning and performing our audits, we considered FHA's internal control over financial reporting and compliance (internal control) as a basis for designing our audit procedures that are appropriate in the circumstances and to comply with Office of Management and Budget (OMB) audit guidance, but not for the purpose of expressing an opinion on the effectiveness of FHA's internal control. Accordingly, we do not express an opinion on FHA's internal control.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a deficiency in internal control, or a combination of deficiencies, that adversely affects FHA's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of FHA's Principal Financial Statements that is more than inconsequential will not be prevented or detected by FHA's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that result in a more than remote likelihood that a material misstatement of the Principal Financial Statements will not be prevented or detected by FHA's internal control. Because of inherent limitations in internal controls, misstatements, losses, or noncompliance may nevertheless occur and not be detected.

Our consideration of internal control was for the limited purpose described in the first paragraph above and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, we noted certain matters, summarized below and more fully described in Appendix A, involving the internal control and its operation that we consider to be significant deficiencies, the first two of which are considered material weaknesses:

***A risk assessment and systems development plan are needed for FHA's Home Equity Conversion Mortgage systems and transaction controls***

FHA maintains a number of different system platforms for processing Home Equity Conversion Mortgage (HECM) endorsements, premiums, claims and assigned notes. These systems are not automatically integrated and require significant compensating manual controls to ensure the accuracy and reliability of financial information being reported in the general ledger. They are neither compliant with federal loan

## INDEPENDENT AUDITORS' REPORT, CONTINUED

financial management system requirements nor with federal information technology security requirements, including regulations for the safeguarding of personally identifiable information. The HECM program is growing rapidly, comprises almost 20 percent of the \$905 million single family upfront premium collections and has resulted in over \$500 million in HECM notes now assigned and being serviced by FHA. The balance of assigned notes is estimated by FHA to exceed \$1 billion within one year. We believe this growth in a manually intensive control environment greatly increases the risk of material errors in financial reporting.

FHA has issued a Request for Information from commercial vendors regarding the availability of existing reverse mortgage system solutions.

### ***HECM credit subsidy cash flow model needs enhancement***

FHA has developed a cash flow model to estimate the net present value of future HECM cash flows, which is recorded as a Liability for Guaranteed Loans in the Principal Financial Statements. This model contains projected cash flows for premiums, pre-foreclosure sales claims, mortgage note assignments, terminations, post-assignment drawdowns and terminated loan note recoveries. FHA uses the limited historical experience available and management assumptions to calculate the conditional rates for most of these complex HECM loan events. We noted significant discrepancies between projected and actual program events which may be caused by changes in interest rates and other external variables. We found management has not effectively documented its assessment of statistical correlations between these various macroeconomic variables that appear to be having a significant impact on the program's experience, including house price appreciation, short term interest rates, and borrower characteristics including gender, age, and mobility patterns due to the limited historical experience for the program. FHA also had not effectively documented its sensitivity analysis of the model and did not have an effective process to document its conclusions regarding the results of its validation review and what changes to the models are needed to improve the model's predictability. FHA has indicated that they are currently assessing new pricing and termination models, the results of which will improve future cash flow estimates.

We also found that the model contained improper calculations relating to terminated note recoveries and was not compliant with federal accounting standards regarding OMB discounting requirements for cash flow models for direct loan and loan guarantee programs. FHA has adjusted the accompanying financial statements to reflect the material adjustments to the related Liability for Guaranteed Loans caused by these errors.

### ***FHA system security controls need to be strengthened***

FHA has not yet implemented a federal information security risk management framework in accordance with federal standards. FHA's information system security officer did not have authority and processes

## INDEPENDENT AUDITORS' REPORT, CONTINUED

in place to ensure FHA system security meets federal and Departmental requirements. FHA program offices and system owners also did not fully understand their system security responsibilities due to an ineffective organizational authority, insufficient staff resources, and inadequate security training. FHA has also not yet resolved a number of system vulnerabilities that result in weakened controls over financial system data.

Additional detail and the related recommendations for these findings are provided in Appendix A of this report. The full text of management's response is included in Appendix B. We did not perform audit procedures on FHA's written response to the significant deficiencies and material weaknesses and accordingly, we express no opinion on it. Our assessment of management's response is included in Appendix C. The current status of prior year findings and recommendations is included in Appendix D.

We also noted other less significant matters involving FHA's internal control and its operation, which we have reported to the management of FHA in a separate letter, dated October 29, 2007.

### Compliance with Laws and Regulations

The results of our tests of compliance with laws and regulations disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 07-04, as described below. Providing an opinion on compliance with laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

The HUD Office of the Chief Financial Officer and CFO Appropriation General Counsel are currently investigating potential Anti-Deficiency Act violations associated with the commitment limitation for FHA's General Insurance/Special Risk Fund programs. No final legal determination regarding these potential compliance matters have been made.

### Other Information

The information in the Management's Discussion and Analysis and Required Supplementary Information sections is not a required part of the Principal Financial Statements, but is supplementary information required by the Federal Accounting Standards Advisory Board and OMB Circular A-136, *Financial Reporting Requirements*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

With respect to the internal control objective relating to the performance measures reported in the Management's Discussion and Analysis (MD&A), we obtained an understanding of the design of internal control relating to the existence and completeness assertions and determined whether they have placed in operation, as required by OMB Bulletin No. 07-04. Our procedures were not designed to provide an opinion on the effectiveness of FHA's internal control over reported performance



## INDEPENDENT AUDITORS' REPORT, CONTINUED

measures, and, accordingly, we do not provide an opinion on the effectiveness of FHA's internal control over these reported performance measures.

### Management Responsibilities

Management is responsible for the information in the Annual Management Report, including the preparation of: (1) the Principal Financial Statements in conformity with accounting principles generally accepted in the United States of America, (2) Management's Discussion and Analysis (including the performance measures), and (3) Required Supplementary Information. Management is also responsible for establishing, maintaining and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers Financial Integrity Act of 1982 (FMFIA) are met, ensuring that FHA's financial management systems substantially comply with the Federal Financial Management Improvement Act of 1996 (FFMIA) and complying with applicable laws and regulations.

### Objectives, Scope and Methodology

Our responsibility is to express an opinion on FHA's Principal Financial Statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and OMB Bulletin No. 07-04. Those standards and OMB Bulletin No. 07-04 require that we plan and perform the audit to obtain reasonable assurance about whether the Principal Financial Statements are free of material misstatement.

An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audits provide a reasonable basis for our opinion. In planning and performing our audits, we considered FHA's internal control over financial reporting (internal control) by obtaining an understanding of FHA's internal control, determined whether internal controls had been placed in operation, assessed control risk, and performed tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 07-04 and *Government Auditing Standards*. We did not test all internal controls relevant to operating objectives as broadly defined by FMFIA, such as those controls relevant to ensuring efficient operations.

Our audit procedures were not designed to test the requirements of OMB Bulletin No. 07-04 relating to FFMIA which are not applicable to FHA. Compliance with FFMIA will be evaluated and reported on by the HUD Office of Inspector General (OIG) in connection with their audit of the consolidated financial statements of HUD. We limited our tests of compliance to the provisions described above and we did not test compliance with all laws and regulations applicable to FHA.

## INDEPENDENT AUDITORS' REPORT, CONTINUED

### Distribution

This report is intended solely for the information and use of the HUD OIG, the management of HUD and FHA, OMB, the Government Accountability Office and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

*Urbach Kahn & Werlin LLP*

Washington DC  
October 29, 2007

## **Appendix A**

### **Significant Deficiencies and Material Weaknesses**

In our report dated October 29, 2007, we described the results of our audits of the consolidated balance sheets of the Federal Housing Administration (FHA), a wholly owned government corporation within the United States Department of Housing and Urban Development (HUD), as of September 30, 2007 and 2006, and the related consolidated statements of net cost, changes in net position, and the combined statements of budgetary resources (Principal Financial Statements) for the years then ended. The objective of our audits was to express an opinion on these financial statements. In connection with our audits, we also considered FHA's internal control over financial reporting and tested FHA's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on its financial statements. The following presents additional detail on the internal control matters discussed in that report.

#### **1. A risk assessment and systems development plan needed for FHA's Home Equity Conversion Mortgage systems and transaction controls.**

FHA's systems for processing Home Equity Conversion Mortgage (HECM) transactions are not automatically integrated and require significant compensating manual controls to ensure the accuracy and reliability of financial information being reported in the general ledger. These application systems or databases are neither compliant with federal loan financial management system requirements nor with federal IT security requirements, including regulations for the safeguarding of personally identifiable information.

FHA did not have a comprehensive documented program level risk assessment that evaluates the current HECM program environment and related infrastructure. An effective risk assessment, like a strategic plan, would document management's expectations for the future of the program and assess the potential risks to FHA and HUD related to program management, lender monitoring and oversight, funding, fraud risks, business processes, internal controls and system requirements. FHA has expanded its Quality Assurance Division (QAD) lender reviews to evaluate compliance of lenders' HECM loan endorsement processes, but does not document how these lender reviews correlate to the assessed program risks.

FHA maintains a separate system for HECM loan, endorsement and premium billing data. Although the system is integrated with FHASL, we found no system-based or manual audit trail for authorization or review of premium billing adjustments.

The following IT general control issues were also noted for the HECM endorsement and premium billing system:

- ✓ A configuration management plan was not in place.
- ✓ The application is not capable of generating audit logs.
- ✓ Interface agreements/memoranda of understanding were not in place for all systems that interface with HECM (i.e. FHA Connection, CHUMS and the premiums servicer).
- ✓ Inadequate segregation of duties (i.e. System Owner and System Security Administrator are the same individual for the system and two HECM developers have concurrent access to development and production)

## Appendix A Significant Deficiencies and Material Weaknesses, Cont'd

- ✓ System security vulnerabilities which are discussed for FHA as a whole in Finding 3.

Requests for reverse mortgage note assignments are sent to an independent contractor for review, validation and processing. Acceptance of note assignments in the form of approval letters are sent to the lenders. These letters are included with other information in a claim request package which is sent by the lender to FHA for review, approval and claim payment determination. Data on approved claims are accumulated in an Access database. Information from each claim request package is separately entered onto a standard form for payment processing.

Queries from the Access database are used to summarize payment transactions for monthly postings to the general ledger. FHA has extensive manual reconciliation procedures to ensure the accuracy and reliability of the aggregate balances of monthly transaction postings; however, FHA did not adequately document supervisory reviews of these reconciliations. During our audit of the September 30, 2007 balance of assigned HECM notes, UKW determined that FHA had not recorded the balance of approved and assigned notes for which lenders had not yet filed claims for insurance benefits. Management has elected not to record the corresponding \$29 million adjustment to the Loans Receivable and Related Foreclosed Property, Net and Accounts Payable balances on the Principal Financial Statements. This unrecorded adjustment does not affect our opinion on those statements.

Upon acceptance of the assigned note, FHA is responsible for future borrower advances or fixed payments, accruing interest and fees and termination of the note upon the borrower's death, refinancing of the loan or sale of the home. The balance of outstanding notes held by FHA at September 30, 2007 exceeds \$550 million and is expected to grow to over \$1 billion in fiscal year 2008. FHA's contractor uses a database to track borrower personal data, the note balance and summarizes interest and premium non-cash transactions and note recoveries for manual posting by FHA. The business processes related to note servicing were neither documented nor assessed as part of FHA's OMB Circular A-123 management control documentation and annual assurance efforts. FHA also has manual controls over the processing of terminated note proceeds. FHA's contractor has not performed a system controls audit of this database. This system is also not compliant with federal system requirements for loan programs.

FHA's HECM pilot program was introduced in 1989. The current systems and business processes were developed based on the anticipated minimal program activity at that time. Growth in the program was modest until 2001 when endorsements began growing in excess of 50 percent per year. The HECM program now comprises almost 20 percent of the \$900 million in single family upfront premium collections. Current models project the future cash transactions required to be processed by FHA for the HECM program will exceed \$45 billion over the next 30 years, without considering the effect of future endorsements.

We believe this rate of growth in the number of transactions and the current volume of business being processed manually creates a risk that the current control structure will not be able to detect a material error in the financial statements. Management has

## Appendix A Significant Deficiencies and Material Weaknesses, Cont'd

represented to us that they consider \$50 million as the materiality threshold for their assessment regarding the effectiveness of their controls.

The Office of Single Family Housing and the FHA Comptroller have issued a Request for Information to identify potential vendors that can provide a cost effective web-based reverse mortgage management system.

Recommendations to FHA's Deputy Assistant Secretary for Finance and Budget to address the above in fiscal 2008 include:

- 1a. Coordinate with the Acting Deputy Assistant Secretary for Single Family Housing to compile and document a comprehensive program risk assessment of the HECM program based on anticipated program volume, and activity. (New)
- 1b. Coordinate with HUD's Acting Chief Information Officer and the Acting Deputy Assistant Secretary for Single Family Housing to establish a comprehensive system functional requirements document in accordance with HUD guidance for the new HECM system based on anticipated future volumes of transactions. (New)
- 1c. Coordinate with HUD's Acting Chief Information Officer to complete a full assessment of the Privacy Act requirements for the HECM notes database and its contractor. (New)
- 1d. Complete a full assessment of the effectiveness of the existing controls (including an Independent Type II review of the service provider under AICPA Statement on Auditing Standards No. 70, *Service Organizations*) over the notes database given the sensitivity of the data and the anticipated growth in reported assigned note balances and transactions. (New)
- 1e. Develop and implement automated system interfaces between the current HECM claims and notes systems and FHASL, if the new system(s) cannot be implemented timely. (New)

### **2. HECM credit subsidy cash flow model needs enhancement**

Federal accounting standards require that the net liability related to federal loan guarantee programs be presented in the financial statements at the net present value of future cash flows. OMB guidance outlines stringent procedures to be followed by each agency in developing cash flow models to calculate the total cost of each program each year (credit subsidy cost) as well as the net present value of future cash flows, also known as the subsidy reestimate. FHA develops complex cash flow models in Excel using Visual Basic programming for each major FHA program area.

As discussed above, FHA's HECM systems and business processes were developed based on the anticipated program activity at that time. Growth in the program was modest until 2001 but endorsements have been growing in excess of 50 percent per year for the last five years. The current model now estimates \$45 billion in undiscounted

## Appendix A Significant Deficiencies and Material Weaknesses, Cont'd

future cash flows for the HECM program which represents 40 percent of the future cash flows for all existing FHA programs.

Due to the unique programmatic aspects of reverse mortgages, FHA has developed a separate model for the HECM program. This model contains projected cash flows for premiums, pre-foreclosure sales claims, assignments, terminations, post-assignment borrower drawdowns and terminated note recoveries. FHA uses the limited prior policy years of historical experience and management assumptions to calculate the conditional event rates for use in the HECM cash flow model.

FHA's HECM program performance is extremely sensitive to certain macroeconomic factors including short term interest rates, house price appreciation, and borrower characteristics including gender, age, and mobility patterns. During our audit, we noted significant variances between projected and actual cash flows caused by recent changes in interest rates and its effect on assignments and premiums. We found that FHA did not provide us with fully documented analysis of these variances or the relationships between these external variables and program performance. We also found certain technical errors in the model, as discussed below. FHA is currently assessing new pricing and termination models, the results of which are expected to improve future cash flow estimates.

### Premiums

Actual premium cash flows for FY2007 (annualized using March 31 data) were 12 percent lower than projected in the prior year model (without considering the current cohort's variance which was due to underestimated FY2006 endorsements). Variances in the earliest cohorts were significantly higher but not material overall. FHA's FY2007 validation review also noted this discrepancy but did not adequately investigate, analyze and explain the causes for this discrepancy to determine whether any corrections to the model were required. During our audit, UKW noted a 54 percent overstatement between the number of active HECM loans reported for the 1992-1999 cohorts in the model and the number of loans remitting premium payments to FHA.

### Conditional Termination Rates

FHA uses a single variable for projecting pre-assignment terminations in the cash flow model, which includes loans terminating due to assignment, as well as voluntary (e.g. borrower relocation or refinancing) and involuntary (e.g. borrower death) termination. FHA has not fully documented any statistical correlations between macroeconomic factors and non-assignment related terminations to illustrate how these factors may impact future termination rate assumptions. FHA has not yet documented the impact of other recent studies on HECM program experience on the cash flow model. These studies, including one recently completed by HUD's Office of Policy Development and Research to assist investors to assess the investment risk in reverse mortgage loans, found FHA's termination data does not distinguish between voluntary termination (move-out) and involuntary termination (mortality or incapacitation) and that FHA's models appear to underestimate terminations.

### Assignments

Lenders may assign the HECM loan to FHA once the unpaid balance reaches 98 percent of the calculated maximum claim amount as determined at loan endorsement.

## Appendix A Significant Deficiencies and Material Weaknesses, Cont'd

We noted actual assignments for FY2007 (\$140 million annualized using March 31, 2007 data) exceeded those projected in the FY2006 model (\$80 million) by 75 percent. The FY2007 model may have corrected for some of this variance as it currently projects peak assignments to occur in policy year 7 whereas historically peak assignment years were around policy year 11. This dramatic shift is due to the low initial interest rates for loans endorsed in FY2004 to FY2006 and increasing variable interest rates, which are causing loans to reach 98 percent of their maximum claim amount much sooner. FHA has neither effectively documented whether better estimates of interest rate changes would have reduced these variances nor documented what other external factors (e.g. interest rates or the overall housing market) may impact actual assignment rates to FHA.

### Post-Assignment Terminations

UKW also found that FHA does not use a separate post-assignment termination experience rate assumption in the cash flow model. Due to the lack of sufficient historical data on post-assignment terminations, FHA's cash flow model assumes all assigned notes will be held for six years and uses a historical average of recovery/assignment ratios to calculate recovery cash flows. Incorporating historical termination data and other macroeconomic variables into this assumption may result in significant changes in recovery cash flow projections.

FHA also uses a median long-term house price appreciation rate assumption of four percent within the model. This assumption is inconsistent with the house price appreciation projections published by Global Insights and used in FHA's MMI forward mortgage model. FHA calculations indicated that the use of these lower assumptions will not materially impact the liability estimate. These calculations were not performed as part of a comprehensive sensitivity analysis.

During the audit, management identified that the HECM model inappropriately included cash flows from existing assigned notes. FHA has adjusted the accompanying financial statements to reflect the \$511 million increase to the related Liability for Guaranteed Loans caused by this error.

### Discounting

The cash flow model improperly discounted cash flows to the beginning of the cohort year rather than the end of the financial reporting year. This error artificially reduced the present value of note recoveries relative to the value of assignments. FHA has adjusted the accompanying financial statements to reflect the \$189 million reduction to the related Liability for Guaranteed Loans caused by this error.

The HECM model was also not using OMB guidance relating to the use of budget assumptions for discount rates and actual discount rates for the 2001 – 2007 cohorts. FHA has adjusted the accompanying financial statements to reflect the \$166 million reduction to the related Liability for Guaranteed Loans caused by this error.

### Credit Subsidy

The cash flow model used the maximum claim amount rather than the cumulative amount of borrower drawdowns in its calculation of the credit subsidy rate. The model also did not use the Credit Subsidy Calculator (CSC2) for determining discount rates as required by OMB.

## Appendix A Significant Deficiencies and Material Weaknesses, Cont'd

### Validation

FHA completed a validation review of the HECM cash flow model in June 2007 and noted discrepancies discussed above regarding premiums and assignments. Management's conclusions did not indicate whether changes to the model or its assumptions were needed to address the findings. There is no evidence that the model or its assumptions for FY2007 were revised as a result of these validation findings. FHA also did not document its review of a sensitivity analysis in connection with the validation review.

Accordingly, we believe the limited historical data available, the program's rapid growth, the lack of sufficient documentation on how macroeconomic factors impact the various program events, the \$866 million in aggregate modeling errors identified and the lack of sufficient analysis of program results combine to present more than a remote risk of material errors in financial reporting not being identified by FHA's internal control over the credit subsidy cash flow model estimates. Management has represented to us that they consider \$50 million as the materiality threshold for purposes of their assessment regarding the effectiveness of their controls.

Recommendations to address the above include:

2. We recommend the Deputy Assistant Secretary for Finance and Budget request the Director of the Office of Evaluation to:
  - a. Enhance its documentation on how specific assignment and termination rates are calculated and how macroeconomic projections are incorporated
  - b. Document the results of the current pricing and termination model reviews and their effect on the methodology for calculating future cash flow reestimates
  - c. Document any impact on the FY2007 HECM liability reestimate as a result of changes in the methodologies for calculating future cash flow estimates
  - d. Document FHA's conclusion on how recent HUD studies on HECM experience can be used to improve the calculation of the model's calculated assumptions
  - e. Establish new validation review procedures to compare the actual premium collections and post-assignment terminations to the balances in the model
  - f. Document the use OMB approved CSC2 calculator in the model
  - g. Ensure the propriety of the discounting algorithm used in next year's model
  - h. Reevaluate the assumption for calculating note recoveries to better reflect the "crossover risk" in the recovery cash flows
  - i. Incorporate the use of disbursements into the calculation of the credit subsidy rate
  - j. Incorporate sensitivity analysis variables directly within the cash flow model and document management's assessment of the results of the sensitivity analysis.
  - k. Develop a more formal process for documenting management's conclusions regarding required model modifications as a result of the annual validation process. (New)



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## Appendix A Significant Deficiencies and Material Weaknesses, Cont'd

### ***3. FHA system security controls need improvement.***

FHA has not yet implemented a federal information security risk management framework required by federal policy. The framework, as defined by the National Institute for Standards and Technology (NIST), is a risk-based approach to security control selection and specification. It consists of information security actions, processes, roles, and activities that consider effectiveness, efficiency, and constraints due to applicable federal laws, directives, executive orders, policies, standards, and HUD regulations.

FHA's information system security officer (security officer) did not have the management authorities and processes necessary to ensure that information security within FHA systems was aligned with business objectives consistent with Federal Information Security Management Act (FISMA) and HUD requirements.

Misalignment between FHA management authorities and HUD Information Technology (IT) Security Policy resulted in poor implementation of information security controls that protect FHA's applications and data. Further, FHA program offices and system owners did not fully understand their various system security responsibilities due in part to a lack of proper organizational authorities and personnel resources. Without this framework in place, FHA management cannot ensure that its systems, data, and assets are adequately protected against theft, loss, or destruction.

HUD IT Security Policy - Handbook 2400.25, REV-1, establishes the information security policy for HUD. The policy prescribes responsibilities, practices, and conditions that directly or indirectly promote security in the development, operation, maintenance, and support of all HUD IT resources.

In addition, the HUD IT Security Policy - Handbook 2400.25, REV-1, defines "system owners" as individuals who use IT to help fulfill the business requirements necessary to achieve the mission needs within their program area of responsibility and are responsible for the successful operation of IT systems within their program area. These designated owners are ultimately accountable for the security of the IT systems and programs under their control.

FHA has not yet corrected known IT security vulnerabilities and updated the required security documents. FHA program area staff indicated that they did not have the staff or contractor resources to perform the needed tasks to resolve the information security weaknesses. Risks to its data will continue to exist until funding to correct the vulnerabilities is available.

FHA management has indicated that as of September 30, 2007 they have made progress on addressing the system deficiencies previously identified in the Plans of Actions and Milestones for 36 major Housing and FHA systems. FHA management has stated that the number of open system deficiencies has been reduced from 1,116 in July 2007 to 498 at September 30, 2007 for a 55 percent reduction. Additionally, FHA has stated that over 75 percent of the security documents for Housing and FHA have been updated to meet current federal standards. HUD OIG has indicated that they have not evaluated the support for the closing of the vulnerabilities or the updated security documents, but will do so in fiscal year 2008.

## Appendix A Significant Deficiencies and Material Weaknesses, Cont'd

While FHA had made progress in closing out open vulnerabilities, it could not ensure that all systems would be adequately protected in the near term and that the high impact vulnerabilities were being closed out. FHA is working with HUD's Office of the Chief Information Officer's Office of Information Technology Security Information Assurance and Compliance to develop a schedule of information technology security activities. Identified tasks that remain include:

- Update risk assessments
- Conduct security training and awareness
- Conduct annual self-assessments
- Update security plans and contingency plans
- Resolve all "plan of actions and milestones" weaknesses or create risk acceptance plans.

FHA program management noted that funding for most of its systems had been limited to operations and maintenance for several years and that no development money had been available for these systems. This condition was due to overall funding issues regarding HUD's working capital fund, which also impacted FHA. FHA saw a reduction in funding from \$71.3 million in fiscal year 2004, which included \$41.7 million for development, to \$43.4 million in fiscal year 2007, which included \$7.2 million for development.

With insufficient funding for all of its needs in fiscal year 2007, FHA decided to fund basic operations and maintenance and critical business needs and to freeze funding for development activity to ensure that current systems were operational. As FHA considered information security a development activity, it did not have the funding necessary to resolve its many outstanding information security vulnerabilities.

The lack of information security funding impacts the level of effort and quality of an individual application's security documentation, as well as the ability to engage the resources (i.e. staff) needed to close out known open information security vulnerabilities.

Details and Recommendations can be found in a separate OIG audit report.<sup>1</sup>

### User Access

In prior years, OIG recommended that HUD develop an action plan to fully implement the HUD Online User Registration System to ensure that all user data are tracked and require system administrators to register users and their access level into this database. In response, HUD implemented the Centralized HUD Account Management Process (CHAMP) on January 31, 2007 to serve as a data repository and a workflow management component of the service desk to ensure requests are forwarded in the proper order to all organizations that have a part in approving or assigning user account rights and privileges.

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<sup>1</sup> Audit Report No. 2008-DP-0002, Review of FHA Controls Over Its Information Technology Resources, dated October 31, 2007

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## Appendix A Significant Deficiencies and Material Weaknesses, Cont'd

During FY2007, FHA validated its current authorized user list for major applications (including FHASL) and provided these user lists to OCIO to incorporate into CHAMP. FHA has also begun to record change requests through CHAMP.

OCIO has developed interim procedures to reconcile CHAMP information with the database that contains background investigation data for all employees and contractors. This reconciliation process is intended to identify users with potentially unauthorized or inappropriate access levels to HUD's systems (e.g. users granted above-read access without the appropriate background check). However, the reconciliation is a tedious manual process that cannot identify all users because CHAMP does not contain all user data including legacy data. As a result, some unauthorized users may escape detection.

Details and Recommendations can be found in a separate OIG audit report.<sup>2</sup>

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<sup>2</sup> Audit Report No. 2007-DP-0004, Fiscal Year 2006 Review of Information Systems In Support of the Financial Statement Audits dated February 22, 2007

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## Appendix B Management's Response



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT  
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-  
FEDERAL HOUSING COMMISSIONER

November 1, 2007

MEMORANDUM FOR: Urbach Kahn & Werlin LLP

FROM:   
Ronald Y. Spraker, Deputy Assistant Secretary for Finance and Budget, HW

SUBJECT: Response to UKW's Fiscal Year 2007 FHA Audit Report

I am pleased to present Federal Housing Administration (FHA) management's responses to your audit report on the fiscal year 2007 FHA financial statements.

### General Comments

FHA welcomes the opportunity to comment on this report. We are pleased that UKW noted the resolution of all our prior year internal control report findings. Also, we appreciate UKW reviewing and taking into consideration our comments on their initial draft report. However, of the two material weaknesses identified by UKW, we continue to believe that one is unsupported and therefore unwarranted, and that the detailed narrative associated with the other is inaccurate and needlessly portrays the HECM program negatively.

### Report on Internal Controls – Material Weaknesses

#### 1. FHA's systems for processing Home Equity Conversion Mortgage (HECM) transactions need improvement.

FHA does not concur with the materiality of this finding. As noted by the auditors themselves, FHA has significant compensating controls to ensure the accuracy and reliability of HECM financial information. It is difficult to understand how this could be classified as a material weakness when FHA's controls are effective and working as designed.

As stated by the auditors, a material weakness is a significant deficiency, or combination of significant deficiencies, that result in a **more than remote** likelihood that a **material misstatement** of the Principal Financial Statements will not be prevented or detected by FHA's internal control. We fail to see how the controls over our manual processes are deficient such that it rises to the level of a material weakness.

## Appendix B Management's Response

The auditors also discuss in Appendix A, the potential growth of the HECM program from \$500 million to \$1 billion:

*We believe this rate of growth in the number of transactions and the current volume of business being processed manually creates a risk that the current control structure will not be able to detect a material error in the financial statements. Accordingly, we believe that the above combination of deficiencies presents more than a remote risk of material errors in financial reporting not being identified by FHA's internal control.*

We disagree with the assumption that an increase in the number of HECM transactions will lead to an increase in errors -- especially since the auditors found no errors in their sampling of HECM transactions.

Again, during their sampling of transactions, no errors were found. As noted in their report, the auditors did identify an adjustment that had not been recorded. However, this adjustment had been identified by FHA's internal controls and FHA was working on a specific detailed resolution to properly record the adjustment. FHA management decided to defer the adjustment until all supporting information could be analyzed. If a generic adjustment had been recorded, it would have only increased total assets by .08% and total liabilities by .18% with no change to net cost or net position. These insignificant changes do not result in a material misstatement and they were detected by FHA's internal controls. While FHA does agree that improvements are needed to more fully automate the processes and accounting of this expanding program, the controls currently in place are effective in detecting and preventing material misstatements.

Over the last several years the HECM program has grown significantly. FHA has used its existing systems and developed manual processes to handle this increased growth. Internal controls have been a major focus in developing our procedures.

For example, FHA routinely performs numerous reconciliations that demonstrate that the HECM financial data is complete and accurate. We have conducted numerous A-123 and Financial Statement audits. FHA has reviewed HECM transactions including source documents and reconciliations, as well as reconciliations between the source systems, cash ledgers, and the general ledger. No exceptions were noted in these reviews.

The auditor's discussion indicates a concern about system compliance with federal financial management and IT security requirements. FHA has integrated its mixed financial and programmatic systems, including the systems supporting HECM, with a Federal Systems Integration Office (FSIO) compliant core financial system. The integration of these systems provides FSIO compliance overall, as documented in our A-127 and A-123 reviews. All transactional activity, including HECM premiums and notes servicing, is recorded in FHASL in accordance with FSIO standards. Additionally, FHASL records and reports activities in compliance with Federal accounting standards and credit reform accounting.

The auditor's discussion includes many references to a HECM database, which mischaracterizes the systems that support the HECM program. This characterization suggests that automated controls and business processes are not supported. However, all of the systems that support HECM transactional activity are systems with automated controls and businesses processes. For

## Appendix B Management's Response

example, HECM notes management activity is processed through an external servicer, referred to as the SMART service. SMART was developed to provide comprehensive loan servicing processes necessary to meet HUD guidelines for servicing the various HUD loan programs. The system is required to provide accounting level detail on forward and reverse mortgages; case-tracking ability; report generating capability; query functions; database management and the capability to interface with the appropriate HUD systems. Additionally, the SMART contractor is required to maintain the security and integrity of its systems, for providing systems maintenance, training and technical support to the various users. SMART services also include access controls to the SMART data. All users must be approved by the HUD GTR and then are given access by the system administrator.

Internal testing of the SMART service has been on-going. An assessment of the service began on November 9, 2006 and was completed on January 9, 2007 by Cherry, Bekaert & Holland, LLP, an independent firm. The assessment revealed that the contractor's SMART system is able to completely process mortgage transactions for both forward and reverse mortgages, including interest, appreciation, amortization and other calculations in conformance with HUD handbooks, circulars, mortgagee letters, and other written guidance or directives from HUD. The report includes several recommendations on system documentation improvements.

In the area of HECM claims, FHA is using a desktop program to track and record HECM claims. The number of HECM claims has increased dramatically and FHA has developed adequate internal controls to ensure claim payments are accurate.

FHA recognizes that our current HECM systems need to be improved. To address this issue, during FY 2007, FHA sent out a Request for Information to determine contractor capabilities for an integrated HECM process. During FY 2008, FHA plans to initiate procurement activities to obtain a HECM services to provide an integrated process.

Many of the concerns listed in the audit report are addressed by FHA's existing extensive compensating controls. The effectiveness of these controls and the absence of errors relating to FHA's HECM financial records demonstrate that the risks associated with FHA's HECM systems and controls do not rise to a material level.

Regarding the recommendations, FHA will request additional information in order to fully understand what is being recommended and will provide a more detailed response at a later date.

### **2. HECM credit subsidy cash flow model needs enhancement.**

FHA does not concur that FHA's HECM cash flow models constitute a material weakness.

The Home Equity Conversion Mortgage (HECM) product is nowhere better understood than at FHA. The HECM product and actuarial pricing model were developed at HUD in 1989. HUD and FHA staff have written the majority of reports to Congress and research publications regarding the HECM product. Furthermore, FHA is currently involved in extensive research on the HECM program re-examining the original pricing model and developing termination models. It is using actual program experience and techniques, such as logistic regression and stochastic

## Appendix B Management's Response

simulations, to see if adjustments are needed. A HECM working group, consisting of Ph.D. economists, senior financial economists, and the developers of the original pricing model, meets weekly to discuss and review HECM modeling efforts.

The HECM cash flow model was developed, with the assistance of the original developers of the HECM product and contractor support, to reflect the current and future cash flows of the HECM program. The cash flow model is regularly reviewed and has evolved in response to historical program experience, published research, and management's understanding of the program. The cash flow model takes advantage of all historical program experience available, makes use of proxy data if no historical experience exists, and uses management assumptions based on economic theory to estimate the liability for loans guaranteed.

FHA appreciates the effort that UKW invested in review of the HECM cash flow model, but disagrees with the findings of the material weakness. This response addresses each of UKW's observations in succession. The first section titled "Overview" addresses UKW's observations taken as a whole, the second section titled "Individual Responses to Audit Findings" provides FHA's response to each specific audit observation, and the third section titled "FHA Response to Recommendations" counters each of UKW's recommendations.

### **Overview**

#### ***UKW Applies Forward Mortgage Expectations to Reverse Mortgages***

UKW mistakenly applies assumptions garnered from the Nation's decades of experience with forward mortgages to reverse mortgages. It expects interest rates and house price appreciation, commonly used to explain forward mortgage claim and prepayment behavior, to explain reverse mortgage behavior. In contrast, in its most recent HECM study completed in August 2007, FHA found that the primary drivers of reverse mortgage termination are the borrower's age, gender and policy year, while macroeconomic factors including house price appreciation rate and interest rate are secondary drivers.

UKW expects changes in interest rates and house price appreciation rates to affect HECM loan terminations, but the direction of the hypothesized relationship is often unclear. Will borrowers prepay their mortgages more rapidly to realize the remaining equity in their properties because their equity is growing, or because it is declining? Why would changes in interest rates motivate prepayments or move-outs? Interest rates and house price appreciation rates presumably have no impact on death or disability rates. If interest rates rise, unpaid balances will grow more rapidly, but this is an accounting, not a behavioral matter that drives HECM terminations. Unlike forward mortgage terminations, which are very sensitive to interest rates and house price appreciation rates, HECM terminations are primarily actuarially driven by borrower age, gender, and policy year. FHA acknowledges that interest rates affect the rate and number of HECM loan assignments. In fact, FHA utilizes Global Insight's interest rate forecast to project the growth of future average unpaid loan balances at assignment and to determine the probabilities of future assignments for existing cohorts.



## Appendix B Management's Response

UKW has not adequately considered the unique character of reverse mortgages. Although interest rates and house price appreciation rates undoubtedly influence some aspects of reverse mortgagor behavior, the impacts are unlikely to be the same as those affecting forward mortgagor behavior. Reverse mortgagor behavior is uniquely filtered through the elderly borrowers' life experiences as they struggle to use their equity to remain in their homes. Some of the patterns of behavior will become known only as the historical experience of FHA's borrowers accumulates.

### *UKW Overlooks the Numerous Uses that FHA Makes of Econometric Analysis*

UKW observes: "We found management has not effectively documented its assessment of statistical correlations between these various macroeconomic variables that appear to be having a significant impact on the program's experience, including house price appreciation, short term interest rates, and borrower characteristics including gender, age, and mobility patterns due to the limited historical experience for the program." FHA strongly disagrees with this assessment. Throughout the 17 years of its program experience, FHA and PD&R staff have prepared or overseen numerous studies and reports to Congress that have assessed the adequacy of the assumptions used in the original HECM pricing model and have developed models to compare termination expectations to actual historical experience. Many of these studies examined the impact of macroeconomic factors on program performance, and findings from these studies have guided the development and evolution of FHA's HECM cash flow models.

FHA developed its pricing model in 1989. Assuming a given premium structure, the model solves for principal limit factors which represent the net present value of the payments that a borrower can receive under a HECM, expressed as a fraction of the maximum claim amount, based on the borrowers' age and the "expected average interest rate" (defined as the applicable 10-year Treasury rate plus lender's margin). It includes assumptions about the average rate and the variance of house price appreciation as well as actuarial mortality rates by age. Historical experience was not available to test the assumptions of this pioneering program in 1989. However, subsequent reports to Congress and more recent work to update the 1989 pricing model (see below) show that the original assumptions were quite reasonable. Contrary to UKW's expectation that some of these assumptions should vary with current and projected interest rates and house price appreciation rates, the principal limit factors are the HECM program's equivalents to maximum loan-to-value ratios, and as such should remain stable from year-to-year. At the present time, FHA has a project underway to test the original pricing assumptions against a growing body of historical experience and to consider alternatives to the current premium structure that could lower front-end costs to the borrower<sup>1</sup>.

Termination models are yet another type of model. At the most modest level, termination models describe the actual historical termination probabilities per loan policy year. These data, used in FHA's HECM cash flow model, have been published by HUD staff because they are of great interest to the reverse mortgage industry and potential investors in HECM-backed securities. With the accretion of historical data, FHA has undertaken more sophisticated termination modeling efforts, examining the impact of various loan-specific and macroeconomic

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<sup>1</sup> The project utilizes the approach of optimization via stochastic simulation, where loan terminations, house price appreciation rate and interest rate are stochastically modeled.

## Appendix B Management's Response

factors on termination behavior. These efforts were described to the auditor, but ignored by them in reaching their conclusions that FHA had not sufficiently documented its use of macroeconomic modeling. In fact, FHA's August 2007 study shows that sufficient data exist to model the first six years of a book of reverse mortgage loans, but after that data limitations<sup>2</sup> lead to erratic results. FHA has repeatedly tested these results in its cash flow model and plans to make use of them when the findings mature.

At several points, UKW notes that "FHA is currently assessing new pricing and termination models, the results of which are expected to improve future cash flow estimates," an observation incompatible with its finding of material weakness.

### **Individual Responses to Audit Findings**

The following section will address each of the audit findings:

#### **Audit Finding: Premiums**

Actual premium cash flows for FY2007 (annualized using March 31 data) were 12% lower than projected in the prior year model (without considering the current cohort's variance which was due to underestimated FY2006 endorsements). Variances in the earliest cohorts were significantly higher but not material overall. FHA's FY2007 validation review also noted this discrepancy but did not adequately investigate, analyze and explain the causes for this discrepancy to determine whether any corrections to the model were required. During our audit, UKW noted a 54% overstatement between the number of active HECM loans reported for the 1992-1999 cohorts in the model and the number of loans remitting premium payments to FHA.

#### **FHA Response:**

The Fiscal Year 2006 Model overestimated total premium collections by 0.21% or \$198,000 for the HECM portfolio. For Cohorts 2002 to 2005, which includes 84% of the endorsements from all Cohorts before 2006, the model overestimates premium collection by 4%. UKW notes the high variance in the earlier cohorts as being not material overall (only 16% endorsements for Cohort 1992 to 2001) but still includes it in its analysis. FHA believes that, given the small data set available on HECM loans, it is doing an extremely good job of estimating annual premiums for the HECM portfolio.

#### **Audit Finding: Conditional Termination Rates**

FHA uses a single variable for projecting pre-assignment terminations in the cash flow model, which includes loans terminating due to assignment, as well as voluntary (e.g. borrower relocation or refinancing) and involuntary (e.g. borrower death) termination. FHA has not fully documented any statistical correlations between macroeconomic factors and non-assignment related terminations to illustrate how these factors may impact future termination rate assumptions. FHA has not yet documented the impact of other recent studies on HECM program experience on the cash flow model. These studies, including one recently completed by HUD's

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<sup>2</sup> As of September 2007, only 6.9% of all loans ever endorsed in the HECM program have loan age greater than six years.

## Appendix B Management's Response

Office of Policy Development and Research to assist investors to assess the investment risk in reverse mortgage loans, found FHA's termination data does not distinguish between voluntary termination (move-out) and involuntary termination (mortality or incapacitation) and that FHA's models appear to underestimate terminations. FHA is currently assessing new pricing and termination models, the results of which are expected to improve future cash flow estimates.

### FHA Response:

FHA uses all historical termination data to create its conditional termination rates per policy year in the cash flow model. FHA does not distinguish between pre-assignment and post-assignment terminations because both types of terminations are driven by very similar factors--for example, borrower's attained age and policy year. Pre-assignment terminations, also known as Type I Claims, are the very small number of claims that occur prior to loan assignment where the house value is insufficient to cover the mortgage balance. UKW expects interest rates and house price appreciation rates to influence the Type I Claims. In fact, these claims are generally due to circumstances beyond the control of the borrower. Unless a borrower dies or is unable to remain in the home, there is no incentive for the borrower to terminate the HECM loan just because the loan balance has grown to exceed the house value. Rather, the rational behavior for a borrower is to remain in the home and continue to draw payments. FHA believes that the model is doing a sufficient job of predicting the number of Type I Claims.

FHA has created a terminations model for HECM that incorporates macroeconomic factors, including house price appreciation and interest rate changes, but shows that the primary drivers of loan terminations are loan-specific characteristics, including borrower's age, gender, and policy year. FHA is using these variables in the current terminations model that determines the survival probabilities based on actual loans terminations for each policy year. FHA consistently reviews these variables and their impact on the projected future assumptions and cash flows. These findings have been documented in studies written and directed by the HUD and FHA staff involved with the development and refinement of FHA's HECM cash flow models.

### Audit Finding: Assignments

Lenders may assign the HECM loan to FHA once the unpaid balance reaches 98% of the calculated maximum claim amount as determined at loan endorsement. We noted actual assignments for FY2007 (\$140 million annualized using March 31, 2007 data) exceeded those projected in the FY2006 model (\$80 million) by 75%. The FY2007 model may have corrected for this some of this variance as it currently projects peak assignments to occur in policy year 7 whereas historically peak assignment years were around policy year 11. This dramatic shift is due to the low initial interest rates for loans endorsed in FY2004 to FY2006 and increasing variable interest rates, which are causing loans to reach 98% of their maximum claim amount much sooner. FHA has neither effectively documented whether better estimates of interest rate changes would have reduced these variances nor documented what other external factors (e.g. interest rates or the overall housing market) may impact actual assignment rates to FHA.

### FHA Response:

FHA acknowledges that recent interest rate increases may cause unpaid loan balances (UPB) to reach the 98% maximum claim amount faster than in previous years. FHA has incorporated

## Appendix B Management's Response

interest rate assumptions in determining future UPB projections in the cash flow model and changed its assumption regarding peak assignment from policy year 11 to policy year 7. Additionally, FHA believes that interest rates are the key driver of assignment rates, while the other external factors have minimal impact on assignments.

### Audit Finding: Post-Assignment Terminations

UKW also found that FHA does not use a separate post-assignment termination experience rate assumption in the cash flow model. Due to the lack of sufficient historical data on post-assignment terminations, FHA's cash flow model assumes all assigned notes will be held for six years and uses a historical average of recovery/assignment ratios to calculate recovery cash flows. Incorporating historical termination data and other macroeconomic variables into this assumption may result in significant changes in recovery cash flow projections.

FHA also uses a median long-term house price appreciation rate assumption of four percent within the model. This assumption is inconsistent with the house price appreciation projections published by Global Insights and used in FHA's MMI forward mortgage model. FHA calculations indicated that the use of these lower assumptions will not materially impact the liability estimate. These calculations were not performed as part of a comprehensive sensitivity analysis.

During the audit, management identified that the HECM model inappropriately included cash flows from existing assigned notes. FHA has adjusted the accompanying financial statements to reflect the \$511 million increase to the related Liability for Guaranteed Loans caused by this error.

### FHA Response:

As noted in the FHA response to Claim Type I audit finding above, FHA uses all historical termination data to create its conditional termination rates per policy year in the cash flow model. FHA does not distinguish between pre-assignment and post-assignment terminations because (i) both types of terminations are driven by very similar factors--for example, borrower's attained age and policy year, and (ii) the small number of post-assignment terminations does not warrant a separate analysis (only 2,100 post-assignment terminations since the inception of the HECM program). Based on its extensive research in terminations mentioned above, FHA found that loan-level characteristics are the primary drivers of terminations (for both pre-assignment and post-assignment), but macroeconomic factors are clearly secondary drivers. Due to the limited historic data for older loans, FHA has concluded that it is premature to incorporate macroeconomic variables to predict conditional termination rates in the cash flow model. FHA believes that its current termination modeling approach is more than sufficient.

UKW is incorrect in its understanding that FHA uses the 4% house price appreciation (HPA) rate in its cash flow model. Based on a sensitivity analysis that FHA performed and explained to UKW, HECM is actually using an implied 1.28% annual HPA rate compounded each year. FHA has repeatedly emphasized that it conducts sensitivity analyses on HPA periodically to ensure the soundness of its assumptions.

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In contrast to forward mortgages, reverse mortgages have not been terminated at the time that they are assigned to HUD, and so, they are not included in a recovery on assets model. The assigned note continues to accrue interest, premium, and service fee in addition to any payouts to the borrower. FHA initially accounted for these assets in the HECM cash flow model. Subsequently, FHA made a decision to remove these loans from the cash flow model and account for them separately as assets for purposes of the reestimates. As a result, FHA reduced the liability for HECM loans by \$511 million, an amount offset by the recognition of \$525 million as assets in the reestimates calculation. This decision was made after FHA has submitted the FY 2007 models to the auditors. FHA brought this accounting change to the attention of the auditors, and provided them with an updated model at that time. This change has no impact on the performance of HECM loans or the model. It recognizes the unique nature of HECM loan assignments.

### Audit Finding: Discounting and Credit Subsidy

The cash flow model improperly discounted cash flows to the beginning of the cohort year rather than the end of the financial reporting year. This error artificially reduced the present value of note recoveries relative to the value of assignments. FHA has adjusted the accompanying financial statements to reflect the \$189 million reduction to the related Liability for Guaranteed Loans caused by this error.

The HECM model was also not using OMB guidance relating to the use of budget assumptions for discount rates and actual discount rates for the 2001 – 2007 cohorts. FHA has adjusted the accompanying financial statements to reflect the \$166 million reduction to the related Liability for Guaranteed Loans caused by this error.

The cash flow model used the maximum claim amount rather than the cumulative amount of borrower drawdowns in its calculation of the credit subsidy rate. The model also did not use the Credit Subsidy Calculator (CSC2) for determining discount rates as required by OMB.

### FHA Response:

FHA updated a discounting formula to correctly reflect the net present valued cash flows. The change did not affect any aspect of performance of the HECM program and was related only to the discounting of future cash flows. The change corrected an overestimate of HECM liability by \$189 million.

HECM loans are disbursed based on borrower preferences over an extended period of time. Because of the complexity of the disbursement schedule and the limited amount of historical data, FHA has used the maximum claim amount as a proxy for total disbursements. FHA believes that this approach best reflects the nature of the program. Believing that FHA should base its credit subsidy estimates on disbursements over the life of the loan, the auditors cited OMB guidance and urged FHA to change its discounting method from using the single effective rate basket of zero (BOZ) discount factors to the budget BOZ discount factors. FHA made the changes requested by the auditors, which resulted in a presumed decrease of \$166 million in liability. Although FHA made the change, it will raise this topic with OMB during this year's discussions of technical budget and modeling issues. OMB has not objected to the use of the maximum claim amount for credit subsidy modeling in previous years. FHA believes that once

## Appendix B Management's Response

OMB reviews this issue, there is a high probability that the single effective rate will be put back in the model. The basket of zero discount rates are directly downloaded from the CSC2 for all Cohorts as required by OMB.

### Audit Finding: Validation

FHA completed a validation review of the HECM cash flow model in June 2007 and noted discrepancies discussed above regarding premiums and assignments. Management's conclusions did not indicate whether changes to the model or its assumptions were needed to address the findings. There is no evidence that the model or its assumptions for FY2007 were revised as a result of these validation findings. FHA also did not document its review of a sensitivity analysis in connection with the validation review.

### FHA Response:

FHA annually compares projected and actual cash flows and documents the results in the validations report. This year, FHA found variances in a few of the HECM variables, like pre-assignment and assignment claims, which were documented in FHA's plans for revisions to its FY 2007 model. Given the brief duration of the HECM program, FHA expects variances in the short-term, but expects them to subside in the long-term.

### FHA Response to Recommendations

Audit Recommendation: Enhance its documentation on how specific assignment and termination rates are calculated and how macroeconomic projections are incorporated

FHA Response: FHA will further document how specific assignment and termination rates are calculated and how macroeconomic projections are incorporated in its models.

Audit Recommendation: Document the results of the current pricing and termination model reviews and their effect on the methodology for calculating future cash flow reestimates.

FHA Response: FHA will further document the results of the current pricing and termination model reviews and their effect on the methodology for calculating future cash flow reestimates.

Audit Recommendation: Document any impact on the FY2007 HECM liability reestimate as a result of these changes

FHA Response: FHA has already calculated the FY 2007 HECM liability reestimate in the course of the FY 2007 audit.

Audit Recommendation: Document FHA's conclusion on how recent HUD studies on HECM experience can be used to improve the calculation of the model's calculated assumptions how recent HUD studies on HECM experience can be used to improve the calculation of the model's calculated assumptions

FHA Response: FHA will continue to incorporate the results of HUD studies on the HECM program in its cash flow model assumptions.

Audit Recommendation: Establish procedures to compare the actual premium collections and post-assignment terminations to the balances in the model

## Appendix B Management's Response

FHA Response: FHA already incorporates program data as appropriate into its cash flow model.

Audit Recommendation: Use the OMB approved CSC2 calculator in the model

FHA Response: FHA already uses the CSC2 calculator for HECM credit subsidy estimation.

Audit Recommendation: Ensure the propriety of the discounting algorithm used in next year's model

FHA Response: FHA will ensure the propriety of its discounting formulas.

Audit Recommendation: Reevaluate the assumption for calculating note recoveries to better reflect the "crossover risk" in the recovery cash flows

FHA Response: FHA will continue to improve its method for estimating note recoveries as historical data accumulates.

Audit Recommendation: Incorporate the use of disbursements into the calculation of the credit subsidy rate

FHA Response: FHA will discuss with OMB the wisdom of using disbursements for the calculation of the HECM credit subsidy rate.

Audit Recommendation: Document a sensitivity analysis of the variables within the cash flow model

FHA Response: FHA has performed and will continue to perform innumerable sensitivity analyses of variables in the cash flow model.

Audit Recommendation: Develop a more formal process for documenting management's conclusions regarding required model modifications as a result of the annual validation process.

FHA Response: FHA already has a formal process for documenting management's conclusions regarding needed model changes. It takes the form of a memo for signature by the DAS for Finance and Budget describing the current year's proposed changes to the cash flow model.

### Report on Internal Controls – Significant Deficiencies

#### 3. FHA system security controls need improvement.

**FHA concurs with this finding.** FHA management has already taken actions to implement the information security risk-based management framework recommended by Office of Inspector General auditors. The Deputy Assistant Secretaries for the Office of Single Family Housing, the Office of Multifamily Housing, and Office of Finance and Budget have already designated Information System Security Officers (ISSOs) for their respective lines of business. This will improve dissemination and coordination of security requirements. The Office of Housing's ISSO has met with the designated program office ISSOs, discussed their roles and responsibilities, and developed standard operating procedures for managing IT security compliance requirements.

## Appendix B Management's Response

The Office of Housing and FHA have focused management attention across all offices to address system deficiencies previously identified in the Plans of Actions and Milestones (POA&Ms) for 36 major Housing and FHA systems and reduced the number of weaknesses by 55%. We continue to review the POA&M weaknesses and will see substantial reductions as additional security documents are updated and completed. Some control weaknesses may not be closed by November 30<sup>th</sup> because these changes will require additional IT development resources.



## Appendix C UKW's Assessment of Management's Response

UKW has obtained and reviewed FHA management's response to the findings and recommendations made in connection with our audit of FHA's 2007 Principal Financial Statements, which is included as Appendix B. We did not perform audit procedures on FHA's written response to the significant deficiencies and material weaknesses and accordingly, we express no opinion on it. Our assessment of management's responses is discussed below.

### **Assessment of management's response to significant deficiency (material weakness) No. 1:**

We appreciate management's concern over the expression of the HECM internal controls as a material weakness. We believe that Statement of Auditing Standards (SAS) No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, was developed to help auditors proactively identify and report risks to reliable financial reporting rather than waiting for actual errors to occur before reporting the weaknesses to management. SAS 112 states: "*The significance of a control deficiency depends on the potential for a misstatement, not on whether a misstatement actually has occurred. Accordingly, the absence of identified misstatement does not provide evidence that identified control weaknesses are not significant deficiencies or material weaknesses.*"

We acknowledge that the classification of this matter as a material weakness is a matter of professional judgment and is not clear cut. We have conducted several discussions with management to clarify the definition of materiality as it related to management assertions and assessment of materiality for evaluating internal controls. However, we believe the factors described in the finding provide a reasonable basis for our determination.

We believe that the first steps have been undertaken for a long term solution, but we do not believe the recommendations are unclear and are concerned that FHA has not committed to implementing all or any of the proposed recommendations which are aimed at mitigating the control risks for the short term and enhancing the effectiveness of the implementation of any new or modified HECM systems.

A comprehensive program risk assessment should document the anticipated program environment in the near term and the resource requirements needed to support its needs. In a manually intensive business process environment, this assessment should focus on documenting how FHA can ensure it has adequate personnel to ensure the HECM transactions related to endorsements, note assignments, borrower payments, and note terminations can be recorded timely and accurately with the anticipated significant increases in transaction volume. OMB Circular A-130, *Management of Federal Information Resources*, states:

*Establish oversight mechanisms that require periodic review of information systems to determine how mission requirements might have changed, and whether the information system continues to fulfill ongoing and anticipated mission requirements. These mechanisms must also require information regarding the future levels of performance, interoperability, and maintenance necessary to ensure the information system meets mission requirements cost effectively;*

## Appendix C UKW's Assessment of Management's Response

A functional systems requirement document is a technical design of a system which must consider the future systems operational and control environment to be effective or else the new system, once implemented, may not be capable of handling the transaction or user volume required.

We were not provided or made aware of the management review of the SMART system referred to by either the contractor or FHA but, based on the description provided, this review does not appear to provide the written audit assurance on the general systems and privacy controls required by Federal regulation.

Implementing automated interfaces with FHASL could significantly reduce the amount of duplicated data entry now performed and reduce the risk of data error.

### **Assessment of management's response to significant deficiency (material weakness) No. 2:**

As with the first finding above, we believe there are a number of factors that combine to lead to our assessment of the HECM cash flow model reestimate process as a material weakness. As indicated by management's response, there is a tremendous amount of effort currently underway in evaluating the assumptions of the HECM program now that there is more historical data for analysis. We look forward to seeing this additional information incorporated into the documentation and analysis of future HECM subsidy reestimates.

However, the nature and extent of management's analysis and documentation provided for audit review in support of its HECM program FY2007 reestimate calculation had not significantly changed from prior years despite the growth in the program and is not as extensive as that provided in support of the other FHA single family or multifamily program subsidy models. We believe insufficient analysis was a contributing factor to the three material technical errors in the model. The rapid growth in the program volume combined with changes in interest rates and the decline in the overall housing market complicates effective analysis of the model's results. This greatly increases the risk for errors in the estimation methodology not being detected timely.

FHA's responses to our recommendations do not fully address our concerns as documented. Recommendation 2c addresses documenting whether there would be any monetary impact to the current year liability if the enhancements to the models were implemented for FY2007. While the impact of technical model changes is normally documented in FHA's decomposition process, significant changes in liabilities caused solely by changes in the estimation methodology may be relevant to the readers of the FY2008 financial statements.

Recommendation 2e focuses on additional tests to be performed as part of the annual validation review whereby premium data from the HECM premium billing system (F12) and actual post-assignment terminations from SMART can be compared to the prior year's projected volume to enhance management's assessment of the models performance.

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## Appendix C UKW's Assessment of Management's Response

Recommendation 2f is to incorporate the use of the CSC2 calculator into the complete model documentation submitted for audit to enhance our review and assessment of compliance with OMB policy.

Recommendation 2j is aimed at obtaining a documented sensitivity analysis similar to that already generated for each of the four single family and eighteen multifamily risk categories. FHA should incorporate this sensitivity analysis functionality directly into the cash flow models for routine analysis by management and auditors.

Recommendation 2k is to enhance the linkage between the variances observed and conclusions drawn in the annual validation review, management's overall conclusions regarding the effectiveness of the model and the decisions regarding any enhancements needed to the model as documented in the Deputy Assistant Secretary for Finance and Budget (DAS) memo.

We have clarified the language in our recommendations in response to management's comments related to recommendations 2c, 2e, 2f and 2k.

### **Assessment of management's response to significant deficiency No. 3:**

While management has concurred with the finding, their response does not provide specific information on the actions taken to implement a risk-based management framework. Management has also not outlined the plan for correcting the remaining system vulnerabilities, or indicated whether the designated Information System Security Officers (ISSOs) will be responsible for completing the remaining tasks (i.e. risk assessment updates, self assessments, security plan updates, etc.).

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## Appendix D Status of Prior Year Findings and Recommendations

Our assessment of the current status of reportable conditions and material weaknesses identified in prior year audits is presented below:

| <b><i>Prior Finding/Recommendation</i></b>   | <b><i>Type</i></b>        | <b><i>Fiscal Year 2006 Status</i></b>   |
|--|---------------------------|---|
| 1a. FHA's Assistant Secretary for Housing should implement interim Headquarters and field control policies and procedures to ensure that effective funds control is maintained until full implementation and integration of the subsidiary application systems is accomplished                                     | 2006 Reportable Condition | Resolved. FHA has incorporated Headquarters and field funds control policies and procedures.  |
| 1b. FHA's Assistant Secretary for Housing should effectively coordinate with HUD's Office of the Chief Procurement Officer to ensure expired or inactive contracts are promptly closed out and that any excess funds, including the \$107,176,596 identified in the FY2006 audit, are deobligated timely           |                           | Resolved. FHA has deobligated about \$107,169,096 of the \$107,179,596 expired or inactive contracts in FY 2007. The remaining \$7,500 could not be deobligated due to legal issues. UHY did not identify any material expired or inactive contracts to be deobligated in FY 2007.                                    |
| 2a. The HUD Chief Information Officer should ensure that the Deputy Chief Information Officer for Security maintain current and complete records of User Access Request (UAR) forms for all FHA application systems.   | 2006 Reportable Condition | Issue has been substantially resolved by FHA. However, assurance over access security cannot be obtained without fully implementing recommendation 2b. Remaining issues are included in the FY 2007 Management Letter   |
| 2b. The FHA Comptroller should ensure that each FHA application owner reviews and updates their user access list annually and reconciles their records with the ADP Security Office. The UAR forms should be electronically stored by the HITS contractor in a non-editable format in the Lotus Notes environment. |                           | See Finding No. 3 Partially resolved. FHA management has updated their user access lists for recording in CHAMPS. The OCIO plan is to migrate all the data to the new CHAMPS repository for central user access by September 2008. Our remaining recommendations to FHA are included in the FY2007 Management Letter. |
| 3a. The HUD Chief Information Officer should ensure that the disaster recovery backup plans maintained by the HITS contractor are updated to include FHASL. The backup plans should also be tested to ensure data can be restored within the contractually required timeframe.                                     | 2006 Reportable Condition | Resolved. The disaster recovery backup plans were successfully tested in March 2007 and again in September 2007.  |

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PRINCIPAL  
FINANCIAL  
STATEMENTS

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**FEDERAL HOUSING ADMINISTRATION**  
**(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)**  
**CONSOLIDATED BALANCE SHEETS**  
**As of September 30, 2007 and 2006**  
**(Dollars in Millions)**

|  | <u>2007</u>          | <u>2006</u>          |
|--|----------------------|----------------------|
| <b>ASSETS</b>  |                      |                      |
| Intragovernmental  |                      |                      |
| Fund Balance with U.S. Treasury (Note 3)                       | \$ 9,559             | \$ 10,568            |
| Investments (Note 4)   | 22,481               | 22,012               |
| Other Assets (Note 7)  | 4                    | 24                   |
| Total Intragovernmental  | 32,044               | 32,604               |
| Investments (Note 4)   | 121                  | 98                   |
| Accounts Receivable, Net (Note 5)                              | 119                  | 168                  |
| Loans Receivable and Related Foreclosed Property, Net (Note 6) | 4,738                | 4,283                |
| Other Assets (Note 7)  | 143                  | 140                  |
| <b>TOTAL ASSETS</b>  | <b>\$ 37,165</b>     | <b>\$ 37,293</b>     |
| <br><b>LIABILITIES</b>   |                      |                      |
| Intragovernmental  |                      |                      |
| Borrowings from U.S. Treasury (Note 9)                         | 4,573                | 6,258                |
| Other Liabilities (Note 10)                                    | 3,657                | 2,486                |
| Total Intragovernmental  | 8,230                | 8,744                |
| Accounts Payable (Note 8)                                      | 385                  | 396                  |
| Loan Guarantee Liability (Note 6)                              | 7,431                | 3,482                |
| Debentures Issued to Claimants (Note 9)                        | 70                   | 95                   |
| Other Liabilities (Note 10)                                    | 474                  | 577                  |
| <b>TOTAL LIABILITIES</b>                                       | <b>16,590</b>        | <b>13,294</b>        |
| <br><b>NET POSITION</b>  |                      |                      |
| Unexpended Appropriations (Note 16)                            | 544                  | 594                  |
| Cumulative Results of Operations                               | 20,031               | 23,405               |
| <b>TOTAL NET POSITION</b>                                      | <b>20,575</b>        | <b>23,999</b>        |
| <br><b>TOTAL LIABILITIES AND NET POSITION</b>                  | <br><b>\$ 37,165</b> | <br><b>\$ 37,293</b> |

The accompanying notes are an integral part of these statements.

**FEDERAL HOUSING ADMINISTRATION**  
**(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)**  
**CONSOLIDATED STATEMENTS OF NET COST**  
**For the periods ended September 30, 2007 and 2006**  
**(Dollars in Millions)**

|  | <u>2007</u>     | <u>2006</u>       |
|--|-----------------|-------------------|
| <b><i>MMI/CMHI PROGRAM COSTS</i></b>             |                 |                   |
| Intragovernmental Gross Costs (Note 12)          | \$ 284          | \$ 387            |
| Less: Intragovernmental Earned Revenue (Note 13) | <u>1,299</u>    | <u>1,334</u>      |
| Intragovernmental Net Costs                      | (1,015)         | (947)             |
| <br>   |                 |                   |
| Gross Costs with the Public (Note 12)            | 4,700           | 1,135             |
| Less: Earned Revenue from the Public (Note 13)   | <u>24</u>       | <u>94</u>         |
| Net Costs with the Public                        | <u>4,676</u>    | <u>1,041</u>      |
| <b>NET MMI/CMHI PROGRAM COST (SURPLUS)</b>       | <b>\$ 3,661</b> | <b>\$ 94</b>      |
| <br>   |                 |                   |
| <b><i>GI/SRI PROGRAM COSTS</i></b>               |                 |                   |
| Intragovernmental Gross Costs (Note 12)          | \$ 141          | \$ 147            |
| Less: Intragovernmental Earned Revenue (Note 13) | <u>107</u>      | <u>188</u>        |
| Intragovernmental Net Costs                      | 34              | (41)              |
| <br>   |                 |                   |
| Gross Costs with the Public (Note 12)            | (1,235)         | (2,049)           |
| Less: Earned Revenue from the Public (Note 13)   | <u>91</u>       | <u>85</u>         |
| Net Costs with the Public                        | <u>(1,326)</u>  | <u>(2,134)</u>    |
| <b>NET GI/SRI PROGRAM COST (SURPLUS)</b>         | <b>(1,292)</b>  | <b>(2,175)</b>    |
| <br>   |                 |                   |
| <b>NET COST (SURPLUS) OF OPERATIONS</b>          | <b>\$ 2,369</b> | <b>\$ (2,081)</b> |

The accompanying notes are an integral part of these statements.

**FEDERAL HOUSING ADMINISTRATION**  
**(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)**  
**CONSOLIDATED STATEMENTS OF CHANGES IN NET POSITION**  
**For the periods ended September 30, 2007 and 2006**  
**(Dollars in Millions)**

|   | <u>2007</u><br>Cumulative<br>Results of<br>Operations | <u>2007</u><br>Unexpended<br>Appropriations | <u>2006</u><br>Cumulative<br>Results of<br>Operations | <u>2006</u><br>Unexpended<br>Appropriations |
|---|---|---|---|---|
| <b>BEGINNING BALANCES</b>                 | \$ 23,405   | \$ 594                                      | \$ 22,546   | \$ 609                                      |
| <b><i>BUDGETARY FINANCING SOURCES</i></b> |   |   |   |   |
| Appropriations Received (Note 16)         | -   | 1,252                                       | -   | 1,281                                       |
| Other Adjustments (Note 16)               | 2   | (119)                                       | -   | (83)  |
| Appropriations Used (Note 16)             | 415   | (415)                                       | 1,178   | (1,178)                                     |
| Transfers-Out (Note 15 and Note 16)       | (1,014)   | (768)                                       | (731)   | (35)  |
| <b><i>OTHER FINANCING SOURCES</i></b>     |   |   |   |   |
| Transfers-Out (Note 15)                   | (445)   | -   | (1,692)   | -   |
| Imputed Financing (Note 12)               | 37  | -   | 23  | -   |
| <b>TOTAL FINANCING SOURCES</b>            | <b>(1,005)</b>  | <b>(50)</b>                                 | <b>(1,222)</b>  | <b>(15)</b>                                 |
| <b>NET (COST) SURPLUS OF OPERATIONS</b>   | <b>(2,369)</b>  | <b>-</b>                                    | <b>2,081</b>  | <b>-</b>                                    |
| <b>ENDING BALANCES</b>                    | <b>\$ 20,031</b>                                      | <b>\$ 544</b>                               | <b>\$ 23,405</b>                                      | <b>\$ 594</b>                               |

The accompanying notes are an integral part of these statements.

**FEDERAL HOUSING ADMINISTRATION**  
**(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)**  
**COMBINED STATEMENT OF BUDGETARY RESOURCES**  
**For the period ended September 30, 2007**  
**(Dollars in Millions)**

|  | <u>2007</u><br>Budgetary | <u>2007</u><br>Non-Budgetary | <u>2007</u><br>Total |
|--|--------------------------|------------------------------|----------------------|
| <b><i>BUDGETARY RESOURCES</i></b>  |                          |                              |                      |
| Unobligated Balance, brought forward, October 1                                | \$ 22,390                | \$ 7,032                     | \$ 29,422            |
| Recoveries of prior year unpaid obligations                                    | 89                       | 124                          | 213                  |
| Budget Authority:  |                          |                              |                      |
| Appropriations   | 1,252                    | 2                            | 1,254                |
| Borrowing authority  | 15                       | 602                          | 617                  |
| Spending authority from offsetting collections (gross):                        |                          |                              |                      |
| Earned   |                          |                              |                      |
| Collected (Note 18)  | 2,057                    | 9,104                        | 11,161               |
| Change in receivables from Federal sources                                     | 56                       | 42                           | 98                   |
| Change in unfilled customer order w/o advance                                  | -                        | (4)                          | (4)                  |
| Nonexpenditure transfers net (Note 19)   | (609)                    | -                            | (609)                |
| Permanently not available  | (291)                    | (2,315)                      | (2,606)              |
| <b>TOTAL BUDGETARY RESOURCES</b>   | <b>\$ 24,959</b>         | <b>\$ 14,587</b>             | <b>\$ 39,546</b>     |
| <b><i>STATUS OF BUDGETARY RESOURCES</i></b>                                    |                          |                              |                      |
| Obligations incurred, Direct (Note 20)   | \$ 2,116                 | \$ 10,510                    | \$ 12,626            |
| Unobligated balance-Apportioned  | 187                      | 993                          | 1,180                |
| Unobligated balance-Not available  | 22,656                   | 3,084                        | 25,740               |
| <b>TOTAL STATUS OF BUDGETARY RESOURCES</b>                                     | <b>\$ 24,959</b>         | <b>\$ 14,587</b>             | <b>\$ 39,546</b>     |
| <b><i>Change in Obligated Balances</i></b>                                     |                          |                              |                      |
| Obligated balance, net:  |                          |                              |                      |
| Unpaid obligations, brought forward, October 1                                 | \$ 980                   | \$ 1,377                     | \$ 2,357             |
| Uncollected customer payments from Federal sources, brought forward, October 1 | (207)                    | (7)                          | (214)                |
| Total, unpaid obligated balance, brought forward, net                          | 773                      | 1,370                        | 2,143                |
| Obligations incurred (Note 20)   | 2,116                    | 10,510                       | 12,626               |
| Gross outlays  | (2,053)                  | (10,420)                     | (12,473)             |
| Recoveries of prior-year unpaid obligations, actual                            | (89)                     | (124)                        | (213)                |
| Change in uncollected customer payments-Federal sources                        | (56)                     | (38)                         | (94)                 |
| Total, unpaid obligated balance, net, end of period                            | 691                      | 1,298                        | 1,989                |
| Obligated balance, net, end of period:   |                          |                              |                      |
| Unpaid obligations   | 954                      | 1,342                        | 2,296                |
| Uncollected customer payments from Federal sources                             | (263)                    | (44)                         | (307)                |
| Total, unpaid obligated balance, net, end of period                            | 691                      | 1,298                        | 1,989                |
| Net outlays:   |                          |                              |                      |
| Gross outlays  | 2,053                    | 10,420                       | 12,473               |
| Offsetting collections (Note 18)   | (2,057)                  | (9,104)                      | (11,161)             |
| Less: Distributed offsetting receipts  | 2,759                    | -                            | 2,759                |
| <b>NET OUTLAYS</b>   | <b>\$ (2,763)</b>        | <b>\$ 1,316</b>              | <b>\$ (1,447)</b>    |

**The accompanying notes are an integral part of these statements.**

**FEDERAL HOUSING ADMINISTRATION**  
**(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)**  
**COMBINED STATEMENT OF BUDGETARY RESOURCES**  
**For the period ended September 30, 2006**  
**(Dollars in Millions)**

|  | <u>2006</u><br>Budgetary | <u>2006</u><br>Non-Budgetary | <u>2006</u><br>Total |
|--|--------------------------|------------------------------|----------------------|
| <b><i>BUDGETARY RESOURCES</i></b>  |                          |                              |                      |
| Unobligated Balance, brought forward, October 1                                | \$ 23,602                | \$ 5,891                     | \$ 29,493            |
| Recoveries of prior year unpaid obligations                                    | 97                       | 6                            | 103                  |
| Budget Authority:  |                          |                              |                      |
| Appropriations   | 1,281                    | -                            | 1,281                |
| Borrowing authority  | 9                        | 888                          | 897                  |
| Spending authority from offsetting collections (gross):                        |                          |                              |                      |
| Earned   | -                        | -                            | -                    |
| Collected (Note 18)  | 2,636                    | 11,470                       | 14,106               |
| Change in receivables from Federal sources                                     | (55)                     | (46)                         | (101)                |
| Change in unfilled customer order w/o advance                                  | -                        | -                            | -                    |
| Nonexpenditure transfers net (Note 19)   | -                        | -                            | -                    |
| Permanently not available  | (152)                    | (2,186)                      | (2,338)              |
| <b>TOTAL BUDGETARY RESOURCES</b>   | <b>\$ 27,418</b>         | <b>\$ 16,023</b>             | <b>\$ 43,441</b>     |
| <b><i>STATUS OF BUDGETARY RESOURCES</i></b>                                    |                          |                              |                      |
| Obligations incurred, Direct (Note 20)   | \$ 5,028                 | \$ 8,990                     | \$ 14,018            |
| Unobligated balance-Appportioned   | 161                      | 2,132                        | 2,293                |
| Unobligated balance-Not available  | 22,229                   | 4,901                        | 27,130               |
| <b>TOTAL STATUS OF BUDGETARY RESOURCES</b>                                     | <b>\$ 27,418</b>         | <b>\$ 16,023</b>             | <b>\$ 43,441</b>     |
| <b><i>Change in Obligated Balances</i></b>                                     |                          |                              |                      |
| Obligated balance, net:  |                          |                              |                      |
| Unpaid obligations, brought forward, October 1                                 | \$ 1,067                 | \$ 1,263                     | \$ 2,330             |
| Uncollected customer payments from Federal sources, brought forward, October 1 | (262)                    | (52)                         | (314)                |
| Total, unpaid obligated balance, brought forward, net                          | 805                      | 1,211                        | 2,016                |
| Obligations incurred (Note 20)   | 5,028                    | 8,990                        | 14,018               |
| Gross outlays  | (5,018)                  | (8,871)                      | (13,889)             |
| Recoveries of prior-year unpaid obligations, actual                            | (97)                     | (6)                          | (103)                |
| Change in uncollected customer payments-Federal sources                        | 55                       | 46                           | 101                  |
| Total, unpaid obligated balance, net, end of period                            | 773                      | 1,370                        | 2,143                |
| Obligated balance, net, end of period:   |                          |                              |                      |
| Unpaid obligations   | 980                      | 1,377                        | 2,357                |
| Uncollected customer payments from Federal sources                             | (207)                    | (7)                          | (214)                |
| Total, unpaid obligated balance, net, end of period                            | 773                      | 1,370                        | 2,143                |
| Net outlays:   |                          |                              |                      |
| Gross outlays  | 5,018                    | 8,871                        | 13,889               |
| Offsetting collections (Note 18)   | (2,636)                  | (11,470)                     | (14,106)             |
| Less: Distributed offsetting receipts  | 677                      | -                            | 677                  |
| <b>NET OUTLAYS</b>   | <b>\$ 1,705</b>          | <b>(2,599)</b>               | <b>\$ (894)</b>      |

**The accompanying notes are an integral part of these statements.**

## **NOTES TO FINANCIAL STATEMENTS**

### **September 30, 2007**

#### **Note 1. Significant Accounting Policies**

##### **Entity and Mission**

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

FHA administers a wide range of activities to make mortgage financing more accessible to the home-buying public and to increase the availability of affordable housing to families and individuals, particularly to the nation's poor and disadvantaged. FHA insures private lenders against loss on mortgages, which finance Single Family homes, Multifamily projects, health care facilities, property improvements, manufactured homes, and reverse mortgages (also referred to as HECM). The objectives of the activities carried out by FHA relate directly to developing affordable housing.

FHA categorizes its activities as Single Family, Multifamily, or Title I. Single Family activities support initial or continued home ownership; Multifamily activities support high-density housing and medical facilities; Title I activities support manufactured housing and property improvement.

FHA organizes its operations into two overall program types – MMI/CMHI and GI/SRI. These program types are composed of four major funds. The Mutual Mortgage Insurance fund (MMI), FHA's largest fund, provides basic Single Family mortgage insurance and is a mutual insurance fund, whereby mortgagors, upon non-claim termination of their mortgages, share surplus premiums paid into the MMI fund that are not required for operating expenses and losses or to build equity. The Cooperative Management Housing Insurance fund (CMHI), another mutual fund, provides mortgage insurance for management-type cooperatives. The General Insurance fund (GI), provides a large number of specialized mortgage insurance activities, including insurance of loans for property improvements, cooperatives, condominiums, housing for the elderly, land development, group practice medical facilities, nonprofit hospitals, and reverse mortgages. 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.

##### **Basis of Accounting**

The principal financial statements are presented in conformity with accounting principles generally accepted in the United States of America (GAAP) applicable to Federal agencies as promulgated by the Federal Accounting Standards Advisory Board (FASAB). The recognition and measurement of budgetary resources and their status for purposes of preparing the Combined Statements of Budgetary Resources, is based on concepts and guidance provided by Office of Management and Budget (OMB) Circular A-11, *Preparation, Submission, and Execution of the Budget*. The format of the SBR is based on the SF 133, *Report on Budget Execution and Budgetary Resources*.

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## **Basis of Consolidation**

The accompanying principal financial statements include all Treasury Account Fund Symbols (TAFSS) designated to FHA, which consist of two principal program funds, six revolving funds, two general funds and a deposit fund. All inter-fund accounts receivable, accounts payable, transfers in and transfers out within these TAFSS have been eliminated to prepare the consolidated balance sheets, statements of net cost, and statements of changes in net position. The statement of budgetary resources is prepared on a combined basis as allowed by OMB Circular A-136, *Financial Reporting Requirements*.

## **Fund Balance with U.S. Treasury**

Fund balance with U.S. Treasury consists of amounts collected and available to fund payments for expenses and of amounts collected but unavailable until authorizing legislation is enacted (see Notes 2 and 3).

## **Investments**

FHA investments include investments in U.S. Treasury securities, Multifamily risk sharing debentures and investments in private-sector entities where FHA is a member with other parties under the Accelerated Claims Disposition Demonstration program (see Note 4).

Under current legislation, FHA invests available MMI/CMHI capital reserve fund resources in excess of its current needs in non-marketable market-based U.S. Treasury securities. These U.S. Treasury securities may not be sold on public securities exchanges, but do reflect prices and interest rates of similar marketable U.S. Treasury securities. Investments are presented at acquisition cost net of unamortized premium or discount. Amortization of the premium or discount is recognized monthly in interest income on investments in U.S. Treasury securities on the effective interest rate basis.

The Departments of Veterans Affairs and Housing and Urban Development Appropriations Act of 1999 and Section 601 of the Independent Agencies Act of 1999 provide FHA with new flexibility in reforming its Single Family claims and property disposition activities. In accordance with these Acts, FHA implemented the Accelerated Claims Disposition Demonstration program (the 601 program) to shorten the claim filing process, obtain higher recoveries from its defaulted guaranteed loans, and support the Office of Housing's mission of keeping homeowners in their home. To achieve these objectives, FHA transfers assigned mortgage notes to private sector entities in exchange for cash and equity interest. The servicing and disposition of the mortgage notes are performed by the private-sector entities whose primary mission is dedicated to these types of activity. With the transfer of assigned mortgage notes under the 601 program, FHA obtains ownership interest in the private-sector entities. This level of ownership interest enables FHA to exercise significant influence over the operating and financial policies of the entities. Accordingly, to comply with the requirement of Opinion No. 18 issued by the Accounting Principles Board (APB 18), FHA uses the equity method of accounting to measure the value of its investments in these entities. The equity method of accounting requires FHA to record its investments in the entities at cost initially. Periodically, the carrying amount of the investments is adjusted for cash distributions to FHA and for FHA's share of the entities' earnings or losses.

Multifamily Risk Sharing Debentures [Section 542(c)] is a program available to lenders. The lender shares the risk in a property by issuing debentures for claim amount paid by FHA on defaulted insured loans. HUD must approve FHA's participation in the risk sharing program and determines the portion of risk FHA assumes. If FHA's risk is over 50%, HUD must review and approve the underwriting standards, terms, and conditions of the loan. If the loan defaults, the lender has 75 days to file a claim with FHA. FHA then pays the lender the initial settlement. The initial settlement is the Unpaid Principal Balance (UPB) and interest at the note rate from the date of the default to the date of the initial settlement. On the settlement date the lender issues FHA a debenture for the amount of the settlement at the note rate (determined by the U.S. Treasury) thus sharing the risk in the property. The percentage of risk for each party is stated in the debenture. Interest is accrued monthly and is paid on the

anniversary date of the initial settlement. Only interest payments are required. The term of the debenture is 5 years. The debenture can be redeemed early if the property is sold. The lender will be paid their percentage of risk sharing from the net proceeds of the sale of the property after adjustments for escrows, reserve for placement, and interest on debenture, hazard insurance and property repairs. The net amount is considered to be the final claim profit or loss.

### **Credit Reform Accounting**

The FCRA established the use of program, financing, general fund receipt and capital reserve accounts to separately account for transactions that are not controlled by the Congressional budget process. It also established the liquidating account for activity relating to any loan guarantees committed and direct loans obligated before October 1, 1991 (pre-Credit Reform). These accounts are classified as either budgetary or non-budgetary in the Combined Statements of Budgetary Resources. The budgetary accounts include the program, capital reserve and liquidating accounts. The non-budgetary accounts consist of the credit reform financing accounts.

The program account receives and obligates appropriations to cover the subsidy cost of a direct loan or loan guarantee and disburses the subsidy cost to the financing account. The program account also receives appropriations for administrative expenses. The financing account is a non-budgetary account that is used to record all of the cash flows resulting from Credit Reform direct loans or loan guarantees. It includes loan disbursements, loan repayments and fees, claim payments, borrowing from the U.S. Treasury, interest, negative subsidy and the subsidy cost received from the program account.

The general fund receipt account is used for the receipt of amounts paid from the financing account when there is a negative subsidy from the original estimate or a downward reestimate. In most cases, the receipt account is a general fund receipt account and amounts are not earmarked for the FHA's credit programs. They are available for appropriations only in the sense that all general fund receipts are available for appropriations. Any assets in this account are non-entity assets and are offset by intragovernmental liabilities. At the beginning of the following fiscal year, the fund balance in the general fund receipt account is transferred to the U.S. Treasury general fund. The FHA general fund receipt account of the GI and SRI funds are in this category.

The liquidating account is a budget account that is used to record all cash flows to and from FHA resulting from pre-Credit Reform direct loans or loan guarantees. Liquidating account collections in any year are available only for obligations incurred during that year or to repay debt. Unobligated balances remaining in the GI and SRI liquidating funds at year-end are transferred to the U.S. Treasury's general fund. Consequently, in the event that resources in the GI/SRI liquidating account are otherwise insufficient to cover the payments for obligations or commitments, the FCRA provides that the GI/SRI liquidating account can receive permanent indefinite authority to cover any resource shortages.

### **Loans Receivable and Related Foreclosed Property, Net**

FHA's loans receivable include mortgage notes assigned (MNA), also described as Secretary-held notes, and purchase money mortgages (PMM). Under the requirements of the FCRA, PMM notes are considered to be direct loans while MNA notes are considered to be defaulted guaranteed loans. The PMM loans are generated from the sales on credit of FHA's foreclosed properties to qualified non-profit organizations. The MNA notes are created when FHA pays the lenders for claims on defaulted guaranteed loans and takes assignment of the defaulted loans for direct collections. In addition, Multifamily and Single Family performing notes insured pursuant to Section 221(g)(4) of the National Housing Act may be assigned automatically to FHA at a pre-determined point.

In accordance with the FCRA and Statement of Federal Financial Accounting Standards (SFFAS) No. 2, *Accounting for Direct Loans and Loan Guarantees*, Credit Reform direct loans, defaulted guaranteed loans and foreclosed property are reported at the net present value of expected cash flows associated with these assets, primarily estimated proceeds less selling and maintenance costs. The difference between the cost of these loans



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and property and the net present value is called the allowance for subsidy cost. Pre-Credit Reform loans receivable and foreclosed property in inventory are recorded at net realizable value, which is based on historical recovery rates net of any selling expenses (see Note 6).

### **Loan Guarantee Liability**

The net potential future losses related to FHA's central business of providing mortgage insurance are reflected in the Loan Guarantee Liability in the consolidated balance sheets. As required by SFFAS No. 2, the Loan Guarantee Liability includes the Credit Reform related Liabilities for Loan Guarantees (LLG) and the pre-Credit Reform Loan Loss Reserve (LLR) (see Note 6).

The LLG is calculated as the net present value of anticipated cash outflows and cash inflows. Anticipated cash outflows include lender claims arising from borrower defaults, (i.e., claim payments), premium refunds, property costs to maintain foreclosed properties arising from future defaults and selling costs for the properties. Anticipated cash inflows include premium receipts, proceeds from asset sales and principal and interest on Secretary-held notes.

FHA records loss estimates for its Single Family LLR (includes MMI and GI/SRI) to provide for anticipated losses incurred (e.g., claims on insured mortgages where defaults have taken place but claims have not yet been filed). Using the net cash flows (cash inflows less cash outflows), FHA computes an estimate based on conditional claim rates and loss experience data, and adjusts the estimate to incorporate management assumptions about current economic factors.

FHA records loss estimates for its Multifamily LLR (includes CMHI and GI/SRI) to provide for anticipated outflows less anticipated inflows. Using the net present value of claims less premiums, fees, and recoveries, FHA computes an estimate based on conditional claim rates, prepayment rates, and recovery assumptions based on historical experience.

### **Use of Estimates**

The preparation of the principal financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

Amounts reported for net loans receivable and related foreclosed property and the Loan Guarantee Liability represent FHA's best estimates based on pertinent information available.

To estimate the allowance for subsidy (AFS) associated with loans receivable and related to foreclosed property and the liability for loan guarantees (LLG), FHA uses cash flow model assumptions associated with loan guarantee cases subject to the Federal Credit Reform Act of 1990 (FCRA), as described in Note 6, to estimate the cash flows associated with future loan performance. To make reasonable projections of future loan performance, FHA develops assumptions, as described in Note 6, based on historical data, current and forecasted program and economic assumptions.

Certain programs have higher risks due to increased chances of fraudulent activities perpetrated against FHA. FHA accounts for these risks through the assumptions used in the liabilities for loan guarantee estimates. FHA develops the assumptions based on historical performance and management's judgments about future loan performance.

## **General Property, Plant and Equipment**

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

Current HUD policy concerning SFFAS No. 10 *Accounting for Internal Use Software* indicates that HUD will either own the software or the functionality provided by the software in the case of licensed or leased software. This includes “commercial off-the-shelf” (COTS) software, contractor-developed software, and internally developed software. FHA had several procurement actions in place and had incurred expenses for software development. FHA identified and transferred those expenses to HUD to comply with departmental policy.

## **Unearned Premiums**

Unearned premiums are recognized for pre-Credit Reform loan guarantee premiums collected but not yet earned in the liquidating account. Premiums charged by FHA’s MMI fund include up-front and annual risk-based premiums. Up-front risk-based premiums are recorded as unearned revenue upon collection and are recognized as revenue over the period in which losses and insurance costs are expected to occur. Annual risk-based premiums are recognized as revenue on a straight-line basis throughout the year. FHA’s other funds charge periodic insurance premiums over the mortgage insurance term. Premiums on annual installment policies are recognized for the liquidating account on a straight-line basis throughout the year. Premiums associated with Credit Reform loan guarantees are included in the calculation of the LLG and are not included in the unearned premium amounts reported in the consolidated balance sheets.

## **Appropriations and Monies Received from Other HUD Programs**

The National Housing Act of 1990, as amended, provides for appropriations from Congress to finance the operations of GI and SRI funds. For Credit Reform loan guarantees, appropriations to the GI and SRI funds are provided at the beginning of each fiscal year to cover estimated losses on insured loans during the year. For pre-Credit Reform loan guarantees, FHA has permanent indefinite appropriation authority to finance any shortages of resources needed for operations.

Monies received from other HUD programs, such as interest subsidies and rent supplements are recorded as revenue for the liquidating accounts when services are rendered. Monies received for the financing accounts are recorded as additions to the LLG or the Allowance for Subsidy (AFS) when collected.

## **Full Cost Reporting**

SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards*, requires that Federal agencies report the full cost of program outputs in the financial statements. Full cost reporting includes all direct, indirect, and inter-entity costs. For purposes of HUD’s consolidated financial statements, HUD identifies each responsibility segment’s share of the program costs or resources provided by other Federal agencies. As a responsibility segment of HUD, FHA’s portion of these costs was \$19 million for fiscal year 2007 and \$23 million for fiscal year 2006, and was included in FHA’s financial statements as an imputed cost in the Consolidated Statements of Net Cost, and an imputed financing in the Consolidated Statements of Changes in Net Position. An additional \$18 million was included in fiscal year 2007 for a legal judgment paid by judgment fund on FHA’s behalf.

In a separate effort, FHA conducts time allocation surveys of all Office of Housing operational managers. These surveys determine FHA’s direct personnel costs associated with the Housing Salaries and Expenses (S&E) transfer to HUD and where to allocate these costs between the MMI/CMHI and GI/SRI programs. The HUD Chief Financial Officer (CFO) office also conducts surveys to determine how the department’s fiscal year overhead, Office of Inspector General, and Working Capital Fund costs, which are paid for by S&E transfer,

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should be accounted for by responsibility segments. This data is an integral part of the FHA direct cost S&E allocation prepared for financial statement reporting.

### **Distributive Shares**

As mutual funds, excess revenues in the MMI Fund and CMHI Fund may be distributed to mortgagors at the discretion of the Secretary of HUD. Such distributions are determined based on the funds' financial positions and their projected revenues and costs. As previously discussed, in November 1990, Congress passed the NAHA, which effectively suspended payment of distributive shares from the MMI fund, other than those already declared by the Secretary, until the fund meets certain Capital Ratio requirements. Although the Capital Ratio requirement has been met since September 30, 1995, no distributive shares have been declared from the MMI fund because legislation is not yet enacted.

### **Liabilities Covered by Budgetary Resources**

Liabilities of federal agencies are required to be classified as those covered and not covered by budgetary resources, as defined by OMB Circular A-136, and in accordance with SFFAS No. 1, *Selected Assets and Liabilities*. In the event that available resources are insufficient to cover liabilities due at a point in time, FHA has authority to borrow monies from the U.S. Treasury (for post-1991 loan guarantees) or to draw on permanent indefinite appropriations (for pre-1992 loan guarantees) to satisfy the liabilities. Thus, all of FHA's liabilities are considered covered by budgetary resources.

### **Statement of Budgetary Resources**

The Statement of Budgetary Resources has been prepared as a combined statement and as such, intra-entity transactions have not been eliminated. Budget authority is the authorization provided by law to enter into obligations to carry out the guaranteed and direct loan programs and their associated administrative costs, which would result in immediate or future outlays of federal funds. FHA's budgetary resources include current budgetary authority (i.e., appropriations and borrowing authority) and unobligated balances brought forward from multi-year and no-year budget authority received in prior years, and recoveries of prior year obligations. Budgetary resources also include spending authority from offsetting collections credited to an appropriation or fund account.

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

FHA funds its programs through borrowings from the U.S. Treasury and debentures issued to the public. These borrowings and debentures are authorized through a permanent indefinite authority at interest rates set each year by the U.S. Treasury and the prevailing market rates.

**Note 2. Non-entity Assets**

Non-entity assets consist of assets that belong to other entities but are included in FHA's consolidated balance sheets. To reflect FHA's net position accurately, these non-entity assets are offset by various liabilities. FHA's non-entity assets as of September 30, 2007 and 2006 are as follows:

| (Dollars in millions)                   | <b>2007</b>      | <b>2006</b>      |
|---|------------------|------------------|
| Intragovernmental:                      |                  |                  |
| Fund Balance with U.S. Treasury         | \$ 2,828         | \$ 731           |
| Investments in U.S. Treasury Securities | 5                | 5                |
| <b>Total Intragovernmental</b>          | <b>2,833</b>     | <b>736</b>       |
| <b>Other Assets</b>                     | <b>110</b>       | <b>111</b>       |
| <b>Total Non-entity Assets</b>          | <b>2,943</b>     | <b>847</b>       |
| <b>Total Entity Assets</b>              | <b>34,222</b>    | <b>36,446</b>    |
| <b>Total Assets</b>                     | <b>\$ 37,165</b> | <b>\$ 37,293</b> |

FHA's non-entity assets consist of FHA's U.S. Treasury deposit of negative credit subsidy in the GI/SRI general fund receipt account and of escrow monies collected by FHA from the borrowers of its loans.

According to the FCRA, FHA transfers negative credit subsidy from new endorsements and downward credit subsidy reestimates from the GI/SRI financing account to the GI/SRI general fund receipt account. At the beginning of each fiscal year, fund balance in the GI/SRI general fund receipt account is transferred into the U.S. Treasury's general fund.

Other assets consisting of escrow monies collected from FHA borrowers are either deposited at the U.S. Treasury or Minority-owned banks or invested in U.S. Treasury securities. Subsequently, FHA disburses these escrow monies to pay for property taxes, property insurance or maintenance expenses on behalf of the borrowers.

### **Note 3. Fund Balance with U.S. Treasury**

FHA's fund balance with U.S. Treasury was composed of the following as of September 30, 2007 and 2006:

(Dollars in millions)

|                       | <b>2007</b>     | <b>2006</b>      |
|-----------------------|-----------------|------------------|
| <b>Fund Balances:</b> |                 |                  |
| Revolving Funds       | \$ 6,450        | \$ 9,393         |
| Appropriated Funds    | 321             | 408              |
| Other Funds           | 2,788           | 767              |
| <b>Total</b>          | <b>\$ 9,559</b> | <b>\$ 10,568</b> |

#### **Status of Fund Balance with U.S. Treasury:**

|                                     |                 |                  |
|-------------------------------------|-----------------|------------------|
| Unobligated Balance:                |                 |                  |
| Available                           | 1,180           | 2,292            |
| Unavailable                         | 6,083           | 5,919            |
| Obligated Balance not yet Disbursed | 2,296           | 2,357            |
| <b>Total</b>                        | <b>\$ 9,559</b> | <b>\$ 10,568</b> |

#### **Revolving Funds**

FHA's revolving funds include the liquidating and financing accounts as required by the FCRA. These funds are created to finance a continuing cycle of business-like operations in which the fund charges for the sale of products or services. These funds also use the proceeds to finance spending, usually without requirement of annual appropriations.

#### **Appropriated Funds**

FHA's appropriated funds consist of the program accounts created by the FCRA. Annual or multi-year program accounts expire at the end of the time period specified in the authorizing legislation. For the subsequent five fiscal years after expiration, the resources are available only to liquidate valid obligations incurred during the unexpired period. Adjustments are allowed to increase or decrease valid obligations incurred during the unexpired period that were not previously reported. At the end of the fifth expired year, the annual and multi-year program accounts are cancelled and any remaining resources are returned to the U.S. Treasury.

#### **Other Funds**

FHA's other funds include the general fund receipt accounts established under the FCRA. Additionally, included with these funds is the capital reserve account that is used to retain the MMI/CMHI negative subsidy and downward credit subsidy reestimates transferred from the financing account. If subsequent upward credit subsidy reestimates are calculated in the financing account or there is shortage of budgetary resources in the liquidating account, the capital reserve account will return the retained negative subsidy to the financing account or transfer the needed funds to the liquidating account, respectively.

#### **Status of Fund Balance with U.S. Treasury**

Unobligated Fund Balance with U.S. Treasury represents Fund Balance with U.S. Treasury that has not been obligated to purchase goods or services either because FHA has not received apportionment authority from OMB to use the resources (unavailable unobligated balance) or because FHA has not obligated the apportioned resources (available unobligated balance). Fund Balance with U.S. Treasury that is obligated, but not yet

disbursed, consists of resources that have been obligated for goods or services but not yet disbursed either because the ordered goods or services have not been delivered or because FHA has not yet paid for goods or services received by the end of the fiscal year.

#### **Note 4. Investments**

##### **Investment in U.S. Treasury Securities**

As discussed in Note 1, all FHA investments in Treasury securities are in non-marketable securities issued by the U.S. Treasury. These securities carry market-based interest rates. The market value of these securities is calculated using the bid amount of similar marketable U.S. Treasury securities as of September 30. The cost, par value, net unamortized discount, net investment, and market values of FHA's investments in U.S. Treasury securities as of September 30, 2007 were as follows:

(Dollars in millions)

|                           | <b>Cost</b>      | <b>Par Value</b> | <b>Unamortized Premium (Discount), Net</b> | <b>Investment, Net</b> | <b>Market Value</b> |
|---------------------------|------------------|------------------|--|------------------------|---------------------|
| MMI/CMHI Investments      | \$ 22,129        | \$ 22,405        | \$ (191)                                   | \$ 22,214              | \$ 22,667           |
| GI/SRI Investments        | 5                | 5                | -  | 5                      | 5                   |
| Subtotal                  | 22,134           | 22,410           | (191)                                      | 22,219                 | 22,672              |
| MMI/CMHI Accrued Interest | -                | -                | -  | 262                    | -                   |
| <b>Total</b>              | <b>\$ 22,134</b> | <b>\$ 22,410</b> | <b>\$ (191)</b>                            | <b>\$ 22,481</b>       | <b>\$ 22,672</b>    |

The cost, par value, net unamortized discount, net investment, and market values as of September 30, 2006 were as follows:

(Dollars in millions)

|                           | <b>Cost</b>      | <b>Par Value</b> | <b>Unamortized Premium (Discount), Net</b> | <b>Investment, Net</b> | <b>Market Value</b> |
|---------------------------|------------------|------------------|--|------------------------|---------------------|
| MMI/CMHI Investments      | \$ 21,715        | \$ 22,030        | \$ (223)                                   | \$ 21,807              | \$ 21,987           |
| GI/SRI Investments        | 6                | 6                | -  | 6                      | 6                   |
| Subtotal                  | 21,721           | 22,036           | (223)                                      | 21,813                 | 21,993              |
| MMI/CMHI Accrued Interest | -                | -                | -  | 199                    | -                   |
| <b>Total</b>              | <b>\$ 21,721</b> | <b>\$ 22,036</b> | <b>\$ (223)</b>                            | <b>\$ 22,012</b>       | <b>\$ 21,993</b>    |

### Investments in Private-Sector Entities

The following table presents financial data on FHA's investments in private-sector entities as of September 30, 2007 and 2006:

(Dollars in millions)

|             | <b>Beginning<br/>Balance</b> | <b>New<br/>Acquisitions</b> | <b>Share of<br/>Earnings<br/>or Losses</b> | <b>Return of<br/>Investment</b> | <b>Other<br/>Adjustments</b> | <b>Ending<br/>Balance</b> |
|-------------|------------------------------|-----------------------------|--|---------------------------------|------------------------------|---------------------------|
| <b>2007</b> | \$ 98                        | \$ -                        | \$ (1)                                     | \$ (56)                         | \$ -                         | \$ 41                     |
| <b>2006</b> | \$ 201                       | \$ 49                       | \$ 15                                      | \$ (167)                        | \$ -                         | \$ 98                     |

The fiscal year for these private-sector entities is from January 1 to December 31. Their condensed, audited financial information as of December 31, 2006 and 2005 are as follows:

(Dollars in millions)

|  | <b>2007</b>   | <b>2006</b>   |
|--|---------------|---------------|
| Total assets, primarily mortgage loans         | \$ 258        | \$ 422        |
| Liabilities                                    | 2             | 3             |
| Partners' capital                              | 256           | 419           |
| <b>Total liabilities and partners' capital</b> | <b>\$ 258</b> | <b>\$ 422</b> |
| Revenues                                       | 78            | 184           |
| Expenses                                       | (23)          | (20)          |
| <b>Net Income</b>                              | <b>\$ 55</b>  | <b>\$ 164</b> |

This table of investments consists of the debentures issued to FHA by lenders participating in the Multifamily Risk-Sharing program under Section 542(c) as of September 30, 2007. The cost is the amount paid at settlement date.

(Dollars in millions)

|              | <b>Beginning<br/>Balance</b> | <b>Debentures<br/>Acquired</b> | <b>Debentures<br/>Redeemed</b> | <b>Ending<br/>Balance</b> |
|--------------|------------------------------|--------------------------------|--------------------------------|---------------------------|
| Debentures   | \$ -                         | \$ 80                          | \$ -                           | \$ 80                     |
| <b>Total</b> | <b>\$ -</b>                  | <b>\$ 80</b>                   | <b>\$ -</b>                    | <b>\$ 80</b>              |

**Note 5. Accounts Receivable, Net**

Accounts receivable, net, as of September 30, 2007 and 2006 are as follows:

| (Dollars in millions)                        | Gross         |               | Allowance     |                | Net           |               |
|--|---------------|---------------|---------------|----------------|---------------|---------------|
|  | 2007          | 2006          | 2007          | 2006           | 2007          | 2006          |
| <b>From the Public:</b>                      |               |               |               |                |               |               |
| Receivables related to credit program assets | \$ 6          | \$ 73         | \$ (5)        | \$ (4)         | \$ 1          | \$ 69         |
| Premiums receivable                          | 97            | 50            | -             | -              | 97            | 50            |
| Miscellaneous receivables                    | 21            | 127           | -             | (78)           | 21            | 49            |
| <b>Total</b>                                 | <b>\$ 124</b> | <b>\$ 250</b> | <b>\$ (5)</b> | <b>\$ (82)</b> | <b>\$ 119</b> | <b>\$ 168</b> |

**Receivables Related to Credit Program Assets**

These receivables include sale proceeds receivable and rents receivable from FHA's foreclosed properties. The sale proceeds receivable should be differentiated from the PMM notes receivables, which are created by the sales of FHA's foreclosed properties on credit to qualifying non-profit organizations.

**Premiums Receivable**

These amounts consist of the up-front and periodic premiums due to FHA from the mortgagors at the end of the reporting period. The details of FHA premium structure are discussed in Note 13 – Earned Revenue/Premium Revenue.

**Miscellaneous Receivables**

Miscellaneous receivables include late charges and penalties receivable on premiums receivable, generic debt receivables, refunds receivable from overpayments of claims and distributive shares and other immaterial receivables.

**Allowance for Loss**

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



**Note 6. Direct Loans and Loan Guarantees, Non-Federal Borrowers**

FHA Direct Loan and Loan Guarantee Programs and the related loans receivable, foreclosed property, and Loan Guarantee Liability as of September 30, 2007 and 2006 are as follows:

**Direct Loan and Loan Guarantee Programs Administered by FHA Include:**

MMI/CMHI Direct Loan Program  
 GI/SRI Direct Loan Program  
 MMI/CMHI Loan Guarantee Program  
 GI/SRI Loan Guarantee Program

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

(Dollars in millions)

|                             |           | Loans<br>Receivable,<br>Gross |           | Interest<br>Receivable |           | Allowance<br>for Loan<br>Losses |           | Foreclosed<br>Property |           | Value of<br>Assets<br>Related<br>to Direct<br>Loans |
|-----------------------------|-----------|-------------------------------|-----------|------------------------|-----------|---------------------------------|-----------|------------------------|-----------|---|
| <b>Direct Loan Programs</b> |           |                               |           |                        |           |                                 |           |                        |           |   |
| <b>FY 2007:</b>             |           |                               |           |                        |           |                                 |           |                        |           |   |
| MMI/CMHI                    | \$        | 1                             | \$        | 1                      | \$        | (1)                             | \$        | -                      | \$        | 1   |
| GI/SRI                      |           | 15                            |           | 4                      |           | (6)                             |           | -                      |           | 13  |
| <b>Total</b>                | <b>\$</b> | <b>16</b>                     | <b>\$</b> | <b>5</b>               | <b>\$</b> | <b>(7)</b>                      | <b>\$</b> | <b>-</b>               | <b>\$</b> | <b>14</b>   |
| <b>FY 2006:</b>             |           |                               |           |                        |           |                                 |           |                        |           |   |
| MMI/CMHI                    | \$        | 3                             | \$        | -                      | \$        | (2)                             | \$        | -                      | \$        | 1   |
| GI/SRI                      |           | 14                            |           | 3                      |           | (5)                             |           | -                      |           | 12  |
| <b>Total</b>                | <b>\$</b> | <b>17</b>                     | <b>\$</b> | <b>3</b>               | <b>\$</b> | <b>(7)</b>                      | <b>\$</b> | <b>-</b>               | <b>\$</b> | <b>13</b>   |

**Direct Loans Obligated After Fiscal Year 1991:**

(Dollars in millions)

|                             |           | Loans<br>Receivable,<br>Gross |           | Interest<br>Receivable |           | Foreclosed<br>Property |           | Allowance<br>for<br>Subsidy<br>Cost |           | Value of<br>Assets<br>Related<br>to Direct<br>Loans |
|-----------------------------|-----------|-------------------------------|-----------|------------------------|-----------|------------------------|-----------|-------------------------------------|-----------|---|
| <b>Direct Loan Programs</b> |           |                               |           |                        |           |                        |           |                                     |           |   |
| <b>FY 2007:</b>             |           |                               |           |                        |           |                        |           |                                     |           |   |
| MMI/CMHI                    | \$        | 1                             | \$        | -                      | \$        | -                      | \$        | (3)                                 | \$        | (2)   |
| GI/SRI                      |           | -                             |           | -                      |           | -                      |           | -                                   |           | -   |
| <b>Total</b>                | <b>\$</b> | <b>1</b>                      | <b>\$</b> | <b>-</b>               | <b>\$</b> | <b>-</b>               | <b>\$</b> | <b>(3)</b>                          | <b>\$</b> | <b>(2)</b>  |
| <b>FY 2006:</b>             |           |                               |           |                        |           |                        |           |                                     |           |   |
| MMI/CMHI                    | \$        | 1                             | \$        | -                      | \$        | -                      | \$        | (3)                                 | \$        | (2)   |
| GI/SRI                      |           | -                             |           | -                      |           | -                      |           | -                                   |           | -   |
| <b>Total</b>                | <b>\$</b> | <b>1</b>                      | <b>\$</b> | <b>-</b>               | <b>\$</b> | <b>-</b>               | <b>\$</b> | <b>(3)</b>                          | <b>\$</b> | <b>(2)</b>  |

**Total Amount of Direct Loans Disbursed (Post-1991):**

(Dollars in millions)

| <b>Direct Loan Programs</b> | <b>FY 2007</b> | <b>FY 2006</b> |
|-----------------------------|----------------|----------------|
| MMI/CMHI                    | \$ 3           | \$ 3           |
| GI/SRI                      | -              | -              |
| <b>Total</b>                | <b>\$ 3</b>    | <b>\$ 3</b>    |

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

(Dollars in millions)

| <b>Loan Guarantee Programs</b> | <b>Defaulted Guaranteed Loans Receivable, Gross</b> | <b>Interest Receivable</b> | <b>Allowance for Loan Losses</b> | <b>Foreclosed Property</b> | <b>Value of Assets Related to Defaulted Guaranteed Loans Receivable, Net</b> |
|--------------------------------|---|----------------------------|----------------------------------|----------------------------|--|
| <b>FY 2007:</b>                |   |                            |                                  |                            |  |
| MMI/CMHI                       | \$ 10   | \$ 4                       | \$ (2)                           | \$ 4                       | \$ 16  |
| GI/SRI                         | 2,979   | 208                        | (802)                            | 5                          | 2,390  |
| <b>Total</b>                   | <b>\$ 2,989</b>                                     | <b>\$ 212</b>              | <b>\$ (804)</b>                  | <b>\$ 9</b>                | <b>\$ 2,406</b>  |
| <b>FY 2006:</b>                |   |                            |                                  |                            |  |
| MMI/CMHI                       | \$ 4  | \$ -                       | \$ (1)                           | \$ 6                       | \$ 9   |
| GI/SRI                         | 2,974   | 135                        | (818)                            | 8                          | 2,299  |
| <b>Total</b>                   | <b>\$ 2,978</b>                                     | <b>\$ 135</b>              | <b>\$ (819)</b>                  | <b>\$ 14</b>               | <b>\$ 2,308</b>  |

**Defaulted Guaranteed Loans from Post-1991 Guarantees:**

(Dollars in millions)

| <b>Loan Guarantee Programs</b> | <b>Defaulted Guaranteed Loans Receivable, Gross</b> | <b>Interest Receivable</b> | <b>Foreclosed Property</b> | <b>Allowance for Subsidy Cost</b> | <b>Value of Assets Related to Defaulted Guaranteed Loans</b> |
|--------------------------------|---|----------------------------|----------------------------|-----------------------------------|--|
| <b>FY 2007:</b>                |   |                            |                            |                                   |  |
| MMI/CMHI                       | \$ 331  | \$ -                       | \$ 2,710                   | \$ (1,661)                        | \$ 1,380   |
| GI/SRI                         | 542   | 186                        | 330                        | (118)                             | 940  |
| <b>Total</b>                   | <b>\$ 873</b>                                       | <b>\$ 186</b>              | <b>\$ 3,040</b>            | <b>\$ (1,779)</b>                 | <b>\$ 2,320</b>  |
| <b>FY 2006:</b>                |   |                            |                            |                                   |  |
| MMI/CMHI                       | \$ 341  | \$ -                       | \$ 2,539                   | \$ (1,257)                        | \$ 1,623   |
| GI/SRI                         | 576   | 48                         | 350                        | (633)                             | 341  |
| <b>Total</b>                   | <b>\$ 917</b>                                       | <b>\$ 48</b>               | <b>\$ 2,889</b>            | <b>\$ (1,890)</b>                 | <b>\$ 1,964</b>  |

**Guaranteed Loans Outstanding:**

(Dollars in millions)

| <b>Loan Guarantee Programs</b>         | <b>Outstanding Principal of<br/>Guaranteed Loans,<br/>Face Value</b> | <b>Amount of Outstanding<br/>Principal Guaranteed</b> |
|--|--|---|
| <b>FY 2007</b>                         |  |   |
| <b>Guaranteed Loans Outstanding:</b>   |  |   |
| MMI/CMHI                               | \$ 352,200   | \$ 322,152  |
| GI/SRI                                 | 86,673   | 77,808  |
| <b>Total</b>                           | <b>\$ 438,873</b>  | <b>\$ 399,960</b>                                     |
| <b>FY 2006</b>                         |  |   |
| <b>Guaranteed Loans Outstanding:</b>   |  |   |
| MMI/CMHI                               | \$ 346,658   | \$ 317,249  |
| GI/SRI                                 | 87,412   | 78,522  |
| <b>Total</b>                           | <b>\$ 434,070</b>  | <b>\$ 395,771</b>                                     |
| <b>FY 2007</b>                         |  |   |
| <b>New Guaranteed Loans Disbursed:</b> |  |   |
| MMI/CMHI                               | \$ 56,510  | \$ 56,167   |
| GI/SRI                                 | 7,001  | 6,971   |
| <b>Total</b>                           | <b>\$ 63,511</b>   | <b>\$ 63,138</b>                                      |
| <b>FY 2006</b>                         |  |   |
| <b>New Guaranteed Loans Disbursed:</b> |  |   |
| MMI/CMHI                               | \$ 51,780  | \$ 50,585   |
| GI/SRI                                 | 9,846  | 9,140   |
| <b>Total</b>                           | <b>\$ 61,626</b>   | <b>\$ 59,725</b>                                      |

HECM (reverse mortgages) are not included in the above table due to the unique nature of the program. Since the inception of the program, FHA has insured 335,798 HECM loans with a maximum claim amount of \$67 billion. Of these 335,798 HECM loans insured by FHA, 259,365 loans with a maximum claim amount of \$57 billion are still active. As of September 30, 2007 the insurance in force (the outstanding balance of active loans) was \$30 billion. The insurance in force includes balances drawn by the mortgagee; interest accrued on the balances drawn, service charges, and mortgage insurance premiums. The maximum claim amount is the dollar ceiling to which the outstanding loan balance can grow before being assigned to FHA.

**Home Equity Conversion Mortgage Loans Outstanding (not included in the balances above):**

(Dollars in millions)

| Loan Guarantee Programs | New Guaranteed Loans | Cumulative                     |                             |
|-------------------------|----------------------|--------------------------------|-----------------------------|
|                         |                      | Guaranteed Balance Outstanding | Maximum Potential Liability |
| <b>FY 2007</b>          | GI/SRI \$ 24,567     | \$ 29,982                      | \$ 56,676                   |
| <b>FY 2006</b>          | GI/SRI \$ 17,994     | \$ 18,295                      | \$ 35,878                   |

**Loan Guarantee Liability, Net:**

(Dollars in millions)

| Loan Guarantee Programs | Liabilities for Losses on Pre-1992 Guarantees, Estimated Future Default Claims (LLR) | Liabilities for Loan Guarantees for Post-1991 Guarantees (LLG) | Total Loan Guarantee Liability, Net |
|-------------------------|--|--|-------------------------------------|
| <b>FY 2007:</b>         |  |  |                                     |
| MMI/CMHI                | \$ 89  | \$ 6,902   | \$ 6,991                            |
| GI/SRI                  | 282  | 158  | 440                                 |
| <b>Total</b>            | <b>\$ 371</b>  | <b>\$ 7,060</b>  | <b>\$ 7,431</b>                     |
| <b>FY 2006:</b>         |  |  |                                     |
| MMI/CMHI                | \$ 51  | \$ 2,828   | \$ 2,879                            |
| GI/SRI                  | 447  | 156  | 603                                 |
| <b>Total</b>            | <b>\$ 498</b>  | <b>\$ 2,984</b>  | <b>\$ 3,482</b>                     |

**Subsidy Expense for Loan Guarantee by Program and Component:**

(Dollars in millions)

| <b>Subsidy Expense for New Loan Guarantees</b> | <b>Defaults</b> | <b>Fees and Other Collections</b> | <b>Other</b>  | <b>Total</b>      |
|--|-----------------|-----------------------------------|---------------|-------------------|
| <b>FY 2007:</b>                                |                 |                                   |               |                   |
| MMI/CMHI                                       | \$ 1,249        | \$ (2,125)                        | \$ 667        | \$ (209)          |
| GI/SRI   | 754             | (1,569)                           | -             | (815)             |
| <b>Total</b>                                   | <b>\$ 2,003</b> | <b>\$ (3,694)</b>                 | <b>\$ 667</b> | <b>\$ (1,024)</b> |
| <b>FY 2006:</b>                                |                 |                                   |               |                   |
| MMI/CMHI                                       | \$ 818          | \$ (2,076)                        | \$ 378        | \$ (880)          |
| GI/SRI   | 647             | (1,138)                           | -             | (491)             |
| <b>Total</b>                                   | <b>\$ 1,465</b> | <b>\$ (3,214)</b>                 | <b>\$ 378</b> | <b>\$ (1,371)</b> |

| <b>Subsidy Expense for Modifications and Reestimates</b> | <b>Total Modifications</b> | <b>Technical Reestimates</b> |
|--|----------------------------|------------------------------|
| <b>FY 2007:</b>  |                            |                              |
| MMI/CMHI   | \$ (5)                     | \$ 3,940                     |
| GI/SRI   | -                          | (310)                        |
| <b>Total</b>   | <b>\$ (5)</b>              | <b>\$ 3,630</b>              |
| <b>FY 2006:</b>  |                            |                              |
| MMI/CMHI   | \$ (9)                     | \$ 1,531                     |
| GI/SRI   | -                          | (1,110)                      |
| <b>Total</b>   | <b>\$ (9)</b>              | <b>\$ 421</b>                |

| <b>Total Loan Guarantee Subsidy Expense</b> | <b>2007</b>     | <b>2006</b>     |
|---|-----------------|-----------------|
| MMI/CMHI                                    | \$ 3,726        | \$ 642          |
| GI/SRI                                      | (1,125)         | (1,601)         |
| <b>Total</b>                                | <b>\$ 2,601</b> | <b>\$ (959)</b> |

**Subsidy Rates for Loan Guarantees by Program and Component:**

(Percentage)

|  | <b>Defaults</b> | <b>Fees and Other Collections</b> | <b>Other</b> | <b>Total</b> |
|--|-----------------|-----------------------------------|--------------|--------------|
| <b>Budget Subsidy Rates for Loan Guarantees of FY 2007 Cohort:</b> |                 |                                   |              |              |
| MMI/CMHI   | 2.21            | (3.76)                            | 1.18         | (0.37)       |
| GI/SRI   | 2.28            | (4.75)                            | -            | (2.47)       |
| <b>Budget Subsidy Rates for Loan Guarantees of FY 2006 Cohort:</b> |                 |                                   |              |              |
| MMI/CMHI   | 1.58            | (4.01)                            | 0.73         | (1.70)       |
| GI/SRI   | 2.32            | (4.09)                            | -            | (1.77)       |

**Schedule for Reconciling Loan Guarantee Liability Balances:**

| (Dollars in millions)   | 2007          |                 | 2006          |                 |
|---|---------------|-----------------|---------------|-----------------|
|   | LLR           | LLG             | LLR           | LLG             |
| <b>Beginning Balance of the Loan Guarantee Liability</b>  | \$ 498        | \$ 2,984        | \$ 1,217      | \$ 3,367        |
| Add: Subsidy Expense for guaranteed loans disbursed during the reporting fiscal years by component: |               |                 |               |                 |
| Default Costs (Net of Recoveries)   | -             | 2,003           | -             | 1,465           |
| Fees and Other Collections  | -             | (3,694)         | -             | (3,214)         |
| Other Subsidy Costs   | -             | 667             | -             | 378             |
| <b>Total of the above subsidy expense components</b>  | -             | <b>(1,024)</b>  | -             | <b>(1,371)</b>  |
| Adjustments:  |               |                 |               |                 |
| Fees Received   | -             | 3,234           | -             | 2,819           |
| Foreclosed Property and Loans Acquired  | -             | 3,756           | -             | 4,011           |
| Claim Payments to Lenders   | -             | (5,869)         | -             | (6,296)         |
| Interest Accumulation on the Liability Balance  | -             | (68)            | -             | 35              |
| Other   | -             | (6)             | -             | 13              |
| <b>Ending Balance before Reestimates</b>  | <b>498</b>    | <b>3,007</b>    | <b>1,217</b>  | <b>2,578</b>    |
| Add or Subtract Subsidy Reestimates by Component:   |               |                 |               |                 |
| Technical/Default Reestimate:   |               |                 |               |                 |
| Subsidy Expense Component   | (127)         | 3,571           | (719)         | (677)           |
| Interest Expense Component  | -             | 381             | -             | (269)           |
| Adjustment to credit subsidy reestimates  | -             | 101             | -             | <b>1,352</b>    |
| <b>Total Technical/Default Reestimate</b>   | <b>(127)</b>  | <b>4,053</b>    | <b>(719)</b>  | <b>406</b>      |
| <b>Ending Balance of the Loan Guarantee Liability</b>   | <b>\$ 371</b> | <b>\$ 7,060</b> | <b>\$ 498</b> | <b>\$ 2,984</b> |

**Administrative Expense:**

(Dollars in millions)

|              | 2007          | 2006          |
|--------------|---------------|---------------|
| MMI/CMHI     | \$ 221        | \$ 227        |
| GI/SRI       | 273           | 274           |
| <b>Total</b> | <b>\$ 494</b> | <b>\$ 501</b> |

**Other Information on Foreclosed Property:**

Additional information on FHA foreclosed property as of September 30, 2007 and 2006 is as follows:

|   | 2007     | 2006     |
|---|----------|----------|
| Number of properties in foreclosure process | 84       | 120      |
| Number of properties held                   | 27,782   | 27,539   |
| Average holding period for property held    | 6 Months | 6 Months |

### **Pre-Credit Reform Valuation Methodology**

FHA values its Pre-Credit Reform related notes and properties in inventory at net realizable value, determined on the basis of net cash flows. To value these items, FHA uses historical claim data, revenues from premiums and recoveries, and expenses of selling and maintaining property.

The majority of FHA's Pre-Credit Reform liability relates to the Mark-to-Market program. A separate analysis was conducted to adjust the loan loss estimate for anticipated reductions for these project-based Section 8 rental assistance subsidies administered by the Office of Affordable Housing Preservation (OAHP). All projects that are required to submit financial statements and have submitted annual financial statements within the past two years, received Section 8 assistance, expected to expire in the next five years, and had contract rents exceeding 100 percent of fair market value were included. In the analysis, the gross rent for these projects was reduced to bring the contract rent for assisted units to fair market levels. The effects of this rent reduction on projects' financial health was assessed and a revised loan principal balance was computed based on a sustainable debt service level. A potential claim was calculated based on this reduction of loan principal.

### **Credit Reform Valuation Methodology**

FHA values its Credit Reform LLG and related receivables on notes and properties in inventory at the net present value of their estimated future cash flows.

To apply the present value computations, FHA divides the loans into cohorts and risk categories. Multifamily cohorts are defined based on the year in which loan guarantee commitments are made. Single Family mortgages are grouped into cohorts based on loan endorsement dates for the GI/SRI fund and commitment dates for the MMI fund. Within each cohort year, loans are subdivided by risk categories. Each risk category has characteristics that distinguish it from others, including risk profile, premium structure, and the type and quality of collateral underlying the loan.

The cash flow estimates that underlie the present value calculations are determined using the significant assumptions detailed below.

**Significant Assumptions** – FHA developed financial models in order to estimate the present value of future program cash flows. The models incorporate information on the cash flows' expected magnitude and timing. The models rely heavily on the following loan performance assumptions:

- Conditional Termination Rates: The estimated probability of an insurance policy claim or non-claim termination in each year of the loan guarantee's term.
- Recovery Rates: The estimated percentage of a claim payment that is recovered through disposition of a mortgage note or underlying property.
- Conditional Claim Amount: The estimated amount of the claim payment relative to the unpaid principal balance at the time the claim occurs.

Additional information about loan performance assumptions is provided below:

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

Economic assumptions: Forecasts of economic conditions used in conjunction with loan-level data to generate Single Family and Multifamily claim and prepayment rates were obtained from Global Insights (formerly DRI)

forecasts of U.S. annual economic figures. OMB provides other economic assumptions used, such as discount rates.

Reliance on historical performance: FHA relies on the average historical performance of its insured portfolio to forecast future performance of that portfolio. Changes in legislation, subsidy programs, tax treatment and economic factors all influence loan performance. FHA assumes that similar events may occur during the remaining life of existing mortgage guarantees, which can be as long as 40 years for Multifamily programs and affect loan performance accordingly.

Current legislation and regulatory structure: FHA's future plans allowed under current legislative authority have been taken into account in formulating assumptions when relevant. In contrast, future changes in legislative authority may affect the cash flows associated with FHA insurance programs. These changes cannot be reflected in LLG calculations because of uncertainty over their nature and outcome.

Discount rates: The disbursement weighted interest rate on U.S. Treasury securities of maturity comparable to the guaranteed loan term is the discount factor used in the present value calculation for cohorts 1992 to 2000. For the 2001 and future cohorts, the rate on U.S. Treasury securities of maturity comparable to the term of each cash flow for the loan guarantee is used in the present value calculation. This methodology is referred to as the basket of zeros discounting methodology. OMB provides these rates to all Federal agencies for use in preparing credit subsidy estimates and requires their use under OMB Circular A-11, Part 4, "Instructions on Budget Execution." The basket of zeros discount factors are also disbursement weighted.

### **Analysis of Change in the Liability for Loan Guarantees**

FHA has estimated and applied credit subsidy rates to each FHA loan guarantee program since fiscal year 1992. Over this time FHA's credit subsidy rates have varied. The variance is caused by three factors: (1) additional loan performance data underlying the credit subsidy rate estimates, (2) revisions to the calculation methodology used to estimate the credit subsidy rates, and (3) revisions on expected claims and prepayments derived from the revised Actuarial Review of the MMI Fund. Loan performance data, which reflect mortgage market performance and FHA policy direction, are added as they become available. Revisions to the estimation methodology result from legislative direction and technical enhancements.

FHA estimated the credit subsidy rates for the 2007 cohort in fiscal year 2005. At the time of budget submission, the rates reflected prevailing policy and loan performance assumptions based on the most recent information available. These credit subsidy rates can be reconciled to the credit subsidy rates estimated at the end of 2007. Credit subsidy reestimates allow FHA to adjust the LLG and subsidy expense to reflect the most current and accurate credit subsidy rate.

Described below are the programs that comprise the majority of FHA's fiscal year 2007 business. In addition, the Hospital Insurance program is also described. These descriptions highlight the factors that contributed to changing credit subsidy rates and the credit subsidy reestimate. Overall, FHA's liability increased by \$4 billion from the fiscal year 2006 estimates.

*Mutual Mortgage Insurance (MMI)* - During fiscal year 2007, FHA continued to experience increased claim rates due to two factors: (1) increased insurance of loans with down payment assistance, and (2) the nationwide decrease in house price appreciation, which results in increased claims and lower proceeds from the sale of foreclosed properties. The decline in proceeds is also attributable to loans where borrowers received down payment assistance from seller-financed nonprofits. A recent Internal Revenue Service ruling that had withdrawn nonprofit status from such entities has not reduced the incidence of these loans.



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*GI/SRI Home Equity Conversion Mortgage (HECM)* - As the HECM volume increased significantly during fiscal year 2007, the HECM liability also increased from \$123 million in fiscal year 2006 to \$169 million in fiscal year 2007.

*GI/SRI Section 221(d)(4)* - The Section 221(d)(4) program was established to provide mortgage insurance for the construction or substantial rehabilitation of Multifamily rental properties with five or more units. Under this program, HUD may insure up to 90 percent of the total project cost and is prohibited from insuring loans with HUD-subsidized interest rates. The Section 221(d)(4) program is the largest Multifamily program in the GI/SRI fund. The Section 221(d)(4) liability decreased in FY 2007 and was impacted by the improved risk profile of cohorts 2002 through 2004.

*Mark-to-Market* – The Mark to Market (MTM) program was established by legislation to assess rents at the time of Section 8 Assistance contract renewal. If rents are above market levels, the project is referred to OAHF. OAHF then evaluates the project for potential financial restructuring to determine if the project could survive given the lower revenues from reduced rents. The MTM liability decreased in fiscal year 2007 as a result of a reduced pool of loans that are eligible for restructuring. This eligible pool is comprised of active loans with Section 8 assistance and FHA insurance. However, since Section 8 assistance is no longer offered to newly endorsed loans, the number of existing FHA-insured and assisted loans continues to shrink every year, thereby reducing the number of loans eligible for MTM restructuring.

*GI/SRI Section 234(c)* - The Section 234(c) program insures loans for condominium purchases. One of the many purposes of FHA's mortgage insurance programs is to encourage lenders to make affordable mortgage credit available for non-conventional forms of ownership. Condominium ownership, in which the separate owners of the individual units jointly own the development's common areas and facilities, is one particularly popular alternative. Historically, the program generates a reduction in credit subsidy expense (\$95 million in fiscal year 2006). As in the MMI fund, the projected losses from future foreclosures were significantly increased to factor the decrease in proceeds and the additional losses from down payment assistance loans. These changes resulted in a liability of \$107 million for fiscal year 2007.

### ***Hurricane Cost Estimate***

At the end of fiscal year 2005 the damage assessments for hurricane Katrina were not complete and there was not sufficient information for FHA to reasonably estimate the losses or predict the liability. This was subsequently addressed during the preparation of the fiscal year 2007 budget, at which time OMB included additional liability estimates for hurricane Katrina. These additional amounts were apportioned by OMB and recorded by FHA during fiscal year 2006. This adjustment resulted in an additional \$250 million added to the GI/SRI reestimate and an additional \$1.1 billion added to the MMI/CMHI reestimate, which was combined with current year cost estimates for the MMI and GI/SRI funds to provide for the total liability to the LLG and LLR of \$3.5 billion for fiscal year 2006.

#### ***Single Family Hurricane Cost***

FHA evaluated all open default cases from the hurricane-impacted areas as of August 31, 2007. The various status categories found for these default cases was used to estimate number of claims and cost for each category. Based on this evaluation, FHA estimated 2,548 total claims (including failed loss mitigation actions) with an unpaid principal balance of \$203.1 million. FHA program offices estimated a 62% loss rate for these properties, which is higher than the normal loss rate of 36% in the national portfolio. The 62% loss rate was taken from the pool of not-for-profit sales in the MMI fund in fiscal year 2006. Based on this evaluation and assumptions the estimated net present value hurricane cost is \$139.05 million.

#### ***Multifamily Hurricane Cost***

Impacted properties included in the Multifamily hurricane cost estimate were determined from physical inspections conducted by FHA's Office of Multifamily Housing Programs. During fiscal year 2007, it was

determined no additional Multifamily liabilities related to Hurricane Katrina were required.

### **Note 7. Other Assets**

The following table presents the composition of other assets held by FHA as of September 30, 2007 and 2006:

(Dollars in millions)

|   |           | <b>2007</b> |           | <b>2006</b> |
|---|-----------|-------------|-----------|-------------|
| <b>Intragovernmental:</b>                         |           |             |           |             |
| Advances to HUD for Working Capital Fund Expenses | \$        | 4           | \$        | 24          |
| <b>Total</b>                                      | <b>\$</b> | <b>4</b>    | <b>\$</b> | <b>24</b>   |
| <b>With the Public:</b>                           |           |             |           |             |
| Escrow Monies Deposited at Minority-Owned Banks   | \$        | 110         | \$        | 110         |
| Undistributed Charges                             |           | 33          |           | 30          |
| <b>Total</b>                                      | <b>\$</b> | <b>143</b>  | <b>\$</b> | <b>140</b>  |

#### **Advances to HUD for Working Capital Fund Expenses**

The Working Capital Fund was established by HUD to consolidate, at the department level, the acquisition of certain property and equipment to be used by different organizations within HUD. Advances to HUD for Working Capital Fund expenses represent the amount of payments made by FHA to reimburse the HUD Working Capital Fund for its share of the fund's expenses prior to the receipt of goods or services from this fund.

#### **Escrow Monies Deposited at Minority-Owned Banks**

FHA holds in trust escrow monies received from the borrowers of its Multifamily mortgage notes to cover property repairs and renovations expenses. These escrow monies are deposited at the U.S. Treasury (see Note 2), invested in U.S. Treasury securities (see Note 4 - GI/SRI Investments) or deposited at minority-owned banks.

#### **Undistributed Charges**

Undistributed charges include FHA disbursements processed by the U.S. Treasury but the identification of the specific FHA operating area associated with the disbursement has not been determined by the end of the reporting period. When the FHA operating area that initiated the disbursement is identified, the undistributed charges are reclassified by recognizing new expenses or by liquidating previously established accounts payable.

**Note 8. Accounts Payable**

Accounts payable as of September 30, 2007 and 2006 are as follows:

(Dollars in millions)

|   | 2007          | 2006          | Claims |
|---|---------------|---------------|--------|
| <b>With the Public:</b>                         |               |               |        |
| Claims Payable                                  | \$ 224        | \$ 206        |        |
| Premium Refunds and Distributive Shares Payable | 81            | 84            |        |
| Disbursements in Transit                        | 61            | 46            |        |
| Miscellaneous Payables                          | 19            | 60            |        |
| <b>Total</b>                                    | <b>\$ 385</b> | <b>\$ 396</b> |        |

**Payable**

Claims payable represents the amount of claims that have been processed by FHA, but the disbursement of payment to lenders has not taken place at the end of the reporting period.

**Premium Refunds and Distributive Shares Payable**

Premium refunds payable are refunds of previously collected Single Family premiums that will be returned to the borrowers resulting from prepayment of the insured mortgages. Distributive shares payable represents the amount of excess revenues in the liquidating account of the CMHI fund that is to be distributed to the mortgagors at the discretion of the Secretary of HUD.

**Disbursements in Transit**

Disbursements in transit represent the payments recorded in FHA financial systems that have not been processed by the U.S. Treasury. The disbursements in transit will be reclassified into the reductions of the Fund Balance with U.S. Treasury once the disbursements are confirmed as paid by the U.S. Treasury.

**Miscellaneous Payables**

Miscellaneous payables include interest enhancement payables, interest penalty payables for late payment of claims, generic debt payables and other payables related to various operating areas within FHA.

**Note 9. Debt**

The following tables describe the composition of debt held by FHA as of September 30, 2007 and 2006:

| (Dollars in millions)          | 2006              |                   |                 | 2007              |                 |
|--------------------------------|-------------------|-------------------|-----------------|-------------------|-----------------|
|                                | Beginning Balance | Net Borrowing     | Ending Balance  | Net Borrowing     | Ending Balance  |
| <b>Agency Debt:</b>            |                   |                   |                 |                   |                 |
| Debentures Issued to Claimants | \$ 132            | \$ (37)           | \$ 95           | \$ (25)           | \$ 70           |
| <b>Other Debt:</b>             |                   |                   |                 |                   |                 |
| Borrowings from U.S. Treasury  | 7,548             | (1,290)           | 6,258           | (1,685)           | 4,573           |
| <b>Total</b>                   | <b>\$ 7,680</b>   | <b>\$ (1,327)</b> | <b>\$ 6,353</b> | <b>\$ (1,710)</b> | <b>\$ 4,643</b> |

|                                | 2007            | 2006            |
|--------------------------------|-----------------|-----------------|
| <b>Classification of Debt:</b> |                 |                 |
| Intragovernmental Debt         | \$ 4,573        | \$ 6,258        |
| Debt held by the Public        | 70              | 95              |
| <b>Total</b>                   | <b>\$ 4,643</b> | <b>\$ 6,353</b> |

**Debentures Issued to Public**

The National Housing Act authorizes FHA, in certain cases, to issue debentures in lieu of cash to settle claims. FHA-issued debentures bear interest at rates established by the U.S. Treasury. Interest rates related to the outstanding debentures ranged from 4.00 percent to 12.875 percent in both fiscal years 2007 and 2006. Lenders may redeem FHA debentures prior to maturity in order to pay mortgage insurance premiums to FHA, or they may be called with the approval of the Secretary of the U.S. Treasury.

The par value of debentures outstanding at September 30 was \$70 million in fiscal year 2007 and \$95 million in fiscal year 2006. The fair values for fiscal years 2007 and 2006 were \$101 and \$143 million, respectively.

**Borrowings from U.S. Treasury**

In accordance with Credit Reform accounting, FHA borrows from the U.S. Treasury when cash is needed in its financing accounts. Usually, the need for cash arises when FHA has to transfer the negative credit subsidy amounts related to new loan disbursements, and existing loan modifications from the financing accounts to the general fund receipt account (for cases in GI/SRI funds) or to the liquidating account (for cases in MMI/CMHI funds). In some instances, borrowings are also needed to transfer the credit subsidy related to downward reestimates from the GI/SRI financing account to the GI/SRI receipt account or when available cash is less than claim payments due.

During fiscal year 2007, FHA's U.S. Treasury borrowings carried interest rates ranging from 2.33 percent to 7.34 percent. In fiscal year 2006 the carried interest rates ranged from 2.41 percent to 7.36 percent. Fiscal year 2007 maturity dates occur from August 2010 – April 2027. Loans may be repaid in whole or in part without penalty at any time prior to maturity.

## **Note 10. Other Liabilities**

The following table describes the composition of other liabilities as of September 30, 2007 and 2006:

| (Dollars in millions)             | Current         |                 | Non-Current |               | Total           |                 |
|-----------------------------------|-----------------|-----------------|-------------|---------------|-----------------|-----------------|
|                                   | 2007            | 2006            | 2007        | 2006          | 2007            | 2006            |
| <b>Intragovernmental:</b>         |                 |                 |             |               |                 |                 |
| Special Receipt Account Liability | \$ 3,657        | \$ 2,486        | \$ -        | \$ -          | \$ 3,657        | \$ 2,486        |
| <b>Total</b>                      | <b>\$ 3,657</b> | <b>\$ 2,486</b> | <b>\$ -</b> | <b>\$ -</b>   | <b>\$ 3,657</b> | <b>\$ 2,486</b> |
| <b>With the Public:</b>           |                 |                 |             |               |                 |                 |
| Trust and Deposit Liabilities     | \$ 155          | \$ 170          | \$ -        | \$ -          | \$ 155          | \$ 170          |
| Unearned Premiums                 | 24              | 21              | 7           | 120           | 31              | 141             |
| Undistributed Credits             | 48              | 50              | -           | -             | 48              | 50              |
| Miscellaneous Liabilities         | 240             | 216             | -           | -             | 240             | 216             |
| <b>Total</b>                      | <b>\$ 467</b>   | <b>\$ 457</b>   | <b>\$ 7</b> | <b>\$ 120</b> | <b>\$ 474</b>   | <b>\$ 577</b>   |

### **Special Receipt Account Liability**

The special receipt account liability is created from negative subsidy endorsements and downward credit subsidy in the GI/SRI special receipt account.

### **Trust and Deposit Liabilities**

Trust and deposit liabilities include mainly escrow monies received by FHA for the borrowers of its mortgage notes and earnest money received from potential purchasers of the FHA foreclosed properties. The escrow monies are eventually disbursed to pay for insurance, property taxes, and maintenance expenses on behalf of the borrowers. The earnest money becomes part of the sale proceeds or is returned to any unsuccessful bidders.

### **Unearned Premiums**

As discussed in Note 1, unearned premiums represent premiums collected for the pre-1992 loan guarantees, but not recognized as revenue because the earning process has not been completed.

### **Undistributed Credits**

Undistributed credits represent FHA collections processed by U.S. Treasury, but the identification of the specific operating area associated with the collections has not been determined at the end of the reporting period. When the FHA operating area that is entitled to the collections is identified, the undistributed credits are reclassified by recognizing revenue or by liquidating previously established accounts receivable.

### **Miscellaneous Liabilities**

Miscellaneous liabilities include mainly other unearned revenue from Single Family and Multifamily operations. It also includes loss contingencies that are recognized by FHA for past events that warrant a probable, or likely, future outflow of measurable economic resources.

**Note 11. Commitments and Contingencies****Litigation**

FHA is party in various legal actions and claims brought by or against it. In the opinion of management and general counsel, the ultimate resolution of two of these legal actions and claims will have a material affect FHA's consolidated financial statements as of September 30, 2007. FHA has recognized an estimated amount of \$11 million as a contingent liability due to the probable, or likely, adverse judgment in these cases. Additionally, there are two cases where judgment against FHA is considered reasonably possible with an estimated potential loss of \$3 million.

During FY 2007 two judgments against FHA were paid. One was paid by The Department of Justice judgment fund and the other judgment was paid from FHA's funds. The judgments totaled \$30 million.

**Pending or Threatened Litigation Against FHA**

(Dollars in millions)

| Expected Outcome    | 2007           |                 | 2006           |                 |
|---------------------|----------------|-----------------|----------------|-----------------|
|                     | Estimated Loss | Number of Cases | Estimated Loss | Number of Cases |
| Probable            | \$11           | 2               | \$24           | 1               |
| Reasonably Possible | \$3            | 2               | \$18           | 1               |
| Remote              | -              | 8               | -              | 5               |

**Note 12. Gross Costs**

Gross costs incurred by FHA for the fiscal years ended September 30, 2007 and 2006 are as follows:

| (Dollars in millions)              | 2007            |                   | 2006            |                   |
|------------------------------------|-----------------|-------------------|-----------------|-------------------|
|                                    | MMI/CMHI        | GI/SRI            | MMI/CMHI        | GI/SRI            |
| <b>Intragovernmental:</b>          |                 |                   |                 |                   |
| Interest Expense                   | \$ 263          | \$ 104            | \$ 342          | \$ 101            |
| Imputed Costs                      | 8               | 29                | 10              | 13                |
| Other Expenses                     | 13              | 8                 | 35              | 33                |
| <b>Total</b>                       | <b>\$ 284</b>   | <b>\$ 141</b>     | <b>\$ 387</b>   | <b>\$ 147</b>     |
| <b>With the Public:</b>            |                 |                   |                 |                   |
| Salary and Administrative Expenses | \$ 208          | \$ 265            | \$ 192          | \$ 241            |
| Subsidy Expense                    | 3,726           | (1,125)           | 642             | (1,601)           |
| Interest Expense                   | 697             | (338)             | 284             | (248)             |
| Bad Debt Expense                   | (20)            | 11                | 20              | (24)              |
| Loan Loss Reserve Expense          | 48              | (143)             | (3)             | (734)             |
| Other Expenses                     | 41              | 95                | -               | 317               |
| <b>Total</b>                       | <b>\$ 4,700</b> | <b>\$ (1,235)</b> | <b>\$ 1,135</b> | <b>\$ (2,049)</b> |

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**Interest Expense**

Intragovernmental interest expense includes interest expense on borrowings from the U.S. Treasury in the financing account. Interest expense is calculated annually for each cohort using the interest rates provided by the U.S. Treasury. Interest expense with the public consists of interest expense on debentures issued to claimants to settle claim payments and interest expense on the annual credit subsidy reestimates.

**Imputed Costs/Imputed Financing**

Imputed costs represent FHA's share of the departmental imputed cost calculated and allocated to FHA by the HUD CFO office. Federal agencies are required by SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards*, to account for costs assumed by other Federal organizations on their behalf. The HUD CFO receives its imputed cost data from the Office of Personnel Management (OPM) for pension costs, federal employee health benefits (FEHB) and life insurance costs. It also receives Federal Employees' Compensation Act (FECA) costs from the Department of Labor (DOL). Subsequently, using its internally developed allocation basis, HUD CFO allocates the imputed cost data to each of its reporting offices. An additional \$18 million was included in fiscal year 2007 for a legal judgment paid by judgment fund on FHA's behalf. The imputed costs reported by FHA in its Statements of Net Cost are equal to the amounts of imputed financing in its Statements of Changes in Net Position.

**Salary and Administrative Expenses**

Salary and administrative expenses include FHA's reimbursement to HUD for FHA personnel costs and FHA's payments to third party contractors for administrative contract expenses.

**Subsidy Expense**

Subsidy expense, positive and negative, consists of credit subsidy expense from new endorsements, modifications, and annual credit subsidy reestimates and the subsidy expense incurred by the Church Arson program. Credit subsidy expense is the estimated long-term cost to the U.S. Government of a direct loan or loan guarantee, calculated on a net present value basis of the estimated future cash flows associated with the direct loan or loan guarantee. Subsidy expense incurred by the Church Arson program is the expense of a HUD program administered by the Office of Community Planning and Development (CPD) even though its cost is funded through a FHA program account.

**Bad Debt Expense**

Bad debt expense represents the provision for loss recorded for uncollectible amounts related to FHA's pre-1992 accounts receivable and credit program assets. FHA calculates its bad debt expense based on the estimated change of these assets' historical loss experience and FHA management's judgment concerning current economic factors.

**Loan Loss Reserve Expense**

Loan loss reserve expense is recorded to account for the change in the balance of the loan loss reserve liabilities associated with FHA's pre-1992 loan guarantees. The loan loss reserve is provided for the estimated losses incurred by FHA to pay claims on its pre-1992 insured mortgages when defaults have taken place but the claims have not yet been filed with FHA.

## Other Expenses

Other expenses with the public include only those associated with the FHA pre-1992 loan guarantees. They consist of net losses or gains on sales of FHA credit program assets, insurance claim expenses, fee expenses, and other miscellaneous expenses incurred to carry out FHA operations. Other intragovernmental expenses include FHA's share of HUD expenses incurred in the Working Capital Fund and expenses from intra-agency agreements.

## Note 13. Earned Revenue

Earned revenues generated by FHA for the fiscal years ended September 30, 2007 and 2006 are as follows:

| (Dollars in millions)                           | 2007            |               | 2006            |               |
|---|-----------------|---------------|-----------------|---------------|
|   | MMI/CMHI        | GI/SRI        | MMI/CMHI        | GI/SRI        |
| <b>Intragovernmental:</b>                       |                 |               |                 |               |
| Interest Revenue from Deposits at U.S. Treasury | \$ 308          | \$ 107        | \$ 293          | \$ 188        |
| Interest Revenue from MMI/CMHI Investments      | 991             | -             | 1,041           | -             |
| <b>Total</b>                                    | <b>\$ 1,299</b> | <b>\$ 107</b> | <b>\$ 1,334</b> | <b>\$ 188</b> |
| <b>With the Public:</b>                         |                 |               |                 |               |
| Premium Revenue                                 | \$ 13           | \$ 38         | \$ 86           | \$ 36         |
| Interest Revenue                                | 2               | 53            | -               | 49            |
| Other Revenue                                   | 9               | -             | 8               | -             |
| <b>Total</b>                                    | <b>\$ 24</b>    | <b>\$ 91</b>  | <b>\$ 94</b>    | <b>\$ 85</b>  |

## Interest Revenue

Intragovernmental interest revenue includes interest revenue from deposits at the U.S. Treasury and investments in U.S. Treasury securities. FHA's U.S. Treasury deposits are generated from post-1991 loan guarantees and direct loans in the financing accounts. FHA's investments in U.S. Treasury securities consist of investments of surplus resources in the MMI/CMHI liquidating accounts and of escrow monies collected from borrowers in the GI/SRI liquidating accounts.

Interest revenue with the public is generated mainly from FHA's acquisition of pre-1992 performing MNA notes from payments to lenders for defaulted guaranteed loans. Interest revenue associated with the post-1991 MNA notes is included in the Allowance for Subsidy balance.

## Premium Revenue

According to the FCRA accounting, FHA's premium revenue includes only premiums associated with the pre-1992 loan guarantee business. Premium revenue for post-1991 loan guarantee cases is included in the balance of the LLG. The FHA premium structure, set by the National Affordable Housing Act and published in the Code of Federal Regulations, which became effective July 1991, includes both up-front premiums and annual periodic premiums.



### Up-front Premiums

The up-front premium rates, which are set by legislation, vary according to the mortgage type and the year of origination. The pre-1992 up-front premiums in the MMI fund were recorded as unearned revenue upon collection and are recognized as revenue over the period in which losses and insurance costs are expected to occur. Other FHA funds' unearned revenue is recognized monthly as revenue on a straight-line basis.

The FHA up-front premium rates in fiscal year 2007 were:

|               | Premium Rate                  |
|---------------|-------------------------------|
| Single Family | 1.50%                         |
| Multifamily   | 0.45 %, 0.50%, 0.57% or 0.80% |

### Periodic Premiums

The periodic premium rate is used to calculate monthly or annual premiums receivable. These rates, which are also legislated, vary by mortgage type and program. The FHA periodic premium rate in fiscal year 2007 for Single Family and Multifamily were:

|               | Mortgage Term 15<br>Years or Less | Mortgage Term More<br>Than 15 Years |
|---------------|-----------------------------------|-------------------------------------|
| Single Family | 0.25%                             | 0.50%                               |
| Multifamily   | 0.45 %, 0.50%, 0.57%<br>or 0.80%  | 0.45 %, 0.50%, 0.57%<br>or 0.80%    |

For Title I, the maximum insurance premium paid for guaranteed cases endorsed in years 1992 through 2001 is equal to 0.50 percent of the loan amount multiplied by the number of years of the loan term. The annual insurance premium for a Title I Property Improvement loan is 0.50 percent of the loan amount until the maximum insurance charge is paid. The annual insurance premium of a Title I Manufactured Housing loan is calculated in tiers by loan term until the maximum insurance charge is paid. For guaranteed cases endorsed in fiscal years 2006 and 2007, the Title I annual insurance premium is 1.00 percent of the loan amount until maturity.

### Other Revenue

Other revenue includes revenue associated with FHA pre-1992 loan guarantees. FHA's other revenue consists of late charges and penalty revenue, fee income, and miscellaneous income generated from FHA operations.

### **Note 14. Gross Cost and Earned Revenue by Budget Functional Classification**

FHA cost and earned revenue reported on the Statements of Net Cost is categorized under the budget functional classification (BFC) for Mortgage Credit (371). All FHA U.S. Treasury account symbols found under the department code "86" for Department of Housing and Urban Development appear with the Mortgage Credit BFC.

**Note 15. Transfers Out**

Transfers out incurred by FHA for the fiscal years ended September 30, 2007 and 2006 are as follows:

| (Dollars in millions)       | U.S. Treasury |              | HUD       |            | Total           |
|-----------------------------|---------------|--------------|-----------|------------|-----------------|
| Budgetary Financing Sources | \$            | 1,173        | \$        | 609        | \$ 1,782        |
| Other Financing Sources     |               | 834          |           | (389)      | 445             |
| <b>FY 2007 Total</b>        | <b>\$</b>     | <b>2,007</b> | <b>\$</b> | <b>220</b> | <b>\$ 2,227</b> |
| Budgetary Financing Sources | \$            | 532          | \$        | 234        | \$ 766          |
| Other Financing Sources     |               | 1,692        |           | -          | 1,692           |
| <b>FY 2006 Total</b>        | <b>\$</b>     | <b>2,224</b> | <b>\$</b> | <b>234</b> | <b>\$ 2,458</b> |

**Transfers Out to U.S. Treasury**

Transfers out to U.S. Treasury consists of negative subsidy from new endorsements, modifications and downward credit subsidy reestimates in the GI/SRI general fund receipt account, and the prior year unobligated balance of budgetary resources in the GI/SRI liquidating account.

**Transfers Out to HUD**

Transfers out to HUD include a certain portion of FHA's payments to HUD for salaries and expenses as well as amounts related to FHA's share in the departmental Working Capital Fund capitalized expense.

**Note 16. Unexpended Appropriations**

Unexpended appropriation balances at September 30, 2007 and 2006 are as follows:

| (Dollars in millions)   | Beginning Balance | Appropriations Received | Other Adjustments | Appropriations Used | Transfers-Out   | Ending Balance |
|-------------------------|-------------------|-------------------------|-------------------|---------------------|-----------------|----------------|
| Positive Subsidy        | \$ 64             | \$ 9                    | \$ (40)           | \$ (5)              | \$ -            | \$ 28          |
| Administrative Expenses | 365               | 721                     | (79)              | (105)               | (609)           | 293            |
| Reestimates             | -                 | 109                     | -                 | (109)               | -               | -              |
| GI/SRI Liquidating      | 165               | 413                     | -                 | (196)               | (159)           | 223            |
| <b>FY 2007 Total</b>    | <b>\$ 594</b>     | <b>\$ 1,252</b>         | <b>\$ (119)</b>   | <b>\$ (415)</b>     | <b>\$ (768)</b> | <b>\$ 544</b>  |
| Positive Subsidy        | \$ 58             | \$ 9                    | \$ -              | \$ (3)              | \$ -            | \$ 64          |
| Administrative Expenses | 450               | 728                     | (83)              | (730)               | -               | 365            |
| Reestimates             | -                 | 361                     | -                 | (361)               | -               | -              |
| GI/SRI Liquidating      | 101               | 183                     | -                 | (84)                | (35)            | 165            |
| <b>FY 2006 Total</b>    | <b>\$ 609</b>     | <b>\$ 1,281</b>         | <b>\$ (83)</b>    | <b>\$ (1,178)</b>   | <b>\$ (35)</b>  | <b>\$ 594</b>  |

As required under FCRA, FHA receives appropriations to cover expenses or fund shortages related to its loan guarantee and direct loan operations.

FHA receives appropriations in the annual program accounts for administrative and contract expenses. The GI/SRI no-year program account also receives appropriations for positive credit subsidy and upward reestimates.

Additionally, FHA obtains permanent indefinite appropriations to cover any shortfalls for its GI/SRI pre-1992 loan guarantee operations.

When appropriations are first received, they are reported as unexpended appropriations. As these appropriations are expended, appropriations used are increased and unexpended appropriations are decreased. Additionally, unexpended appropriations are decreased when: salaries, administrative expenses, and working capital funds are transferred out to HUD; the year-end unobligated balance in the GI/SRI liquidating account is returned to the U.S. Treasury; appropriations are rescinded; or other miscellaneous adjustments are required.

### **Note 17. Budgetary Resources**

The SF-133 and the Statement of Budgetary Resources for fiscal year 2006 have been reconciled to the fiscal year 2006 actual amounts included in the P&F Schedules presented in the Budget of the United States Government. There were no significant reconciling items. Information from the fiscal year 2007 Statement of Budgetary Resources will be presented in the fiscal year 2009 Budget of the U.S. Government. The Budget will be transmitted to Congress on the first Monday in February 2009 and will be available from the Government Printing Office at that time.

Obligated balances at the end of the fiscal year 2007 consist of accounts payable of \$1,046 million, and undelivered orders of \$1,250 million.

#### **Undelivered Orders**

(Dollars in millions)

|              | <b>2007</b>     | <b>2006</b>     |
|--------------|-----------------|-----------------|
| MMI/CMHI     | \$ 662          | \$ 687          |
| GI/SRI       | \$ 588          | \$ 634          |
| <b>Total</b> | <b>\$ 1,250</b> | <b>\$ 1,321</b> |

In fiscal year 2006, the Salaries and Expense cost was obligated in FHA's accounts each month and a cash payment was made to HUD. FHA showed an obligation on its Statement of Budgetary Resources (SBR) and HUD showed an offsetting collection. In fiscal year 2007, FHA made a non-expenditure transfer to HUD for Salaries, Administrative, and Working Capital Fund Expenses. As a result, both FHA and HUD show a non-expenditure transfer on the SBR. The change does not affect the Statement of Net Cost.

**NOTE 18. Budgetary Resources - Collections**

The following table presents the composition of FHA's collections for fiscal year 2007:

(Dollars in millions)

|                                   | MMI/CMHI        | GI/SRI          | Total            |
|-----------------------------------|-----------------|-----------------|------------------|
| <b>Collections:</b>               |                 |                 |                  |
| Premiums                          | \$ 2,148        | \$ 904          | \$ 3,052         |
| Notes                             | \$ 39           | \$ 542          | \$ 581           |
| Property                          | \$ 3,334        | \$ 142          | \$ 3,476         |
| Interest Earned from U.S Treasury | \$ 1,264        | \$ 107          | \$ 1,371         |
| Subsidy                           | \$ 214          | \$ 124          | \$ 338           |
| Reestimates                       | \$ 1,904        | \$ 109          | \$ 2,013         |
| Other                             | \$ 101          | \$ 229          | \$ 330           |
| <b>Total</b>                      | <b>\$ 9,004</b> | <b>\$ 2,157</b> | <b>\$ 11,161</b> |

The following table presents the composition of FHA's collections for fiscal year 2006:

(Dollars in millions)

|                                   | MMI/CMHI         | GI/SRI          | Total            |
|-----------------------------------|------------------|-----------------|------------------|
| <b>Collections:</b>               |                  |                 |                  |
| Premiums                          | \$ 1,909         | \$ 913          | \$ 2,822         |
| Notes                             | \$ 46            | \$ 593          | \$ 639           |
| Property                          | \$ 3,543         | \$ 180          | \$ 3,723         |
| Interest Earned from U.S Treasury | \$ 1,462         | \$ 187          | \$ 1,649         |
| Subsidy                           | \$ 890           | \$ 6            | \$ 896           |
| Reestimates                       | \$ 3,507         | \$ 361          | \$ 3,868         |
| Other                             | \$ 303           | \$ 206          | \$ 509           |
| <b>Total</b>                      | <b>\$ 11,660</b> | <b>\$ 2,446</b> | <b>\$ 14,106</b> |

**Note 19. Budgetary Resources – Non-expenditure Transfers**

The following table presents the composition of FHA's non-expenditure transfers for fiscal year 2007:

(Dollars in millions)

|  | MMI/CMHI      | GI/SRI        | Total         |
|--|---------------|---------------|---------------|
| <b>Transfers:</b>                                      |               |               |               |
| Salaries, Administrative Expenses, and Working Capital | \$ 240        | \$ 369        | \$ 609        |
| <b>Total</b>   | <b>\$ 240</b> | <b>\$ 369</b> | <b>\$ 609</b> |

**Note 20. Budgetary Resources – Obligations**

The following table presents the composition of FHA's obligations for fiscal year 2007:

(Dollars in millions)

|   | MMI/CMHI        | GI/SRI          | Total            |
|---|-----------------|-----------------|------------------|
| <b>Obligations:</b>                                   |                 |                 |                  |
| Claims  | \$ 5,340        | \$ 1,003        | \$ 6,343         |
| Single Family Property Management Contracts           | \$ 360          | \$ 17           | \$ 377           |
| Contract Obligations                                  | \$ 40           | \$ 142          | \$ 182           |
| Subsidy   | \$ 214          | \$ 1,134        | \$ 1,348         |
| Downward Reestimates                                  | \$ 554          | \$ 1,746        | \$ 2,300         |
| Upward Reestimates                                    | \$ 1,351        | \$ 109          | \$ 1,460         |
| Interest on Borrowings                                | \$ 263          | \$ 115          | \$ 378           |
| Other   | \$ 68           | \$ 170          | \$ 238           |
| Salaries, Administrative Expenses and Working Capital | \$ -            | \$ -            | \$ -             |
| <b>Total</b>  | <b>\$ 8,190</b> | <b>\$ 4,436</b> | <b>\$ 12,626</b> |

The following table presents the composition of FHA's obligations for fiscal year 2006:

(Dollars in millions)

|   | MMI/CMHI         | GI/SRI          | Total            |
|---|------------------|-----------------|------------------|
| <b>Obligations:</b>                                   |                  |                 |                  |
| Claims  | \$ 5,530         | \$ 983          | \$ 6,513         |
| Single Family Property Management Contracts           | \$ 448           | \$ 25           | \$ 473           |
| Contract Obligations                                  | \$ 46            | \$ 202          | \$ 248           |
| Subsidy   | \$ 889           | \$ 514          | \$ 1,403         |
| Downward Reestimates                                  | \$ 103           | \$ 180          | \$ 283           |
| Upward Reestimates                                    | \$ 3,404         | \$ 361          | \$ 3,765         |
| Interest on Borrowings                                | \$ 342           | \$ 115          | \$ 457           |
| Other   | \$ 85            | \$ 181          | \$ 266           |
| Salaries, Administrative Expenses and Working Capital | \$ 370           | \$ 240          | \$ 610           |
| <b>Total</b>  | <b>\$ 11,217</b> | <b>\$ 2,801</b> | <b>\$ 14,018</b> |

**NOTE 21. Reconciliation of Net Cost of Operations to Budget**

This note (formerly the Statement of Financing) links the proprietary data to the budgetary data. Most transactions are recorded in both proprietary and budgetary accounts. However, because different accounting bases are used for budgetary and proprietary accounting, some transactions may appear in only one set of accounts.

|  | <u>2007</u>       | <u>2006</u>       |
|--|-------------------|-------------------|
| <b><i>RESOURCES USED TO FINANCE ACTIVITIES</i></b>   |                   |                   |
| Obligations Incurred   | \$ 12,626         | \$ 14,018         |
| Spending Authority from Offsetting Collections and Recoveries  | (11,468)          | (14,108)          |
| Offsetting Receipts  | (2,759)           | (677)             |
| Transfers In / Out   | (445)             | (1,692)           |
| Imputed Financing from Costs Absorbed by Others  | 37                | 23                |
| <b>TOTAL RESOURCES USED TO FINANCE ACTIVITIES</b>  | <b>\$ (2,009)</b> | <b>\$ (2,436)</b> |
| <b><i>RESOURCES THAT DO NOT FUND THE NET COST OF OPERATIONS</i></b>  |                   |                   |
| Undelivered Orders and Adjustments   | \$ 90             | \$ (124)          |
| Revenue and Other Resources  | 12,668            | 13,064            |
| Purchase of Assets   | (9,879)           | (7,228)           |
| Appropriation for prior year Re-estimate   | (1,460)           | (3,768)           |
| <b>TOTAL RESOURCES NOT PART OF NET COST OF OPERATIONS</b>  | <b>\$ 1,419</b>   | <b>\$ 1,944</b>   |
| <b>TOTAL RESOURCES USED TO FINANCE THE NET COST (SURPLUS) OF OPERATIONS</b>  | <b>\$ (590)</b>   | <b>\$ (492)</b>   |
| <b><i>COMPONENTS OF THE NET COST (SURPLUS) OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD</i></b> |                   |                   |
| Upward Re-estimate of Credit Subsidy Expense   | \$ 4,870          | \$ 2,683          |
| Downward Re-estimate of Credit Subsidy Expense   | (817)             | (2,268)           |
| Changes in Loan Loss Reserve Expense   | (127)             | (739)             |
| Changes in Bad Debt Expenses Related to Uncollectible Pre-Credit Reform Receivables  | (9)               | (5)               |
| Reduction of Credit Subsidy Expense from Endorsements and Modifications of Loan Guarantees   | (1,032)           | (1,380)           |
| Gains or Losses on Sales of Credit Program Assets  | 56                | 54                |
| Other  | 18                | 66                |
| <b>TOTAL COMPONENTS OF THE NET COST (SURPLUS) OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD</b>  | <b>\$ 2,959</b>   | <b>\$ (1,589)</b> |
| <b>NET COST (SURPLUS) OF OPERATIONS</b>  | <b>\$ 2,369</b>   | <b>\$ (2,081)</b> |

## Required Supplementary Information

### Schedule A: Intragovernmental Assets

FHA's intragovernmental assets, by federal entity, are as follows for the periods ending September 30, 2007 and 2006:

(Dollars in millions)

| <u>Agency</u>        | <u>Fund<br/>Balance with<br/>U.S.<br/>Treasury</u> | <u>Investments in<br/>U.S. Treasury<br/>Securities</u> | <u>Other<br/>Assets</u> |
|----------------------|--|--|-------------------------|
| U.S. Treasury        | \$ 9,559   | \$ 22,481  | \$ -                    |
| HUD                  | -  | -  | 4                       |
| <b>FY 2007 Total</b> | <b>\$ 9,559</b>                                    | <b>\$ 22,481</b>                                       | <b>\$ 4</b>             |
| U.S. Treasury        | \$ 10,568  | \$ 22,012  | \$ -                    |
| HUD                  | -  | -  | 24                      |
| <b>FY 2006 Total</b> | <b>\$ 10,568</b>                                   | <b>\$ 22,012</b>                                       | <b>\$ 24</b>            |

### Schedule B: Intragovernmental Liabilities

FHA's intragovernmental liabilities, by federal entity, are as follows on September 30, 2007 and 2006:

(Dollars in millions)

| <u>Agency</u>        | <u>Borrowings<br/>from<br/>U.S. Treasury</u> | <u>Other<br/>Liabilities</u> |
|----------------------|--|------------------------------|
| U.S. Treasury        | \$ 4,573                                     | \$ 3,657                     |
| <b>FY 2007 Total</b> | <b>\$ 4,573</b>                              | <b>\$ 3,657</b>              |
| U.S. Treasury        | \$ 6,258                                     | \$ 2,486                     |
| <b>FY 2006 Total</b> | <b>\$ 6,258</b>                              | <b>\$ 2,486</b>              |

**Required Supplementary Information****Schedule C: Comparative Combining Statement of Budgetary Resources by FHA Program for September 30, 2007 and September 30, 2006:**

| (Dollars in millions)                           | MMI/CMHI         |                  | GI/SRI          |                 | Total             |                  |
|---|------------------|------------------|-----------------|-----------------|-------------------|------------------|
|   | 2007             | 2006             | 2007            | 2006            | 2007              | 2006             |
| <b>BUDGETARY RESOURCES</b>                      |                  |                  |                 |                 |                   |                  |
| Unobligated Balance Carried Forward             |                  |                  |                 |                 |                   |                  |
| Beginning of period                             | \$ 26,367        | \$ 26,746        | \$ 3,055        | \$ 2,747        | \$ 29,422         | \$ 29,493        |
| Recoveries of Prior Year Obligations            | 127              | 56               | 86              | 47              | 213               | 103              |
| Budget Authority:                               |                  |                  |                 |                 |                   |                  |
| Appropriations received                         | 413              | 418              | 841             | 863             | 1,254             | 1,281            |
| Borrowing Authority                             | 2                | 536              | 615             | 361             | 617               | 897              |
| Spending Authority from Offsetting Collections: |                  |                  |                 |                 |                   |                  |
| Earned  |                  |                  |                 |                 |                   |                  |
| Collected                                       | 9,004            | 11,660           | 2,157           | 2,446           | 11,161            | 14,106           |
| Receivable from Federal Sources                 | 63               | (62)             | 35              | (39)            | 98                | (101)            |
| Unfilled Customer Orders                        | -                | -                | (4)             | -               | (4)               | -                |
| Net Transfers                                   | (369)            | -                | (240)           | -               | (609)             | -                |
| Permanently Not Available                       | (1,919)          | (1,769)          | (687)           | (569)           | (2,606)           | (2,338)          |
| <b>TOTAL BUDGETARY RESOURCES</b>                | <b>\$ 33,688</b> | <b>\$ 37,585</b> | <b>\$ 5,858</b> | <b>\$ 5,856</b> | <b>\$ 39,546</b>  | <b>\$ 43,441</b> |
| <b>STATUS OF BUDGETARY RESOURCES</b>            |                  |                  |                 |                 |                   |                  |
| Obligations Incurred                            | \$ 8,190         | \$ 11,218        | \$ 4,436        | \$ 2,800        | \$ 12,626         | \$ 14,018        |
| Unobligated Balance-Appportioned                | 537              | 1,082            | 643             | 1,211           | 1,180             | 2,293            |
| Unobligated Balance Not Available               | 24,961           | 25,285           | 779             | 1,845           | 25,740            | 27,130           |
| <b>TOTAL STATUS OF BUDGETARY RESOURCES</b>      | <b>\$ 33,688</b> | <b>\$ 37,585</b> | <b>\$ 5,858</b> | <b>\$ 5,856</b> | <b>\$ 39,546</b>  | <b>\$ 43,441</b> |
| <b>CHANGE IN OBLIGATED BALANCES</b>             |                  |                  |                 |                 |                   |                  |
| Obligated Balance, Net, Beginning of Period:    |                  |                  |                 |                 |                   |                  |
| Unpaid Obligations Carried Forward              | \$ 1,476         | \$ 1,442         | \$ 881          | \$ 888          | \$ 2,357          | \$ 2,330         |
| Receivable from Federal Sources Carried Forward | (203)            | (262)            | (11)            | (52)            | (214)             | (314)            |
| Obligations Incurred                            | 8,190            | 11,218           | 4,436           | 2,800           | 12,626            | 14,018           |
| Gross Outlays                                   | (8,101)          | (11,129)         | (4,372)         | (2,760)         | (12,473)          | (13,889)         |
| Obligated Balance Transfers, Net:               |                  | -                |                 | -               |                   | -                |
| Recoveries of Prior Year Obligations            | (127)            | (56)             | (86)            | (47)            | (213)             | (103)            |
| Change in Receivable from Federal Sources       | (63)             | 62               | (31)            | 39              | (94)              | 101              |
| Obligated Balance, Net, End of Period:          |                  |                  |                 |                 |                   |                  |
| Unpaid Obligations                              | 1,435            | 1,477            | 861             | 880             | 2,296             | 2,357            |
| Receivable from Federal Sources                 | (263)            | (203)            | (44)            | (11)            | (307)             | (214)            |
| Outlays:  |                  |                  |                 |                 |                   |                  |
| Disbursements                                   | 8,101            | 11,129           | 4,372           | 2,760           | 12,473            | 13,889           |
| Collections                                     | (9,004)          | (11,660)         | (2,157)         | (2,446)         | (11,161)          | (14,106)         |
| Subtotal  | (903)            | (531)            | 2,215           | 314             | 1,312             | (217)            |
| Less: Offsetting Receipts                       | -                | -                | 2,759           | 677             | 2,759             | 677              |
| <b>NET OUTLAYS</b>                              | <b>\$ (903)</b>  | <b>\$ (531)</b>  | <b>\$ (544)</b> | <b>\$ (363)</b> | <b>\$ (1,447)</b> | <b>\$ (894)</b>  |



**Required Supplementary Information****Schedule D: Comparative Combining Budgetary Resources by Appropriation for the MMI/CMHI Program—Fiscal Year 2007**

(Dollars in millions)

|   | 86 0183         | 86x4070       | 86x4587<br>&<br>86x4242 | 86x0236           | MMI/CMHI<br>Total |
|---|-----------------|---------------|-------------------------|-------------------|-------------------|
| <b>BUDGETARY RESOURCES</b>                      |                 |               |                         |                   |                   |
| Unobligated Balance Carried Forward             |                 |               |                         |                   |                   |
| Beginning of period                             | \$ 43           | \$ 47         | \$ 4,318                | \$ 21,959         | \$ 26,367         |
| Recoveries of Prior Year Obligations            | 16              | 26            | 85                      | -                 | 127               |
| Budget Authority:                               |                 |               |                         |                   |                   |
| Appropriations received                         | 413             | -             | -                       | -                 | 413               |
| Borrowing Authority                             | -               | -             | 2                       | -                 | 2                 |
| Spending Authority from Offsetting Collections: |                 |               |                         |                   |                   |
| Earned  |                 |               |                         |                   |                   |
| Collected                                       | -               | 59            | 7,221                   | 1,724             | 9,004             |
| Receivable from Federal Sources                 | -               | -             | -                       | 63                | 63                |
| Unfilled Customer Orders                        | -               | -             | -                       | -                 | -                 |
| Net Transfers                                   | 981             | -             | -                       | (1,350)           | (369)             |
| Permanently Not Available                       | (17)            | -             | (1,902)                 | -                 | (1,919)           |
| <b>TOTAL BUDGETARY RESOURCES</b>                | <b>\$ 1,436</b> | <b>\$ 132</b> | <b>\$ 9,724</b>         | <b>\$ 22,396</b>  | <b>\$ 33,688</b>  |
| <b>STATUS OF BUDGETARY RESOURCES</b>            |                 |               |                         |                   |                   |
| Obligations Incurred                            | \$ 1,390        | \$ 68         | \$ 6,732                | \$ -              | \$ 8,190          |
| Unobligated Balance-Appportioned                | 4               | 15            | 518                     | -                 | 537               |
| Unobligated Balance Not Available               | 42              | 49            | 2,474                   | 22,396            | 24,961            |
| <b>TOTAL STATUS OF BUDGETARY RESOURCES</b>      | <b>\$ 1,436</b> | <b>\$ 132</b> | <b>\$ 9,724</b>         | <b>\$ 22,396</b>  | <b>\$ 33,688</b>  |
| <b>CHANGE IN OBLIGATED BALANCES</b>             |                 |               |                         |                   |                   |
| Obligated Balance, Net, Beginning of Period:    |                 |               |                         |                   |                   |
| Unpaid Obligations Carried Forward              | \$ 82           | \$ 233        | \$ 1,161                | \$ -              | \$ 1,476          |
| Receivable from Federal Sources Carried Forward | -               | (1)           | (2)                     | (200)             | (203)             |
| Obligations Incurred                            | 1,390           | 68            | 6,732                   | -                 | 8,190             |
| Gross Outlays                                   | (1,385)         | (62)          | (6,654)                 | -                 | (8,101)           |
| Obligated Balance Transfers, Net:               |                 |               |                         |                   |                   |
| Recoveries of Prior Year Obligations            | (16)            | (26)          | (85)                    | -                 | (127)             |
| Change in Receivable from Federal Sources       | -               | -             | -                       | (63)              | (63)              |
| Obligated Balance, Net, End of Period:          |                 |               |                         |                   |                   |
| Unpaid Obligations                              | 71              | 212           | 1,152                   | -                 | 1,435             |
| Receivable from Federal Sources                 | -               | -             | (2)                     | (261)             | (263)             |
| Outlays:  |                 |               |                         |                   |                   |
| Disbursements                                   | 1,385           | 62            | 6,654                   | -                 | 8,101             |
| Collections                                     | -               | (59)          | (7,221)                 | (1,724)           | (9,004)           |
| Subtotal  | 1,385           | 3             | (567)                   | (1,724)           | (903)             |
| Less: Offsetting Receipts                       | -               | -             | -                       | -                 | -                 |
| <b>NET OUTLAYS</b>                              | <b>\$ 1,385</b> | <b>\$ 3</b>   | <b>\$ (567)</b>         | <b>\$ (1,724)</b> | <b>\$ (903)</b>   |

**Required Supplementary Information****Schedule D: Comparative Combining Budgetary Resources by Appropriation for the MMI/CMHI Program—Fiscal Year 2006**

(Dollars in millions)

|   | 86 0183         | 86x4070       | 86x4587<br>&<br>86x4242 | 86x0236          | MMI/CMHI<br>Total |
|---|-----------------|---------------|-------------------------|------------------|-------------------|
| <b>BUDGETARY RESOURCES</b>                      |                 |               |                         |                  |                   |
| Unobligated Balance Carried Forward             |                 |               |                         |                  |                   |
| Beginning of period                             | \$ 50           | \$ 38         | \$ 3,395                | \$ 23,263        | \$ 26,746         |
| Recoveries of Prior Year Obligations            | 11              | 44            | 1                       | -                | 56                |
| Budget Authority:                               |                 |               |                         |                  |                   |
| Appropriations received                         | 418             | -             | -                       | -                | 418               |
| Borrowing Authority                             | -               | -             | 536                     | -                | 536               |
| Spending Authority from Offsetting Collections: |                 |               |                         |                  |                   |
| Earned  |                 |               |                         |                  |                   |
| Collected                                       | -               | 48            | 9,450                   | 2,162            | 11,660            |
| Receivable from Federal Sources                 | -               | -             | -                       | (62)             | (62)              |
| Unfilled Customer Orders                        | -               | -             | -                       | -                | -                 |
| Net Transfers                                   | 3,404           | -             | -                       | (3,404)          | -                 |
| Permanently Not Available                       | (22)            | -             | (1,747)                 | -                | (1,769)           |
| <b>TOTAL BUDGETARY RESOURCES</b>                | <b>\$ 3,861</b> | <b>\$ 130</b> | <b>\$ 11,635</b>        | <b>\$ 21,959</b> | <b>\$ 37,585</b>  |
| <b>STATUS OF BUDGETARY RESOURCES</b>            |                 |               |                         |                  |                   |
| Obligations Incurred                            | \$ 3,816        | \$ 84         | \$ 7,318                | \$ -             | \$ 11,218         |
| Unobligated Balance-Apportioned                 | 1               | 2             | 1,079                   | -                | 1,082             |
| Unobligated Balance Not Available               | 44              | 44            | 3,238                   | 21,959           | 25,285            |
| <b>TOTAL STATUS OF BUDGETARY RESOURCES</b>      | <b>\$ 3,861</b> | <b>\$ 130</b> | <b>\$ 11,635</b>        | <b>\$ 21,959</b> | <b>\$ 37,585</b>  |
| <b>CHANGE IN OBLIGATED BALANCES</b>             |                 |               |                         |                  |                   |
| Obligated Balance, Net, Beginning of Period:    |                 |               |                         |                  |                   |
| Unpaid Obligations Carried Forward              | \$ 94           | \$ 266        | \$ 1,082                | \$ -             | \$ 1,442          |
| Receivable from Federal Sources Carried Forward | -               | -             | (2)                     | (260)            | (262)             |
| Obligations Incurred                            | 3,816           | 84            | 7,318                   | -                | 11,218            |
| Gross Outlays                                   | (3,818)         | (74)          | (7,237)                 | -                | (11,129)          |
| Obligated Balance Transfers, Net:               | -               | -             | -                       | -                | -                 |
| Recoveries of Prior Year Obligations            | (11)            | (44)          | (1)                     | -                | (56)              |
| Change in Receivable from Federal Sources       | -               | -             | -                       | 62               | 62                |
| Obligated Balance, Net, End of Period:          |                 |               |                         |                  |                   |
| Unpaid Obligations                              | 83              | 233           | 1,161                   | -                | 1,477             |
| Receivable from Federal Sources                 | -               | (1)           | (1)                     | (201)            | (203)             |
| Outlays:  |                 |               |                         |                  |                   |
| Disbursements                                   | 3,818           | 74            | 7,237                   | -                | 11,129            |
| Collections                                     | -               | (48)          | (9,450)                 | (2,162)          | (11,660)          |
| Subtotal  | 3,818           | 26            | (2,213)                 | (2,162)          | (531)             |
| Less: Offsetting Receipts                       | -               | -             | -                       | -                | -                 |
| <b>NET OUTLAYS</b>                              | <b>\$ 3,818</b> | <b>\$ 26</b>  | <b>(2,213)</b>          | <b>(2,162)</b>   | <b>(531)</b>      |

**Required Supplementary Information****Schedule E: Comparative Combining Budgetary Resources by Appropriation for the GI/SRI Program—Fiscal Year 2007**

(Dollars in millions)

|   | <b>86 0200</b> | <b>86x4072</b> | <b>86x4077<br/>&amp;<br/>86x4105</b> | <b>GI/SRI<br/>Total</b> |
|---|----------------|----------------|--------------------------------------|-------------------------|
| <b><i>BUDGETARY RESOURCES</i></b>               |                |                |                                      |                         |
| Unobligated Balance Carried Forward             |                |                |                                      |                         |
| Beginning of period                             | \$ 182         | \$ 160         | \$ 2,713                             | \$ 3,055                |
| Recoveries of Prior Year Obligations            | 11             | 36             | 39                                   | 86                      |
| Budget Authority:                               |                |                |                                      |                         |
| Appropriations received                         | 426            | 413            | 2                                    | 841                     |
| Borrowing Authority                             | -              | 15             | 600                                  | 615                     |
| Spending Authority from Offsetting Collections: |                |                |                                      |                         |
| Earned  |                |                |                                      |                         |
| Collected                                       | -              | 274            | 1,883                                | 2,157                   |
| Receivable from Federal Sources                 | -              | (6)            | 41                                   | 35                      |
| Unfilled Customer Orders                        | -              | -              | (4)                                  | (4)                     |
| Net Transfers                                   | (240)          | -              | -                                    | (240)                   |
| Permanently Not Available                       | (101)          | (173)          | (413)                                | (687)                   |
| <b>TOTAL BUDGETARY RESOURCES</b>                | <b>\$ 278</b>  | <b>\$ 719</b>  | <b>\$ 4,861</b>                      | <b>\$ 5,858</b>         |
| <b><i>STATUS OF BUDGETARY RESOURCES</i></b>     |                |                |                                      |                         |
| Obligations Incurred                            | \$ 175         | \$ 484         | \$ 3,777                             | \$ 4,436                |
| Unobligated Balance-Appportioned                | 28             | 140            | 475                                  | 643                     |
| Unobligated Balance Not Available               | 75             | 95             | 609                                  | 779                     |
| <b>TOTAL STATUS OF BUDGETARY RESOURCES</b>      | <b>\$ 278</b>  | <b>\$ 719</b>  | <b>\$ 4,861</b>                      | <b>\$ 5,858</b>         |
| <b><i>CHANGE IN OBLIGATED BALANCES</i></b>      |                |                |                                      |                         |
| Obligated Balance, Net, Beginning of Period:    |                |                |                                      |                         |
| Unpaid Obligations Carried Forward              | \$ 102         | \$ 564         | \$ 215                               | \$ 881                  |
| Receivable from Federal Sources Carried Forward | -              | (6)            | (5)                                  | (11)                    |
| Obligations Incurred                            | 175            | 484            | 3,777                                | 4,436                   |
| Gross Outlays                                   | (165)          | (442)          | (3,765)                              | (4,372)                 |
| Obligated Balance Transfers, Net:               |                |                |                                      |                         |
| Recoveries of Prior Year Obligations            | (11)           | (36)           | (39)                                 | (86)                    |
| Change in Receivable from Federal Sources       | -              | 6              | (37)                                 | (31)                    |
| Obligated Balance, Net, End of Period:          |                |                |                                      |                         |
| Unpaid Obligations                              | 100            | 571            | 190                                  | 861                     |
| Receivable from Federal Sources                 | -              | -              | (44)                                 | (44)                    |
| Outlays:  |                |                |                                      |                         |
| Disbursements                                   | 165            | 442            | 3,765                                | 4,372                   |
| Collections                                     | -              | (274)          | (1,883)                              | (2,157)                 |
| Subtotal  | 165            | 168            | 1,882                                | 2,215                   |
| Less: Offsetting Receipts                       | -              | -              | -                                    | 2,759                   |
| <b>NET OUTLAYS</b>                              | <b>\$ 165</b>  | <b>\$ 168</b>  | <b>\$ 1,882</b>                      | <b>(544)</b>            |

**Required Supplementary Information****Schedule E: Comparative Combining Budgetary Resources by Appropriation for the GI/SRI Program—Fiscal Year 2006**

(Dollars in millions)

|   | 86 0200       | 86x4072       | 86x4077<br>&<br>86x4105 | GI/SRI<br>Total |
|---|---------------|---------------|-------------------------|-----------------|
| <b><i>BUDGETARY RESOURCES</i></b>               |               |               |                         |                 |
| Unobligated Balance Carried Forward             |               |               |                         |                 |
| Beginning of period                             | \$ 216        | \$ 35         | \$ 2,496                | \$ 2,747        |
| Recoveries of Prior Year Obligations            | 14            | 28            | 5                       | 47              |
| Budget Authority:                               |               |               |                         |                 |
| Appropriations received                         | 680           | 183           | -                       | 863             |
| Borrowing Authority                             | -             | 9             | 352                     | 361             |
| Spending Authority from Offsetting Collections: |               |               |                         |                 |
| Earned  |               |               |                         |                 |
| Collected                                       | -             | 426           | 2,020                   | 2,446           |
| Receivable from Federal Sources                 | -             | 6             | (45)                    | (39)            |
| Unfilled Customer Orders                        | -             | -             | -                       | -               |
| Net Transfers                                   | -             | -             | -                       | -               |
| Permanently Not Available                       | (59)          | (68)          | (442)                   | (569)           |
| <b>TOTAL BUDGETARY RESOURCES</b>                | <b>\$ 851</b> | <b>\$ 619</b> | <b>\$ 4,386</b>         | <b>\$ 5,856</b> |
| <b><i>STATUS OF BUDGETARY RESOURCES</i></b>     |               |               |                         |                 |
| Obligations Incurred                            | \$ 668        | \$ 459        | \$ 1,673                | \$ 2,800        |
| Unobligated Balance-Appportioned                | 22            | 138           | 1,051                   | 1,211           |
| Unobligated Balance Not Available               | 161           | 22            | 1,662                   | 1,845           |
| <b>TOTAL STATUS OF BUDGETARY RESOURCES</b>      | <b>\$ 851</b> | <b>\$ 619</b> | <b>\$ 4,386</b>         | <b>\$ 5,856</b> |
| <b><i>CHANGE IN OBLIGATED BALANCES</i></b>      |               |               |                         |                 |
| Obligated Balance, Net, Beginning of Period:    |               |               |                         |                 |
| Unpaid Obligations Carried Forward              | \$ 99         | \$ 608        | \$ 181                  | \$ 888          |
| Receivable from Federal Sources Carried Forward | -             | (1)           | (51)                    | (52)            |
| Obligations Incurred                            | 668           | 459           | 1,673                   | 2,800           |
| Gross Outlays                                   | (652)         | (474)         | (1,634)                 | (2,760)         |
| Obligated Balance Transfers, Net:               | -             | -             | -                       | -               |
| Recoveries of Prior Year Obligations            | (14)          | (28)          | (5)                     | (47)            |
| Change in Receivable from Federal Sources       | -             | (6)           | 45                      | 39              |
| Obligated Balance, Net, End of Period:          |               |               |                         |                 |
| Unpaid Obligations                              | 101           | 564           | 215                     | 880             |
| Receivable from Federal Sources                 | -             | (6)           | (5)                     | (11)            |
| Outlays:  |               |               |                         |                 |
| Disbursements                                   | 652           | 474           | 1,634                   | 2,760           |
| Collections                                     | -             | (426)         | (2,020)                 | (2,446)         |
| Subtotal  | 652           | 48            | (386)                   | 314             |
| Less: Offsetting Receipts                       | -             | -             | -                       | 677             |
| <b>NET OUTLAYS</b>                              | <b>\$ 652</b> | <b>\$ 48</b>  | <b>\$ (386)</b>         | <b>\$ (363)</b> |