U.S. Department of Housing and Urban Development
Federal Housing Administration

FHA

Annual Management Report
Fiscal Year 2006

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

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

A MESSAGE FROM THE COMMISSIONER

TO THE CONGRESS OF THE UNITED STATES, MEMBERS OF THE HOUSING INDUSTRY, AMERICA'S HOMEOWNERS AND TENANTS, AND THE PUBLIC:

Every community throughout America values the pride and financial benefits that accompany homeownership. Homeownership is great for neighborhoods as owners improve property, take pride in their community, and develop deeper roots and interests in their hometown. Increasing homeownership, especially in the minority community, where the homeownership gap is most pronounced, is a top priority for the Federal Housing Administration (FHA). Expanding American homeownership, preserving affordable rental housing, accomplishing hurricane assistance, and remaining a financially sound entity were all priorities for FHA in Fiscal Year 2006.

Expanding American Homeownership Act of 2006

FHA has proposed legislation that would revitalize the federal government's largest mortgage program. The bill, which overwhelmingly passed in the House 415-7 and awaits Senate action, would allow the FHA to offer flexible down payment options for the first time, increase permissible mortgage amounts substantially in high-cost markets, such as California, and provide low-interest rates and consumer protections that are rarely available from "sub-prime" mortgage lenders.

The legislation also could open the FHA marketplace to more mortgage brokers, who are by far the largest source of home mortgages originated nationwide. With brokers able to offer both private-market sub-prime and FHA-insured mortgages, buyers with less-than-perfect credit will be able to directly compare FHA's rates, fees, and consumer protections with competing sub-prime loan offerings.

The FHA would join the rest of the mortgage market in underwriting homebuyers based on their risk of default as measured by credit scores, down-payment amounts and financial profiles, thus allowing more lower-income borrowers the possibility of enjoying the many benefits FHA offers. The bill would authorize the agency to charge lower insurance premiums to applicants with lower risk of default — a standard operating procedure in the private marketplace.

Katrina Accomplishments One Year Later

FHA is committed to providing disaster relief to its borrowers. After the hurricane destruction at the end of Fiscal Year 2005, borrowers living in disaster-declared areas have been assisted through mortgage assistance or foreclosure relief efforts.

FHA provided a limited extension of the foreclosure moratorium provided by Mortgagee Letter 2006-12 in that some Mississippi and Louisiana borrowers whose properties were moderately or severely damaged by the hurricanes may be eligible for grant assistance, but have not yet had the opportunity to apply for and receive funds. These grant funds would allow mortgagors to rebuild their homes or, if rebuilding is not feasible, preserve good credit standing by paying off their mortgage debt. Therefore, for borrowers who may be eligible to apply for Community Development Block Grant funds under either the Mississippi or Louisiana state programs, HUD extended the foreclosure moratorium.

HUD entered into an agreement with the Federal Emergency Management Agency (FEMA) and established a protocol for the transfer of HUD Real Estate Owned (REO) properties to be made available to displaced families. In May 2006, to assist thousands of displaced families looking for affordable replacement housing, the Department began offering all HUD-owned homes at a discount to displaced homebuyers. People displaced by the hurricanes now have an opportunity to purchase the properties prior to the expiration of their lease at a ten percent (10%) discount and receive a fifteen percent (15%) escrow to cover needed repairs and/or household items. In addition, all displaced persons have an opportunity to purchase a HUD-owned home anywhere in the country prior to it being offered to the public at a ten percent (10%) discount off the list price. In an effort to assist these homebuyers with their purchases, HUD has made 100% financing available using its 203(h) loan program.

Fiscal Year 2006 Management Report - Summary

Even with declining endorsements, FHA remains financially sound with a capital ratio of 6.82 percent in the Mutual Mortgage Insurance Fund, substantially exceeding the statutory requirements of at least 2 percent. This financial capacity, as well as significant management initiatives and improvements, have afforded FHA the ability to continue to contribute to its primary mission of providing Americans access to homeownership opportunities, providing services to help families retain their FHA insured homes during economic hardships, increase the supply of affordable rental housing units, and help make possible the financing of healthcare facilities.

Highlights of FHA's Fiscal Year 2006 success are:

- *First-Time Homebuyers.* In Fiscal Year 2006, 79.3 percent of FHA-insured purchase loans involved first-time homebuyers, providing 248,953 families the ability to purchase their first home.

- *Borrowers Experiencing Financial Difficulties.* To assist homeowners facing financial difficulties remain in their homes, FHA again encouraged lenders to increase their use of loss mitigation tools. As a result, loss mitigation cases increased from 24,874 cases in Fiscal Year

1999 to 75,528 in Fiscal Year 2006, a 204% increase.

- *Multifamily Housing.* FHA provides financing support for the development of rental housing and healthcare facilities through its multifamily mortgage insurance programs. In Fiscal Year 2006, FHA initially endorsed 1,016 multifamily loans totaling $5.13 billion.

- *Mark-to-Market.* FHA's Mark-to-Market (M2M) program seeks to preserve affordable housing stock by maintaining the long-term physical and financial integrity of such housing and to reduce the Section 8 rental assistance costs and the cost of FHA insurance claims. FHA completed mortgage restructuring on 286 (22,253 units) properties under the M2M program, with 90 percent resulting in reduced rents and Section 8 savings. Of the 286 properties with mortgage restructuring completed during fiscal year 2006, 130 properties resulted in full debt restructurings, contributing to the long-term preservation of 9,484 units. The restructurings represent an annual Section 8 savings (non-incurrence of cost) of $17.5 million. In addition, 58 properties (4,956 units) charged reduced rents only, representing an annual Section 8 savings (non-incurrence of cost) of over $13.2 million. In total, 188 properties representing over 14,440 units received reduced rents, resulting in annual savings of over $30.7 million.

FHA is also strongly committed to the implementation of President Bush's Management Agenda, which will make government more responsible and responsive. FHA continues to demonstrate this through the phased implementation of a new core FHA Subsidiary Ledger financial management system to strengthen program controls and improve program management.

Following is the Fiscal Year 2006 Annual Management Report in its entirety.

Brian D. Montgomery
Assistant Secretary for Housing-
Federal Housing Commissioner

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MANAGEMENT'S DISCUSSION AND ANALYSIS

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Certain information contained in this discussion is considered "forward-looking information" as defined by the Federal Accounting Standards Advisory Board's (FASAB) Statement of Federal Financial Accounting Standards (SFFAS) No. 15, "Management's Discussion and Analysis," and Statement of Federal Financial Accounting Concepts (SFFAC) No. 3, "Management's Discussion and Analysis Concepts." Such forward-looking information includes estimates and is subject to risks and uncertainties that could cause actual results to differ materially from this discussion.

Performance information contained in this Management's Discussion & Analysis (MD&A) was obtained from operational and management sources and schedules prepared by management. The appropriate levels of FHA management reviewed the information and data to provide reasonable assurance that reported performance information is relevant and reliable.

MISSION AND ORGANIZATIONAL STRUCTURE

In 1934, Congress created the Federal Housing Administration (FHA) in the National Housing Act to expand opportunities for homeownership. The instability in the housing market and the breakdown of the banking system during the Great Depression heightened the need for FHA programs. Congress looked to the FHA to boost the depressed economy and solve the nation's housing shortage.

FHA has expanded its mission since its inception and now provides mortgage insurance to private lenders that finance single family homes, multifamily projects, healthcare facilities, property improvements, and manufactured homes. Availability of FHA mortgage insurance stabilizes the provision of mortgage credit in the marketplace and encourages the provision of credit to households not served or underserved by the private sector, most notably first time and minority homebuyers. FHA has also expanded its mission to include establishing housing quality standards and demonstrating the financial viability of new mortgage instruments.

FHA and several other agencies were consolidated into the Department of Housing and Urban Development (HUD) in 1965. FHA's headquarters are located in Washington, D.C. FHA has field offices located throughout the country, consisting primarily of 4 Single Family Homeownership Centers (HOCs), 18 Multifamily Hubs, and 33 Multifamily Program Centers.

In many ways, FHA can be seen as a specialized insurance company that guarantees the payment of mortgages made by private lenders (banks and other mortgage lenders) who make loans to developers and homebuyers. This guarantee of payment enables lenders to provide market rate loans to all eligible purchasers. Since its inception 72 years ago, FHA has provided mortgage insurance to 34.2 million single family households and 49,259 multifamily projects containing 5.6 million units of housing. FHA currently has 3.9 million insured single family mortgages and 12,319 insured multifamily projects in its portfolio. FHA collects mortgage insurance premiums and other fees for insuring these loans. With these insurance premiums, fees collected, and a small appropriation for the general insurance fund, FHA has been financially self-sustaining, operating in a financially sound manner, pursuing its objectives and responding to the needs of its constituency.

FHA Funds

FHA operates its programs through four funds supported by premium and fee income, interest income, Congressional appropriations, borrowing from the U.S. Treasury, and other miscellaneous sources. The four funds are:

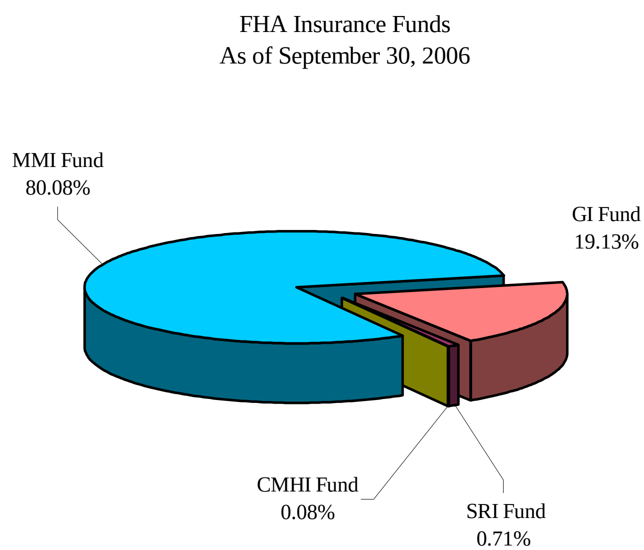
- *The Mutual Mortgage Insurance (MMI) Fund*. This fund supports FHA's basic single family homeownership program. This fund is self-sustaining.

- *The General Insurance (GI) Fund*. This fund supports a wide variety of housing programs including rental apartments, cooperatives, condominiums, nursing homes, hospitals, property improvements, manufactured housing (Title I), home equity conversion mortgages, and disaster assistance.

- *The Special Risk Insurance (SRI) Fund*. This fund supports higher-risk single family and multifamily insured mortgages.

- *The Cooperative Management Housing Insurance (CMHI) Fund*. This fund supports insured loans on market-rate cooperatives. Historically this fund has been self-sustaining.

At the end of fiscal year 2006, the MMI Fund comprised 80.08 percent of the FHA Insurance Fund; the GI Fund 19.13 percent; the SRI Fund 0.71 percent; and the CMHI Fund 0.08 percent. The total mortgage insurance-in-force (IIF) in the FHA Fund was $395.8 billion, a decrease of $20.7 billion, or 5.0 percent, compared to fiscal year 2005. Specifically, the MMI Fund decreased by $18.3 billion, the GI Fund decreased by $1.5 billion, the SRI Fund decreased by $865 million, and the CMHI Fund, the smallest of the four, increased by $22.5 million.



FHA's IIF declines when interest rates decline and house price appreciation is high, as many FHA borrowers are able to refinance into conventional mortgages to eliminate the mortgage insurance premium they had been paying to FHA.

FHA's single family mortgage insurance business is 85.54 percent of its total IIF. The multifamily and healthcare insurance is 14.26 percent of IIF. Title I property improvement and manufactured home insurance is 0.19 percent of IIF.

Office of Single Family Housing

FHA's Office of Single Family Housing administers programs that promote affordable housing. FHA encourages homeownership by making loans more readily available to lower and moderate-income families through its FHA mortgage insurance program. HUD-approved mortgage lenders handle all of the HUD/FHA-insured mortgage loan programs.

Single Family Housing Programs

Single Family Housing programs are the most visible evidence of FHA's success in providing expanded homeownership opportunities for all Americans. Through these programs, FHA targets households that otherwise would have had difficulty obtaining mortgages. During fiscal year 2006, its programs insured 502,049 loans, of which 313,970 were initial purchase endorsements. Of these purchase endorsements, 248,953 were loans to first-time homebuyers and 76,114 were loans to minority first-time homebuyers. The two largest FHA single family programs are Section 203(b) and Section 234(c).

The national homeownership rate as of third quarter 2006 is 69.0 percent, up 0.2 percent from 68.8 percent as of the same period in 2005. Despite the increase in the homeownership rate, FHA saw a decrease in market share due to rising house prices that decreased housing affordability within FHA loan limits and mortgage product innovations in the conventional and non-prime markets that have attracted borrowers who would have normally used FHA. However, FHA's single family housing programs have made substantial contributions to the increase in the national homeownership rate over the past years (from 64.7 percent in 1995 to 69.0 percent today).

In the President's fiscal year 2007 budget submission, FHA requested legislative flexibility from Congress to offer mortgage insurance to first-time homebuyers regardless of how much cash they choose to invest in the transaction, because FHA can still provide a lower cost alternative to many borrowers who are being served in the prime and non-prime conventional mortgage markets. Additionally, FHA has greatly improved its business processes and is working with the Administration and Congress to develop new mortgage products and market the benefits of its mortgage insurance to lenders and the general public. Three of Single Family Housing's more popular programs, Section 203(b), Section 234(c), and Reverse Mortgages, are described below in detail.

Section 203(b)

Section 203(b) is the largest of FHA's single family programs covering 93.6 percent of total single family insurance-in-force. FHA established this program to create a stable mortgage finance market and to serve otherwise underserved borrowers by providing low down payment mortgages. Section 203(b) insures private lenders against loss in the event the borrower defaults on the mortgage. This insurance makes lenders more willing to originate loans to borrowers who do not meet conventional mortgage underwriting requirements. Additionally, lenders are more willing to make loans because they can package FHA-insured mortgages into mortgage-backed securities guaranteed by the Governmental National Mortgage Association, a secondary market entity backed by the full faith and credit of the U.S. Government. FHA insured 368,313 Section

203(b) mortgages in fiscal year 2006, of which 227,109 were first-time homebuyers and 71,536 were minority first-time homebuyers.

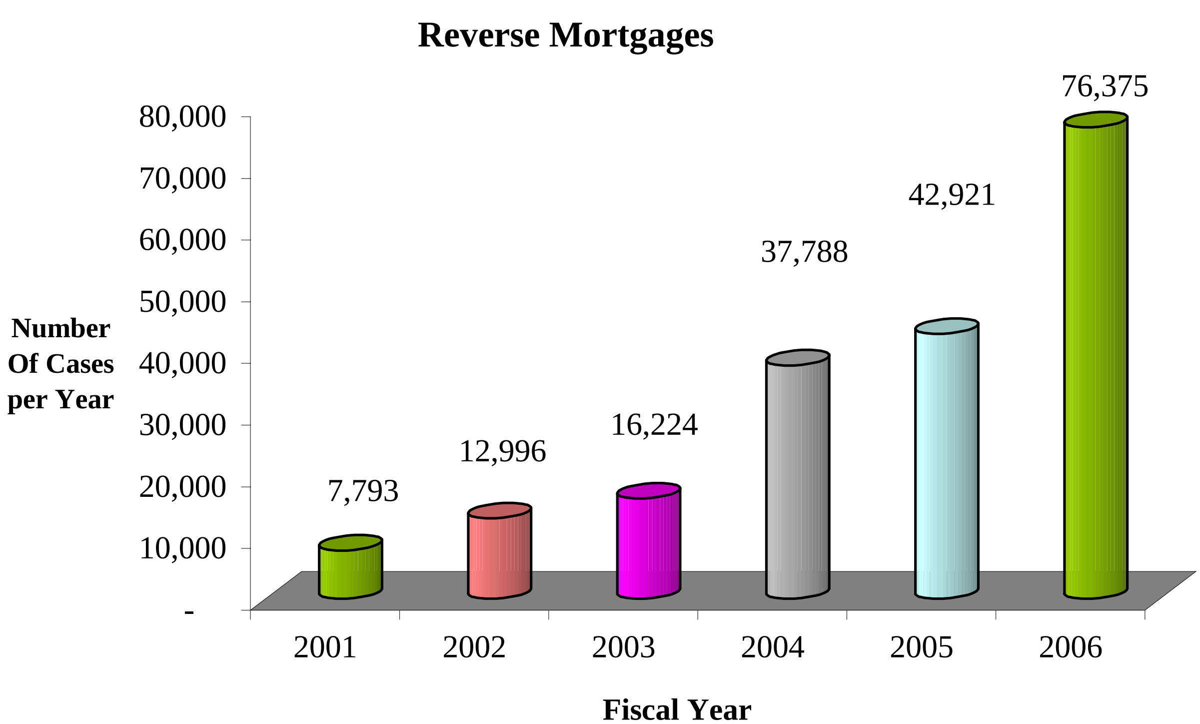
Section 234(c)

Section 234(c) covers 5.5 percent of FHA's total single family insurance-in-force. This program provides mortgage insurance for individual condominium units. A condominium is a single unit owned by an individual or family in a multi-unit project with a shared interest in common areas and facilities. This form of ownership is usually more affordable than other single family housing and often attracts first-time homebuyers who lack the capital for single family homeownership. FHA insured mortgages for 20,288 condominium units in fiscal year 2006.

Home Equity Conversion Mortgages (HECM) - Reverse Mortgages

FHA was the first entity to promote and insure reverse mortgages on a national scale. The HECM program provides eligible homeowners access to the equity in their property with very flexible terms. The loan may provide a lump sum payment, monthly payments, a line of credit or a combination of the above. The financing allows homeowners to stay in their homes with no repayment requirement until the property is vacated or sold. The program is limited to homeowners 62 years of age and older and is designed for those with limited income.

The HECM program has become increasingly popular as more homeowners choose to remain in their homes and tap into their home equity to pay living expenses. The program provides a valuable resource to persons traditionally underserved by the mortgage market. The number of reverse mortgages per year insured by FHA has increased over the past six years, from 7,793 cases in fiscal year 2001 to 76,375 in fiscal year 2006.



Fiscal Year 2006 Accomplishments

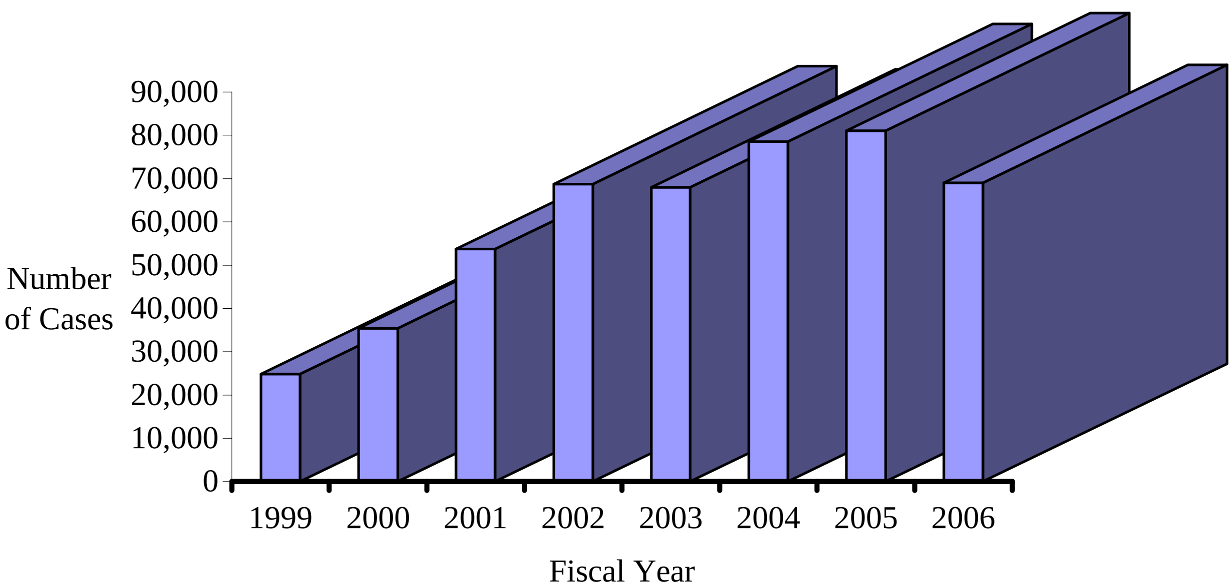
During fiscal year 2006, FHA was highly successful in assisting many Americans to achieve or sustain the goal of homeownership. FHA assisted:

- *First-Time Homebuyers.* In fiscal year 2006, 79.3 percent of FHA-insured purchase loans involved first-time homebuyers. FHA provided 248,953 families with the ability to purchase their first home during the fiscal year.

- *Minority First-Time Homebuyers.* In fiscal year 2006, 31.7 percent of first-time homebuyers who obtained FHA-insured mortgages were minorities.

- *Borrowers Experiencing Financial Difficulties.* One of FHA's most important goals is to assist homeowners facing financial difficulties to remain in their homes through increased use of loss mitigation tools. The use of these tools increased over the past eight years, from 24,874 cases in fiscal year 1999 to 75,528 in fiscal year 2006.

Use of Loss Mitigation Tools



Management Initiatives

FHA implemented several initiatives and policies to ensure that its programs continue to serve target constituencies, while maintaining strong financial viability. These initiatives included:

- *Predatory Lending Prevention.* FHA continues to help prevent millions of families from becoming victims of predatory lending practices. These efforts include denying FHA insurance for mortgages on homes that have been "flipped" at inflated prices and deploying special monitors to pursue unscrupulous appraisers and lenders. Additional efforts to combat predatory lending will focus on print media advertising, publication of informational brochures, and other consumer outreach.

- *Good Neighbor.* HUD's Good Neighbor initiative allows police officers, firefighters, emergency first responders and schoolteachers to purchase HUD homes at significant discounts. The purpose of the Good Neighbor initiative is to strengthen distressed urban communities and to provide homeownership opportunities for public service professionals. This program is a catalyst in promoting the sale and rehabilitation of vacant HUD properties in targeted neighborhoods.

- *Credit Watch Termination.* FHA's Credit Watch Termination program identifies poorly performing mortgage lenders. FHA may temporarily suspend the authority of a branch office or offices of the poorest performing mortgage lenders to originate mortgage loans. The program also warns marginally performing lenders to improve their performance if they wish to maintain their status as approved FHA lenders and continue to participate in FHA insurance programs.

- *TOTAL Scorecard.* FHA's Technology Open to Approved Lenders (TOTAL) Scorecard evaluates mortgage applications and credit information in an objective, consistent manner to assess the creditworthiness of FHA borrowers. The scorecard uses a methodology statistically proven to accurately predict the likelihood of borrower default. FHA developed the automated tool to identify potential homebuyers not currently served by the conventional market due to real or perceived risk. The lender must manually underwrite any loan assessed by TOTAL Scorecard as a "refer" designation to ensure that the applicant receives maximum consideration. Through September 30, 2006, 435,770 loans with case numbers had been scored by TOTAL. Of this amount, 310,113 single family mortgage loans were insured by FHA.

- *Lender Insurance (LI).* During fiscal year 2006, the Office of Single Family Program Development implemented a new initiative, "Lender Insurance," that allows high-performing mortgagees to endorse FHA loans without a pre-endorsement review conducted by FHA. Instead, a mortgagee performs its own pre-endorsement review and submits loan level data to FHA via FHA Connection. Upon transmitting sufficient data to satisfy FHA of the legitimacy of the mortgage insurance request, the FHA Connection system performs an automated verification process to check the data for accuracy and completeness and electronically generates a mortgage insurance certificate to serve as evidence that the loan was endorsed. LI eliminates the need for mortgagees to submit case binders as a pre-condition for obtaining FHA's mortgage insurance endorsement and therefore eliminates the need for binder re-submissions to satisfy Notices of Return (NORs). FHA will continue to select a sample of loans for post-endorsement technical review (PETR).

  LI provides the Department and its program participants enormous benefits by saving time, money and resources for all of the parties involved in the endorsement process. Customer service will dramatically improve under this program by providing lenders with prompt acceptance or denial of the endorsement package. Previously, mortgagees had to spend several days assembling the case binder and mailing it to the appropriate

HOC. After its receipt, the HOC staff processed and insured the loan or returned it for additional documentation. This process generally took two business days, but sometimes lasted as long as several weeks if the case was returned because of the Notice of Return (NOR) procedure. Under LI processing, the NOR procedures are eliminated because endorsement occurs first and case binder review, on a selected sampling of mortgages, occurs later. Only those few mortgage insurance applications that fail risk mitigation tests will be reviewed before endorsement.

FHA took the first step toward implementing LI with the publication of Mortgagee Letter 2005-36 on September 23, 2005. A pilot program was then operated out of all four Single Family HOCs between September 26 and December 31 that tested a paper-based version of LI along with the electronic case binder technology. HUD selected lenders to participate in the pilot program if they had technologies most compatible with those used by HUD. On January 1, 2006 HUD made LI available to all lenders. To qualify for participation in the LI program, lenders must be unconditionally approved for FHA's Direct Endorsement program for at least the past two years and have an acceptable default/claim record at the time the application for participation in the LI program is processed.

- *Accelerated Claims and Asset Disposition (ACD) Demonstration Program.* In 2002, FHA implemented the ACD Demonstration program under Section 601 of the VA, HUD, and Independent Agencies Appropriations Act for fiscal year 1999 by conducting the first of four sealed bid auctions in which qualified bidders participated to acquire an equity interest in a forward pipeline of single family defaulted mortgage loans.

  The initial goals of the ACD Demonstration were to accelerate the claim submission time frame, align private interests with the Department's, increase the recovery to FHA, and to support homeownership retention. By refining the current approach, FHA can potentially reduce losses from defaulted mortgages by accepting assignment of mortgage notes to HUD through the ACD Demonstration rather than paying conveyance claims and acquiring foreclosed properties. The Asset Sales Office has sold previously insured FHA notes through four competitive sealed-bid auctions of majority interests in public/private joint ventures. These Joint Ventures, in which HUD maintains minority ownership interest, then service, manage, and dispose of these defaulted single family mortgage loans. From October 2002 to September 2006, approximately 22,495 loans with loan balances of approximately $2.3 billion were sold into the Joint Ventures. The sale of these loans and their final dispositions resulted in receipts of approximately $594 million to HUD from the sale of the majority interest in the Joint Ventures plus approximately $1.1 billion in distributions of income paid at the monthly settlements by the private sector investors to the Department.

  Continuing refinements and uses of the 601 legislative authority will be made as a result of comments on the Advanced Notice of Public Rulemaking due late October 2006 and from recommendations of the evaluation of the demonstration. The Advanced Notice of Public Rulemaking will ensure that the program benefits from feedback during the policy making phase. The Department is currently planning to schedule another sale in fiscal year 2007 as a part of the ACD Demonstration, based in part on the comments received from the Advance Notice of Proposed Rulemaking process and on the findings from the ongoing evaluation of the program. The comments from the public will assist the Department to improve the program, move the initiative forward from the Demonstration to a permanent program and make it an even more valuable tool for the Department in the future.

- *Other Single Family Improvements.* FHA continues to focus its efforts to improve all stages of the single family mortgage insurance process. These efforts include improved data collection and reporting, improved controls over the post-endorsement technical review process, systems re-engineering, and an increased use of foreclosure alternatives to help homeowners retain possession of their homes.

  During fiscal year 2006, Single Family Housing continued a systems re-engineering and integration effort that started in fiscal year 2004. There are over 40 systems currently in operation using different database platforms with varying capabilities, which cannot easily share or provide critical information. This initiative will modernize all Single Family Housing systems, consolidate the systems in use, and help FHA to comply with federal legislation, to address audit weaknesses, to improve overall monitoring and oversight, and to adhere to HUD's Enterprise Architecture Framework. In addition, the modernization of Single Family's systems will simplify systems administration, reduce the total cost of ownership, provide flexible and adaptable business systems, and improve program support and oversight.

  FHA also undertook several actions during fiscal year 2006 to improve its overall risk management. These actions include improving oversight of Management & Marketing (M&M) contractors, revising protocols for monitoring appraisers listed on the FHA Rosters, revising delinquency rate reporting standards, and taking corrective actions against problem lenders, underwriters and appraisers. To fulfill the requirements of the President's Management Agenda and help remove its programs from GAO's high-risk designation Single Family Housing implemented updated management controls for contractors providing property management services with the publication of an M&M Quality Assurance Plan in November 2005. In December 2005 FHA published a Financial Control Manual for its Single Family Real Estate Owned (REO) divisions that provides guidance on the policies and procedures to be followed when reviewing and/or approving payments to contractors and other vendors.

  FHA also adopted industry-standard 30-day delinquency rate tracking, publishing a final rule establishing the new protocol in the Federal Register on March 31, 2006. Following the issuance of a mortgagee letter that specifies the exact data elements to be used under the new tracking protocol, FHA loan servicers will be allowed time to make the appropriate adjustments to their systems to utilize the 30-day delinquency rate information. FHA anticipates that loan servicers will complete these adjustments and that the new reporting standard will be in use by November 1, 2006.

  To complement its procedural and statutory risk-reduction initiatives, FHA has implemented or is developing risk-based targeting models and system changes to better monitor program performance and combat fraud in its programs. FHA officially implemented one such system, Appraiser Watch, during fiscal year 2004. This system relies on statistical analyses to identify appraisers who may contribute to poor loan performance based on certain risk factors, including association with high mortgage default rates compared to other appraisers. The monitoring approach incorporated into the Appraiser Watch system contrasts with the previous process performed by the Real Estate Assessment Center, by focusing on appraisers rather than appraisals. This saves time and money by reducing the number of physical property reviews that are required to identify and verify inadequate appraiser performance. Using this method, FHA removed 64 appraisers from the FHA roster during fiscal year 2006, compared to 151 appraisers during fiscal year 2005. FHA augmented the benefits provided by its Appraiser Watch system by implementing system changes to its Computerized Homes Underwriting Management System (CHUMS) that automate the appraiser review selection process. As of December 2005 FHA was able to automatically select appraisers for review on the basis of certain risk factors, such as high mortgage default rates compared to other appraisers, as well as on the basis of high volumes of excessive gifts, or fees exceeding six percent of a property's sales price.

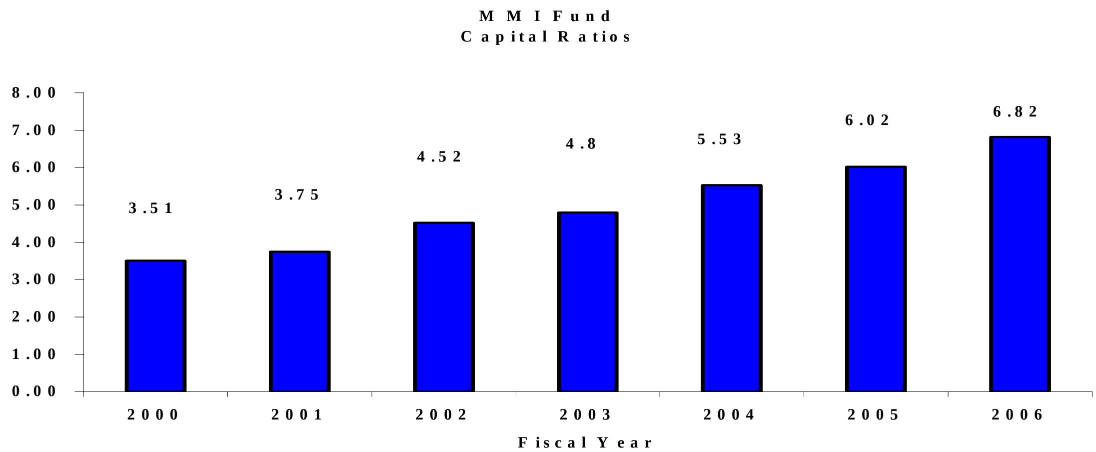
In fiscal year 2005, FHA completed system changes to FHA Connection designed to combat fraud and identity theft by expanding its capability to validate social security numbers through other government agencies. FHA Connection is a web based tool through which approved lenders conduct business with FHA. A lender can verify data immediately upon entry of name, SSN and Date of Birth (DOB) into FHA Connection. However, if the first level of verification suggests a need for further direct verification with the Social Security Administration, the lender gets a response the following day.

FHA uses a risk-based targeting model for REO properties. The Risk-Based Targeting Model (RBTM) was developed to assist in assessing the single family asset portfolio and the contractors' performance. RBTM establishes benchmarking at both the macro and micro levels to determine which HOC, contractor, area or property demonstrates anomalous behavior and needs to receive specific and detailed attention. RBTM prioritizes which risk conditions need immediate follow-up and increases the effectiveness of ongoing monitoring and forecasting functions, while capturing property file review findings, tracking the success of corrective actions that have been implemented, and providing consistent, statistically-based review results.

FHA expanded its Asset Control Area program (ACA) during fiscal year 2006. As of September 30, 2006, HUD had executed new ACA agreements with 3 local government and non-profit entities and currently has 13 ACA participants. HUD is working with one other entity to obtain revised applications and other documentation needed to secure their participation in the program. During fiscal year 2006 HUD sold 496 properties in communities designated for revitalization to ACA participants who are required to complete full rehabilitation and resell the properties to income eligible homebuyers.

MMI Capital Ratio

The MMI Fund constitutes the majority of FHA single family business, with 93.6 percent of the total single family IIF dollars. One measure of the fund's financial soundness is the MMI capital ratio. The National Affordable Housing Act of 1990 requires an independent actuarial analysis of the economic net worth of the MMI Fund. The Act also mandates that the MMI Fund achieve a capital ratio, a measure of the Fund's economic net worth, of at least 2 percent by the year 2000, which was achieved in 1995 and maintained ever since.



As illustrated above, the MMI Fund's capital ratio met the 2 percent minimum requirement in 2000 and exceeded that minimum every year since. The MMI Fund's capital ratio is estimated at 6.82 percent at the end of fiscal year 2006, compared to 6.02 percent in fiscal year 2005. The capital ratio is expected to be sufficient to withstand unexpected losses without exposing the taxpayers to financial risk.

Office of Multifamily Housing

FHA provides financing support for the development of rental housing and healthcare facilities through its Multifamily Mortgage Insurance programs. In fiscal year 2006, FHA initially endorsed 1,016 Multifamily loans totaling $5.13 billion. There are 12,319 mortgages held in the portfolio with an unpaid principal balance (UPB) of approximately $56.5 billion.

Multifamily Housing Programs

FHA's largest multifamily programs in terms of insurance-in-force dollars are Sections 221(d)(4), 207/223(f), Section 223(a)(7) and 232. These programs, as well as the 242 Hospital Programs and Mark-to-Market Programs, are discussed below.

Section 221(d)(4)

Section 221(d)(4) has historically been FHA's most popular multifamily program. It provides mortgage insurance for the construction or substantial rehabilitation of multifamily rental properties consisting of five or more units. FHA may insure mortgages for up to 90 percent of a project's estimated replacement cost under this program. During fiscal year 2006, FHA endorsed 92 mortgages, covering 14,996 units, with a mortgage amount of $0.9 billion. At the end of fiscal year 2006, there were 2,265 active mortgages in place, covering 330,453 units, with an outstanding mortgage balance of $17 billion. The program makes up 30.1 percent of total multifamily insurance-in-force.

Section 207/223(f)

The Section 207/223(f) program provides mortgage insurance for the refinancing or acquisition of existing multifamily rental properties consisting of five or more units. Under this program, FHA may insure mortgages for up to 85 percent of a project's appraised value, or up to 90 percent of a project's appraised value in cases of refinancing or acquisition of properties formerly financed with Section 202/8 Direct Loans. The program applies to both formerly FHA-insured and conventionally financed properties. In fiscal year 2006, FHA insured 365 mortgages. These mortgages, valued at $1.7 billion, covered 36,998 units. At the end of the fiscal year 2006, the active portfolio consisted of 1,419 mortgages, covering 187,542 units, with a total outstanding balance of $6.41 billion. The program makes up 11.4 percent of total Multifamily IIF.

Section 223(a)(7)

The Section 223(a)(7) program provides mortgage insurance for the refinancing of existing multifamily rental properties with FHA-insured mortgages. In fiscal year 2006, FHA insured 235 mortgages. These mortgages, valued at $641.6 million, covered 24,084 units. At the end of the fiscal year 2006, the active portfolio consisted of 2,540 mortgages, covering 277,686 units, with a total outstanding balance of $6.6 billion. The program makes up 11.8 percent of total Multifamily IIF.

Section 232

The Section 232 Mortgage Insurance for Residential Care Facilities program insures loans to finance the construction, substantial rehabilitation, acquisition or refinancing of healthcare facilities. Eligible facilities include nursing homes, intermediate care facilities, board and care homes and assisted living facilities. FHA insured 222 mortgages for $1.3 billion under this program in fiscal year 2006, providing 24,895 units/beds. At the end of the fiscal year 2006, the active portfolio consisted of 2,084 mortgages, covering 252,435 units/beds, with a total outstanding balance of $12.4 billion. This program makes up 22.0 percent of total Multifamily IIF.

Section 242

The Section 242 Mortgage Insurance for Hospitals program provides hospitals access to affordable financing for capital projects, including new construction or modernization. Since its inception in 1968, FHA insured 343 hospital mortgages for $12.0 billion under the program. Clients range from small rural hospitals to major medical centers. Hospitals with FHA-insured loans serve as community anchors, providing jobs as well as healthcare services. FHA administers the program with assistance from the U.S. Department of Health and Human Services. FHA currently has 73 active hospital loans with an unpaid principal balance (UPB) totaling over $4.7 billion. FHA issued insurance commitments totaling $943 million for 9 hospitals in 7 states in fiscal year 2006.

On July 10, The President signed the Rural Health Care Capital Access Act of 2006 into law. The law will help critical access hospitals, small rural hospitals located in some of the most underserved communities in the nation, qualify for HUD's Section 242 mortgage insurance program. The Section 242 program has been the only option for rural communities that need to replace their aging critical access hospitals with facilities that can provide a high standard of care.

Mark-to-Market Program

FHA's Mark-to-Market (M2M) program seeks to preserve affordable housing stock by maintaining the long-term physical and financial integrity of such housing and to reduce the Section 8 rental assistance costs and the cost of FHA insurance claims. Under the M2M program, the Office of Affordable Housing Preservation (OAHP) analyzes FHA-insured multifamily properties for which Section 8 rents exceed comparable market rents, and reduces the rents to bring them in line with comparable market rents or levels that preserve financial viability. Sometimes rent reductions can be accomplished and financial viability assured without affecting project debt. More frequently, however, M2M restructures FHA-insured mortgages on eligible multifamily projects. HUD/FHA analyzes properties under M2M and makes appropriate reductions to the mortgages to allow the project debt to be serviced with reduced subsidy payments while remaining financially viable with market rate rent schedules. The M2M process involves either a full or partial payment of claim by FHA on the original mortgage, followed by FHA's commitment of a new mortgage that can be supported at market rents.

In fiscal year 2006, OAHP completed mortgage restructuring on 286 (22,253 units) properties under the M2M program, with 90 percent resulting in reduced rents and Section 8 savings. Of the 286 properties with mortgage restructuring completed during fiscal year 2006, 130 properties resulted in full debt restructurings, contributing to the long-term preservation of 9,484 units. The restructurings represent an annual Section 8 savings (non-incurrence of cost) of $17.5 million. In addition, 58 properties (4,956 units) charged reduced rents only, representing an annual Section 8 savings (non-incurrence of cost) of over $13.2 million. In total, 188 properties representing over 14,440 units received reduced rents, resulting in annual savings (non-incurrence of cost) of over $30.7 million.

Multifamily Housing Development

The Office of Multifamily Housing Development provides direction and oversight for FHA mortgage insurance loan origination. HUD's Multifamily Hubs and Production Offices initially endorsed 1,016 FHA-insured loans in fiscal year 2006, representing 112,019 units/beds and $5.13 billion in total endorsements. The loans included 85 Risk Sharing loans, totaling $429.6 million and 9,253 units, with state and other approved housing finance agencies. In comparison, FHA insured 1,017 loans in fiscal year 2005, representing 122,467 units/beds and $5.6 billion total endorsement.

The combined number of multifamily endorsements was just one less loan than fiscal year 2005 activity. There was a significant decline in new construction and substantial rehabilitation apartment activity as well as in the number of FHA insured loans refinanced under Section

223(a)(7). This decline was offset by strong production in two major areas: Section 207/223(f) apartments and Section 232. Section 207/223(f) activity more than doubled to 365 loans due primarily to high activity (over 65%) in refinances of Section 202/8 direct loans. Section 232 activities also increased over 10% from 200 to 222 loans with a heavy emphasis on refinancing older nursing homes with major operators.

Management Initiative for Multifamily Housing Development

In fiscal year 2006, FHA implemented an initiative to ensure that its programs continue to serve its target constituency while maintaining the financial viability necessary to further its mission. The initiative includes:

- Lender Quality and Monitoring Division (LQMD) –
    - LQMD is FHA's primary monitoring arm in determining the quality of MAP lender underwriting.

In fiscal year 2006, LQMD out-stationed staff completed 40 project reviews focusing on troubled and large loans.

Management Tools for Multifamily Housing Development

The Office of Multifamily Housing Development has a number of tools in place to assist the Multifamily Hub and Program Centers to expedite and manage the development process.

- *Multifamily Accelerated Processing(MAP).* MAP shifts the responsibility for underwriting loans from HUD Staff to lenders. MAP has shortened HUD's application review time because MAP approved lenders now prepare and review most of the application documents. During fiscal year 2006, 504 Multifamily loans were processed under MAP. These loans, valued at approximately $3.05 billion, covered 59,155 units. These include the following endorsements: New Construction/Substantial Rehabilitation of apartments, 232 Healthcare, and 207/223(f) refinancing eligible for MAP. All applications processed under MAP are subject to HUD field office review and quality control and HUD's risk management reviews through LQMD. Lenders who do not follow FHA's procedures are subject to administrative sanctions. Headquarters staff provides advice and guidance to MAP lenders and FHA field staff.

- *Credit Subsidy.* As a result of improved program performance and asset sales, FHA now only requires credit subsidy on all Section 223(d) operating loss loans and Section 221(d)(3) and 241(a) supplemental apartment loans that do not receive Low Income Housing Tax credit allocations.

- *Streamlining.* FHA issued Mortgagee Letter 06-03, which reemphasizes the importance of the Section 223(a)(7) refinancing program and updates processing procedures. Headquarters staff and the Hubs are working together on streamlining initiatives to improve processing.

- *Delinquency/Claim Information.* Headquarters is able to provide information on delinquencies and claims to the Hubs based upon reports compiled by GNMA and Housing's Office of Evaluation.

Multifamily Asset Management

FHA's Multifamily portfolio has 12,319 insured mortgages. At the end of September 2006, this portfolio covered 1.5 million units, with a total outstanding balance of over $56.5 billion. FHA held 2,990 notes in inventory, with a total outstanding principal balance of $3.3 billion.

Management Initiatives for Multifamily Asset Management

FHA's Multifamily Asset Management has significantly improved the accuracy and timeliness of its information in recent years through automation and significant workload streamlining. Better management information and updated systems have allowed FHA to make improvements in the physical condition of the FHA Multifamily portfolio.

- *Note Sales.* To dispose of multifamily assets, HUD can either sell a property through foreclosure or sell the mortgage note. Note sales have historically demonstrated a greater return to the FHA Insurance Fund as compared to foreclosures. FHA conducted two Multifamily and Healthcare Loan Sales in fiscal year 2006. The assets included in the December 2005 sale had an estimated value to HUD, if retained, of roughly $102 million, or over 46 percent of UPB ($219 million). The net proceeds from the sale of these notes were over $134 million, over 61 percent of UPB, producing approximately $33 million in budget savings. The assets included in the June 2006 sale had an estimated value to HUD, if retained, of roughly $71 million, or over 45 percent of UPB ($156 million). The net proceeds from the sale of these notes were over $108 million, over 69 percent of UPB, producing approximately $37 million in budget savings.

  Combined, the 2 sales produced $70 million in budget savings to HUD.

- *Lead-based paint.* FHA continued to assess lead-based paint hazards in FHA-insured multifamily projects in fiscal year 2006. In addition to assessments, FHA monitors the owners' actions to mitigate or correct the problem. Multifamily developed a monitoring and tracking report that will allow quarterly reviews of the owners' compliance with the regulations. FHA will refer owners who fail to comply with the regulations to HUD's Departmental Enforcement Center and the Office of Healthy Homes and Lead Hazard Control for enforcement action.

- *Handicapped Accessibility Survey*. In the past, HUD conducted nationwide surveys of HUD-insured and uninsured assisted multifamily properties to identify handicapped-accessible units. HUD then posted information on FHA-insured units accessible to handicapped individuals on its web site for public access. Under a new initiative, HUD has modified its management and occupancy review form and process to collect data on handicapped units as part of its annual review. Data will be collected in the Real Estate Management System (REMS), which will then be used to periodically update the information on HUD's web site.

Management Tools for Multifamily Asset Management

The Office of Multifamily Asset Management uses a number of tools in its oversight of insured and subsidized properties, mortgage notes, and HUD-owned properties.

- *Physical Assessment Subsystem (PASS).* PASS is a subsystem that includes the automated implementation of the Uniform Physical Inspection Standards. The subsystem schedules inspections and provides notice to the owner and the inspectors. Using electronic data collection devices or handheld computers, inspectors are assigned a random selection of units to inspect by the system. The inspection results are uploaded to PASS, reviewed and posted on-line for the owner and HUD staff to review. In addition to the overall evaluation of the portfolio's physical condition, HUD tracks the correction or mitigation of Exigent Health and Safety conditions identified in the physical inspection. The owner must correct or mitigate these conditions within 3 business days of the inspection and certify the correction or be subject to administrative action.

  HUD refers properties with scores less than 60 (out of a possible score of 100) to the Enforcement Center who then advises the owners that they have 60 days to bring the properties up to standard condition. HUD re-inspects the properties sometime after the 60-day period expires. If they remain below standard, HUD initiates steps to protect the tenants' community and the government's interests by taking action to permanently correct the problem. Possible options include sale or the physical transfer of the property, foreclosure, and/or termination of any subsidies. As of the end of fiscal year 2006, 479 (about four percent) of 11,930 properties insured and under management in the PASS system had scored less than 60. All of these properties are either being removed from the portfolio, or are under a compliance, disposition and enforcement plan or are being reviewed for one.

- *Multifamily Default and Delinquency Reporting System (MDDR).* MDDR is a Web-enabled system for the collection, tracking, and reporting of FHA-insured mortgage delinquencies, defaults, and elections to assign. MDDR provides the basis for HUD's quarterly report to Congress on multifamily defaults.

- *Real Estate Management System (REMS).* REMS is the primary system for HUD staff to review and manage multifamily properties. REMS draws its data from multifamily data systems, including the Financial Assessment Subsystem (FASS), the Physical Assessment Subsystem (PASS) and others.

- *Financial Assessment Subsystem (FASS*). The FASS subsystem collects annual project financial statement information and assesses a project's financial performance and compliance, for the purpose of identifying financial risks and compliance deficiencies in need of loss mitigation or enforcement actions by the Office of Housing or the Departmental Enforcement Center. As part of an overall asset management strategy, FASS addresses open Office of Inspector General recommendations to improve the processing and use of annual project financial statement information. FHA continues to refine its financial evaluation indicators to better predict which properties may be facing financial difficulties that, if left unaddressed by the owner or HUD, would create a claim against the insurance fund. An enhanced FASS, integrated under Online Property Integrated Information Suite (OPIIS) with other data, creates better servicing and management priorities for staff in the local field offices.

- *Online Property Integrated Information Suite (OPIIS).* OPIIS (formally known as NASS) integrates HUD's multifamily data systems including PASS, FASS, MDDR with REMS and external data for property and portfolio analysis. HUD staff use OPIIS to access multiple years of financial statements and physical inspection results to determine trends in property performance. OPIIS calculates an Integrated Risk Assessment score (IRA) based upon statistical analysis of defaults and delinquencies to predict the likelihood of claims against the insurance fund. The IRA is dynamically updated every time the applicable data change. Portfolio IRAs are used to establish workload priorities. A popular feature enables users to compare a given property with its peers based on location, size, and program characteristics selected by the user.

Hurricane Relief Efforts

As a result of damage incurred by Hurricane Katrina in the Gulf Coast and Southeast, HUD's continuing efforts have been focused on providing relief to displaced residents. The Federal Emergency Management Agency (FEMA) has designated disaster areas that were directly affected by the hurricane in the states of Alabama, Florida, Louisiana, Mississippi, and Texas.

For the Multifamily portfolio, the Department's goal is to work with the owners to repair, rehabilitate or rebuild affordable housing units as quickly as possible and to maintain the rental subsidies (if applicable). HUD Mortgagee letter 2004-38 and Notices 04-22 and 05-20 provided guidance and policies in effect addressing mortgage forbearance, priorities for temporary and permanent rental housing, allowing multiple occupants in a unit, leases and rents, REAC inspections, use of escrows, and flexibility in occupancy. The Department issued additional guidance on September 9, 2005 and October 28, 2005 to provide clarity on policies and procedures regarding occupancy, the right to return for the displaced residents and other occupancy issues. Immediately after the hurricanes, the Department initiated its damage assessment protocol and process for all HUD-assisted properties (1,123) in the affected areas. The process included initial telephone assessments (both of the physical plant as well as the status of the residents), followed by physical site visits to the projects receiving moderate and serve damage and subsequent meetings (both individual and group) with the owners to discuss repairs, rehabilitation or rebuilding the properties and the identification of funding resources. The Department has completed all assessments and met with all the owners regarding their plans for the properties. In Alabama (225 properties) and Texas (69 properties), all repair and rehabilitation work on the properties has been completed or is anticipated to be completed by the end of 2006. In Mississippi (422 properties), work on approximately 90% of the properties has been completed or will be completed by the end of 2006. In Louisiana (407 properties), approximately 75% of repair and rehabilitation has been completed or is anticipated to be completed by March of 2007. The Department continues to monitor the status of the repairs, rehabilitation or rebuilding efforts for each property until the work is complete and the project is fully operational. For those projects that have been severely damaged or destroyed, the Department continues to work with the owners to rebuild on site and obtain the necessary financing or move the rental assistance, use agreement and/or mortgage to alternate sites under Section 318 of the HUD 2006 Appropriations Act.

For the Single Family portfolio, borrowers with FHA-insured mortgages were protected from untimely foreclosure by a series of moratoriums that continued until late summer 2006 for the most severely impacted borrowers. Lenders effectively used HUD's loss mitigation program to cure hurricane related defaults. From the date of the Katrina disaster through the end of fiscal year 2006, more than 25,000 FHA insured borrowers in the 5 Gulf States were able to retain home ownership through these long-term solutions. The Mortgage Assistance Initiative is a loss mitigation option that was crafted specifically for hurricane victims who were committed to rebuilding but needed help with mortgage payments during construction. To date, 550 families have received mortgage payment assistance of up to 12 months PITI.

Additional assistance to victims is made available through Single Family Housing's Section 203(h) program (Mortgage Insurance for Disaster Victims), in which families and individuals whose homes were either destroyed or severely damaged may obtain 100% mortgage financing for the purchase of a new home anywhere in the country. Since Hurricane Katrina struck, FHA has helped 535 individuals and families purchase new homes, with over 80% of the mortgages insured under this program located in the Gulf States of Louisiana, Mississippi and Texas.

Typically, disaster victims have a one-year period to apply with a lender for a 203(h) loan. However, due to the unprecedented extent of destruction caused by 2005 hurricane season, FHA determined that the one-year period was insufficient to meet the housing needs of the hurricanes' victims and extended the application period. Disaster victims of Hurricanes Katrina, Rita and Wilma now have until September 30, 2007 to file applications with lenders under the 203(h) Mortgage Insurance Program for Disaster Victims. Lenders have been advised that disaster victims have until September 30, 2007 to apply for the Section 203(h) program.Under an interagency agreement with FEMA, more than 2,000 families were provided emergency rental housing in HUD REO properties. HUD made minor repairs to homes in its inventory in the Gulf Region and leased the properties to hurricane evacuees for up to 18 months.

Additionally, HUD is making permanent replacement housing available by selling properties in its nationwide REO inventory to hurricane evacuees at very special terms including a discount off the sales price. To date, 79 properties have been sold to evacuees and 71 transactions are pending. Many of these purchasers are also taking advantage of the 203(h) financing option.

FHA has also kept close contact with the HUD-insured hospitals that have been affected by the hurricanes. For example, Baton Rouge General Medical Center (BRGMC), which suffered only minor damage from Hurricane Katrina, operated as a triage center while the community absorbs residents formerly of New Orleans. FHA is actively disseminating information to other affected hospitals about rebuilding, using Section 242 mortgage insurance.

PERFORMANCE GOALS, OBJECTIVES, AND RESULTS

The Government Performance and Results Act (GPRA) and the Government Management Reform Act (GMRA) mandate that Federal agencies improve their financial and program accountability. GPRA requires Federal agencies to develop multiyear strategic plans, set program goals, measure performance against the goals, and publicly report the findings. GMRA mandates improvements and reforms to promote better accountability and financial management of the Federal government. FHA has outlined a series of reforms designed to improve efficiency, responsiveness to clients, and accountability to the public.

<u>Office of Single Family Housing Programs</u>

The following sections summarize the Office of Single Family Housing's success in meeting its fiscal year 2006 performance goals.

Strategic Goal: Increase Homeownership Opportunities

<u>*Resolve 50 percent of total claims on FHA-insured single family mortgages through loss mitigation.*</u>

FHA established a national goal of resolving 50 percent of single family mortgage defaults via loss mitigation techniques. Single Family Housing surpassed this goal resolving 61 percent of defaults through loss mitigation techniques in fiscal year 2006. The fiscal year 2006 rate exceeds the 59.1 percent of mortgage defaults resolved using loss mitigation techniques in fiscal year 2005.

<u>*Endorse at least 483,000 FHA single family mortgages nationwide.*</u>

Although FHA did not establish an output goal in the Annual Performance Plan for the number of single family endorsements nationwide, the agency established an internal field-planning target of 483,000 endorsements. Homeownership Centers can use this target to allocate processing and underwriting workload across the nation to help increase single family homeownership rates. During fiscal year 2006, FHA endorsed 502,049 single family mortgages for insurance, exceeding the internal field-planning target of 483,000 endorsements. The 53,668 decrease in the total volume of single family mortgage insurance endorsements from fiscal year 2005 (555,717) is largely attributable to increasing mortgage interest rates and a slowing real estate market. Contributing factors include a reduced number of mortgage refinance transactions and strong homebuyer acceptance of products that FHA is unable to offer due to statutory constraints. Given these limitations, FHA focused its efforts on process improvements in order to make the program more compatible with the rest of the industry. These changes have been well received by lenders and real estate professionals, and as a result, more low-and moderate-income homebuyers are benefiting from FHA financing. FHA modernization legislation has been approved by the House of Representatives and is awaiting Senate approval. Passage of this legislation will reduce statutory barriers and increase FHA's flexibility to respond to changes in the marketplace. As a result, FHA will be able to reach more prospective homebuyers to provide an alternative to sub-prime loans with high interest rates and closing costs, as well as expensive repayment penalties.

<u>*Endorse 71 percent of FHA-insured single family home purchase mortgages to first-time homebuyers (HOC).*</u>

To help increase the number of families able to secure financing for their first home FHA established a target of 71 percent for its Homeownership Centers for single family home purchase mortgage endorsements to first-time homebuyers. In fiscal year 2006, 79.3 percent of FHA-insured single family home purchase mortgages were to first-time homebuyers, compared with the target of 71 percent and the 79.0 percent achieved in fiscal year 2005. The consistency in the share of home purchase mortgages endorsed to first-time homebuyers from fiscal year

2005 (79.0 percent) may be attributable to FHA's continued commitment to reaching first-time homebuyers. FHA will continue its efforts to reach potential first-time homebuyers through participation in conferences, seminars and other outreach events.

Endorse 35 percent of FHA-insured first-time single family home purchase mortgages to minorities.

To help increase the number of minority families able to secure financing for their first home FHA established a target of 35 percent for its Homeownership Centers for single family home purchase mortgage endorsements to minority first-time homebuyers. In fiscal year 2006, 31.7 percent of FHA-insured single family home purchase mortgages endorsed to first-time homebuyers were to minority homebuyers, compared with the target of 35 percent and the 34.4 percent achieved in fiscal year 2005. The decrease in the share of home purchase mortgages endorsed to minority first-time homebuyers of 2.7 percentage points may be attributable to increasing mortgage interest rates and a slowing real estate market. Contributing factors include a reduced number of mortgage refinance transactions and strong homebuyer acceptance of products that FHA is unable to offer due to statutory constraints. Given these limitations, FHA focused its efforts on process improvements in order to make the program more compatible with the rest of the industry. These changes have been well received by lenders and real estate professionals, and as a result, more low- and moderate-income homebuyers are benefiting from FHA financing. FHA modernization legislation has been approved by the House of Representatives and is awaiting Senate approval. Passage of this legislation will reduce statutory barriers and increase FHA's flexibility to respond to changes in the marketplace. As a result, FHA will be able to reach more prospective homebuyers to provide an alternative to sub-prime loans with high interest rates and closing costs, as well as expensive repayment penalties.

FHA will continue to pursue the President's commitment to reaching minorities and increasing the minority homeownership rate through housing counseling program outreach and print and radio advertising.

Strategic Goal: Strengthen Communities

Endorse at least 35 percent of FHA-insured single family mortgages in underserved communities.

FHA established a national goal to ensure that at least 35 percent of single family mortgages endorsed for insurance by FHA are in underserved communities, thereby enhancing homeownership opportunities in these neighborhoods. During fiscal year 2006, 40.2 percent (201,780 out of 502,049) of single family mortgages endorsed for insurance by FHA were in underserved communities.

Strategic Goal: Embrace High Standards of Ethics, Management and Accountability

The FHA Mutual Mortgage Insurance Fund meets congressionally mandated capital reserve targets.

FHA's Mutual Mortgage Insurance (MMI) Fund is responsible for all expenses, excluding administrative expenses but including insurance claims, incurred under FHA's basic single family mortgage insurance program. The program is expected to be entirely self-financing through up-front earnings and annual insurance premiums paid by borrowers obtaining FHA mortgage loans, as well as from asset sales, earnings on fund assets and other income. The fund is subject to an annual actuarial review. The review assesses the fund's current economic value, its capital ratio, and its ability to provide homeownership opportunities while remaining self-sustaining based on current and expected future cash flows. The capital ratio is an indicator of the MMI Fund's financial soundness. The Cranston-Gonzalez National Affordable Housing Act required that FHA achieve a capital ratio of 2.0 percent by fiscal year 2000. FHA has met this requirement every year since fiscal year 1995. In fiscal year 2006, FHA achieved a 6.82 percent MMI fund ratio compared to 6.02 percent for fiscal year 2005. In the future, this ratio is expected to remain above the 2.0 percent goal.

Average at least 68 percent net recovery rate per property sale.

FHA established a net recovery rate goal of 68 percent per HUD Real Estate Owned (REO) property sale, to reduce insurance claim losses associated with foreclosures. During fiscal year 2006, the average net recovery rate per sale was 64 percent. This result falls short of meeting the goal set for this performance indicator in fiscal year 2006.

Conduct 500 lender-monitoring reviews of FHA-approved lenders.

HUD set a national goal to conduct 500 lender-monitoring reviews of FHA-approved lenders in fiscal year 2006. HUD exceeded that goal by conducting 569 reviews in fiscal year 2006.

Sell 90 percent of FHA-insurable Real Estate Owned (REO) properties to owner-occupants.

During fiscal year 2006, FHA met its goal, selling 90 percent (2378 out of 2648) of FHA-insurable REO single family properties to owner-occupants, compared with the 85.1 percent (3,708 out of 4,356) of FHA-insurable properties sold to owner-occupants during fiscal year 2005.

Office of Multifamily Housing Programs

Strategic Goal: Increase the Availability of Affordable Rental Housing

Increase Multifamily Initial Endorsements to 1,000.

Multifamily initial endorsements for fiscal year 2006 totaled 1,016, exceeding the goal of 1,000 by nearly 2 percent.

Strategic Goal: Improve Management Accountability for Assisted Housing

Multifamily Financial Assessments: 95 percent of the active inventory of Multifamily properties has no compliance flags or have their findings closed.

Multifamily Housing continues to improve the financial condition of properties by assuring that all property owners submit Annual Financial Statements (AFS) to the Real Estate Assessment Center and HUD field offices for review. Multifamily Housing met the goal that at least 98 percent of the inventory properties have no compliance flags or have their findings closed in fiscal year 2006.

HUD-held delinquencies: 75 percent of HUD-held loans that are 90 or more days delinquent are under control.

HUD-held loans are placed under a workout plan when delinquent. Loans that are not under the plan are brought under control by being recommended for foreclosure, put in the mortgage sale, or referred to the Departmental Enforcement Center for further action. In fiscal year 2006, Multifamily Housing exceeded its goal, attaining a 79 percent rate.

Strategic Goal: Help Communities More Readily Access Revitalization Resources to Become More Livable

Maintain the share of multifamily properties in underserved areas insured by FHA at 25 percent of initial endorsements

FHA set a goal of endorsing at least 25 percent of initial endorsements of multifamily properties in underserved areas in fiscal year 2006. FHA exceeded the goal as of the end of the year and FHA endorsed 420 multifamily properties serving underserved communities, equaling 41 percent of its initial endorsements.

FINANCIAL STATEMENTS

Credit Reform Accounting

The financial statements have been prepared in accordance with the Federal Accounting Standards Advisory Board's (FASAB) Statement of Federal Financial Accounting Standards (SFFAS). The authoritative guidance for the statements are contained primarily in: SFFAS No. 2, *Accounting for Direct Loans and Loan Guarantees,* as amended; by SFFAS No. 18, *Amendments to Accounting Standards for Direct Loans and Loan Guarantees;* SFFAS No. 19, *Technical Amendments to Accounting Standards for Direct Loans and Loan Guarantees;* the Federal Credit Reform Act (FCRA) of 1990.

Before the enactment of the FCRA, credit program costs were recorded in the budget of the U.S. federal government on the cash basis. While this accurately reflected the actual cash flows, it did not reflect the ultimate costs of credit programs, and thus hindered the comparison between the costs of these programs with those of other federal programs, such as direct loan programs. Beginning in fiscal year 1992, the FCRA requires that the ultimate costs of a credit program be calculated, and the budgetary resources obtained, before new direct loan obligations are incurred and new loan guarantee commitments are made. The cost of loan guarantee programs is the net present value of the estimated future cash flows from payments (for claims, interest rate subsidies, and other payments) and collections (for loan origination and other fees, penalties and recoveries) by credit agencies.

SFFAS No. 2, which generally mirrors the requirements of the FCRA, established guidance for estimating the cost of direct and guaranteed loan programs, as well as for recording direct loans and the liability for loan guarantees for financial reporting purposes. SFFAS No. 2 states that the actual and expected costs of federal credit programs should be fully recognized in both budgetary and financial reporting. To accomplish this, agencies first predict or estimate the future performance of direct and guaranteed loans when preparing their annual budgets. The data used for these budgetary estimates are re-estimated after the fiscal year-end to reflect changes in actual loan performance and the actual interest rate in effect when the loans were insured. This re-estimated data is then used to report the cost of the loans disbursed under the direct or guaranteed loan program as a "Program Cost" on the agencies' Statement of Net Costs.

The FCRA establishes budgetary and financing control for each credit program through the use of the program, financing, and negative subsidy receipt accounts for loan guarantee commitments and direct loans obligated after September 30, 1991. It also establishes the liquidating account for any loan guarantee commitments and direct loans obligated before October 1, 1991. For further information regarding the FCRA and credit reform accounting, refer to Notes 1 and 6 of the Notes to Principal Financial Statements.

Budgetary Resources

FHA finances its operations primarily through appropriations, borrowings from the U.S. Treasury, spending authority from offsetting collections, and prior year unobligated balances. During fiscal year 2006, FHA received appropriations of $1,281 million, borrowings of $897 million, spending authority from offsetting collections of $14,005 million, and recoveries of prior year obligations of $103 million. Additionally, FHA's budgetary resources were increased by $29,493 million of unobligated balances carried forward from fiscal year 2005 and reduced by $2,338 million for repayment of borrowings, the return of the unobligated GI/SRI liquidating account balances to Treasury, and the return of cancelled program funds.

For fiscal year 2006, $418 million in appropriations were received for MMI/CMHI contract and administrative expenses. FHA obligated $351 million for administrative expenses and $61 million for contract expenses in fiscal year 2006. The GI/SRI program appropriations for subsidy, administrative and contract expenses totaled $320 million in fiscal year 2006. FHA obligated $229 million for administrative expenses, $75 million for contract expenses and $3 million for positive credit subsidy in fiscal year 2006.

During the year, FHA used its borrowing authority to obtain approximately $847 million from the U.S. Treasury. These funds were used to pay for loan guarantee claims and for negative credit subsidy.

Spending authority of $11,600 million and $2,406 million was received from offsetting collections in the MMI and GI/SRI funds, respectively. These offsetting collections include collections of premiums, fees, sales proceeds of credit program assets and credit subsidy transferred between different FHA accounts.

These funds provided FHA the resources to cover the fiscal year 2006 obligations totaling $14,018 million. These obligations included: payments on defaulted guaranteed loans; the cost of acquiring, maintaining and disposing of foreclosed properties; the transfers of credit subsidy re-estimates; and maintaining MMI reserves (capital ratios) as required by the National Affordable Housing Act of 1990.

Assets and Liabilities

FHA maintains a highly liquid balance sheet with the majority of its assets consisting of fund balances with the U.S. Treasury and investments in non-marketable, market-based securities issued by the U.S. Treasury. The nature of FHA's business requires it to carry, or acquire through borrowing, the assets necessary for claim payments on defaulted guaranteed loans. Additionally, FHA must meet credit reform requirements of transferring out negative subsidy and downward credit subsidy re-estimates from the financing accounts. The negative subsidy and downward re-estimate calculations are based on various assumptions about premium and fee collections, prepayments, claims, and recoveries on credit program assets. Accordingly, FHA's total assets and financial leverage can fluctuate significantly depending largely on economic and market conditions, volume of activity, and customer demand.

FHA's total assets at September 30, 2006 increased minimally to $37,293 million from fiscal year 2005. Total liabilities at September 30, 2006 decreased 5 percent to $13,294 million over the same period. The increase in assets is mainly attributable to an increase in fund balance with U.S. Treasury. The decrease in liabilities is primarily attributable to decreases in loan guarantee liability.

Schedule of Balance Sheet
As of September 30th
(Dollars in millions)

	2003	2004	2005	2006
Assets	$36,669	$35,815	$37,161	$37,293
Liabilities	18,434	14,646	14,006	13,294
Net Position	$18,235	$21,169	$23,155	$ 23,999

As of September 30, 2006, FHA assets consisted of: investments in U.S. Treasury securities totaling $22,012 million; a fund balance with U.S. Treasury of $10,568 million; loan receivables and related foreclosed properties, net totaling $4,283 million; other receivables and assets totaling $430 million. FHA liabilities as of September 30, 2006 consisted of: loan guarantee liability totaling $3,482 million; borrowings from the U.S. Treasury of $6,258 million; payables to the public totaling $396 million; debentures issued to claimants totaling $95 million; other liabilities to federal agencies and to the public totaling $3,063 million.

Secretary-Held Mortgage Notes

A note is assigned to the Secretary when FHA pays a claim prior to foreclosure and takes possession of the mortgage note for servicing. Between fiscal years 2005 and 2006, the overall unpaid principal balance of Secretary-held mortgage notes decreased by 2 percent to $3,896 million from $3,971 million and the overall number of notes increased by 6 percent. The number of Title I notes decreased by 21 percent in fiscal year 2006 from 11,820 notes in fiscal year 2005 to 9,350 notes in fiscal year 2006. Notes acquired through the Home Equity Conversion Mortgage (HECM) program comprised $140 million of the total Secretary-held mortgage notes held in fiscal year 2006. The number of multifamily notes in inventory increased by 2 percent from 2,947 notes in fiscal year 2005 to 2,995 notes in fiscal year 2006. The number of single-family notes increased by 13 percent from 47,541 notes in fiscal year 2005 to 53,779 notes in fiscal year 2006.

For the single family programs, mortgage notes in default were assigned to FHA for servicing until 1996 when the program was terminated due to the high cost of servicing assigned notes. However, eligible borrowers in older cohorts who applied for the program before April 26, 1996 may still receive such benefits.

Legislation passed in 1999 allows FHA to accept mortgage note assignments for single family properties again. FHA can either service the notes directly or transfer them to a third party for servicing.

Schedule of Secretary-Held Mortgage Notes
As of September 30th
(Dollars in Millions)

	2003	2004	2005	2006
Single Family	$ 327	$ 474	$ 506	$ 550
Title I	196	147	102	81
Multifamily	2,722	3,184	3,363	3,265
Total	$ 3,245	$ 3,805	$ 3,971	$ 3,896

<u>Secretary - Held Property</u>

FHA acquires single family and multifamily properties through foreclosure or conveyance claims. Secretary-held property increased 3.7 percent in fiscal year 2006 to $2,940 million from $2,835 million in fiscal year 2005. The 3.7 percent increase in property inventory reflects an increase of 2.95 percent in the number of single-family properties from 26,750 properties in fiscal year 2005 to 27,538 properties in fiscal year 2006.

Schedule of Secretary-Held Property
As of September 30th
(Dollars in Millions)

	2003	2004	2005	2006
Single Family	$ 3,337	$ 2,566	$ 2,830	$ 2,939
Multifamily	490	106	5	1
Total	$ 3,827	$ 2,672	$ 2,835	$ 2,940

Loan Guarantee Liability

The loan guarantee liability (LGL) is comprised of two components, the liability for loan guarantee (LLG) for post-1991 loan guarantees and the loan loss reserves (LLR) for pre-1992 loan guarantees.

Post-1991 LLG

The LLG related to Credit Reform loans (made after September 30, 1991) is comprised of the present value of anticipated cash outflows, such as claim payments, premiums refunds, property expense for on-hand properties and sales expense for sold properties, less anticipated cash inflows such as premium receipts, proceeds from property sales and principal and interest on Secretary-held notes.

In fiscal year 2006, the LLG decreased by $383 million from $3,367 million to $2,984 million. The single family LLG increased from a balance of $1,886 million in fiscal year 2005 to a balance of $3,027 million in fiscal year 2006. The Title I LLG remained at $1 million in fiscal year 2006. The multifamily LLG decreased from a balance of $1,480 million in fiscal year 2005 to a balance of $(44) million in fiscal year 2006.

There was a $1,524 million decrease in the multifamily LLG. The majority of the decrease can be attributed to the liability associated with the loans included in the Mark-to-Market program, which decreased from $1,550 million in fiscal year 2005 to $241 million in fiscal year 2006. The liability associated with loans not included in the Mark-to-Market program decreased from $(70) million in fiscal year 2005 to $(332) million in fiscal year 2006. The majority of the Mark-to-Market decrease can be attributed to the assumptions related to Mark-to-Market restructuring eligibility. The single family LLG increased by $1,141 million. The majority of the increase can be attributed to additional liabilities incurred due to the impact of the fiscal year 2005 hurricanes and the increase in the loss rate on foreclosed properties.

Schedule of FHA Liability for Loan Guarantees
As of September 30th
(Dollars in Millions)

	2003	2004	2005	2006
Single Family	$ 2,249	$ 1,444	$ 1,886	$ 3,027
Title I	3	2	1	1
Multifamily	564	1,279	1,480	(44)
Total	$ 2,816	$ 2,725	$ 3,367	$ 2,984

Pre-1992 Loan Loss Reserve (LLR)

The liability associated with pre-Credit Reform endorsements is computed by estimating the LLR. FHA maintains loss reserves for the estimated costs of future mortgage insurance claims resulting from defaults that have occurred or are likely to occur among insured single family and multifamily mortgages and Title I loans. FHA records a loss reserve for its pre-Credit Reform insured mortgages to provide for anticipated losses which may occur on claims for defaults that have taken place but have not yet been filed. The LLR is computed using the present value of anticipated cash outflows, such as claim payments, premiums refunds, property expense for on-hand properties and sales expense for sold properties, less anticipated cash inflows such as premium receipts, proceeds from property sales and principal and interest on Secretary-held notes. Overall, loss reserves decreased by $719 million from $1,217 million in fiscal year 2005 to $498 million in fiscal year 2006. The majority of the decrease can be attributed to the $1,021 million decrease in the Mark to Market program from $1,151 in fiscal year 2005 to $404 million in fiscal year 2006.

Schedule of FHA Loan Loss Reserves
As of September 30th
(Dollars in Millions)

	2003	2004	2005	2006
Single Family	$ 131	$ 91	$ 56	$ 51
Title I	1	2	1	1
Multifamily	3,303	2,256	1,160	446
Total	$ 3,435	$ 2,349	$ 1,217	$ 498

Net Cost/(Surplus)

FHA's program revenues exceeded costs in fiscal year 2006, thus resulting in a net surplus. The most important facet of FHA's cost and revenue activity is the treatment of loan guarantee subsidy cost. Loan guarantee subsidy cost is the estimated long-term cost to FHA of a loan guarantee calculated on a net present value basis, excluding administrative costs. The cost of a loan guarantee is the net present value; at the time the loan is disbursed by the lender, of the estimated cash flows paid by FHA to cover claims, interest subsidies, and other requirements. Payments made to FHA, including origination premiums, penalties, and recoveries are also included in the calculation.

Negative subsidies occur if the present value of cash inflows to FHA exceeds the present value of cash outflows. The MMI fund has substantial negative subsidy generated by loan guarantee endorsements throughout the year. The estimated negative subsidy is recorded at the time of loan endorsement, and appears as a negative program cost.

Schedule of FHA Net Cost (Surplus)
For the year ended September 30th
(Dollars in Millions)

	2003	2004	2005	2006
Program Cost	$ 3,452	$ 52	$ 786	$ (380)
Program Revenues	2,368	1,802	1,854	1,701
Net Cost (Surplus)	$ 1,084	$ (1,750)	$ (1,068)	$ (2,081)

The $1,166 million decrease in the Program Cost between fiscal year 2005 and fiscal year 2006 is comprised primarily of the $1,091 million decrease in gross cost with the public in the GI/SRI program.

The major components of the GI/SRI decrease in gross cost with the public are provided in the following table:

(Dollars in millions)	2005	2006	Change
From subsidy expense	$ (271)	$(1,601)	$ (1,330)
From interest expenses	14	(248)	(262)
Total	$ 257	$(1,849)	$ (1,592)

The large decrease in the subsidy expense is primarily attributable to the decrease in the Mark-to-Market liability resulting from major changes to estimation procedures. These changes were necessary to improve the Mark-to-Market estimations to more closely approximate actual program activity.

The $154 million decrease in the Program revenue between fiscal year 2005 and fiscal year 2006 is comprised primarily of the $198 million decrease of revenue from the public in the GI/SRI program. The major components of the increase are provided in the following table:

(Dollars in millions)	2005	2006	Change
From premium revenue	$ 56	$ 36	$ (20)
From interest revenue	76	48	(28)
From other revenue	190	0	(190)
Total	$ 322	$ 84	$ (238)

<u>Net Position</u>

FHA's Net Position increased to $23,999 million in fiscal year 2006, an increase of 3.6 percent, due to the $859 million increase in Cumulative Results of Operations and the $15 million decrease in Unexpended Appropriations.

Schedule of Statement of Changes in Net Position
As of September 30th
(Dollars in Millions)

	2003	2004	2005	2006
Net Position, Beginning of Year	$ 18,127	$ 18,235	$ 21,169	$ 23,155
Net Change in Cumulative Results of Operations	293	2,811	2,076	859
Increase in Unexpended Appropriations	(185)	123	(90)	(15)
Net Position, End of Year	$ 18,235	$ 21,169	$ 23,155	$ 23,999

SYSTEMS, CONTROLS, AND COMPLIANCE

FHA continues to improve financial management through the phased implementation of an integrated financial system to better support FHA's business needs. The FHA Comptroller developed a Blueprint for Financial Management to implement an integrated core financial management system that would address financial management and system deficiencies previously documented by HUD's Inspector General, FHA and HUD financial statement auditors, OMB examiners and GAO auditors.

Implementation of the core FHA financial management system is included in the President's Management Agenda for HUD to strengthen program controls through improved information systems. Implementing this system is one of the Secretary's strategic actions to address material weaknesses and reportable conditions previously identified in FHA's annual financial statement audits and reports to the Congress. The Blueprint for Financial Management also provided corrective action for 14 different FHA systems that were previously non-compliant with federal financial systems requirements established in OMB Circular A-127.

The FHA Blueprint for an Integrated Financial Management System has the following key objectives:

- Implement U.S. Standard General Ledger and credit reform accounts in the FHA general ledger;
- Implement automated funds control processes using the FHA general ledger;
- Automate FHA's interface with HUD's departmental general ledger;
- Produce FHA financial statements and regulatory reports directly from the FHA general ledger;
- Enhance FHA cash accounting and Treasury reconciliation with automated support from the integrated financial management system;
- Enhance FHA contract accounting with automated support from the integrated financial management system; and
- Eliminate manual accounting processes and improve integration of FHA financial and program systems, including daily or real-time funds control for insurance operations.

This systems project has a phased implementation. In Phase I, FHA identified its financial management requirements, defined and built translation software to produce financial transactions in a common format from 19 different automated sources, and acquired a JFMIP-compliant, commercial off the shelf product to serve as its new core financial system. In September 2000, FHA selected the financial software offered by PeopleSoft, and named the new system the FHA Subsidiary Ledger.

In Phase II, FHA implemented the new PeopleSoft financial software to perform central accounting functions of the FHA Comptroller's office, such as general ledger operations and cash management. FHA accomplished the first major milestone of Phase II in October 2002 by implementing the general ledger module of the FHA Subsidiary Ledger system. With this step, FHA acquired the capability for the first time to record and track budgetary resources using the U.S. Standard General Ledger at the transaction level, to control expenditures against available resources (on a monthly basis), and to produce financial statement reports directly from the general ledger. In October 2003, FHA upgraded the software for web operation to improve critical accounting processes such as funds control.

FHA completed parallel operations for the final Phase II milestones in June 2004, implementing accounts payable, accounts receivable, procurement, and projects modules to perform the following central accounting functions:

- Certification of Treasury payments and cash reconciliation of payments and collections
- Accounting and funds control for certain FHA contracts and grants
- Funds control for all FHA disbursements on a daily basis and
- Credit subsidy accounting

Phase III of the project accomplished several major milestones in fiscal year 2005, including:

- Tracking total liability for new insurance against annual limits.
- Upgrading PeopleSoft from version 8.4 to version 8.8
- Enhanced system reporting
- Improved system performance by reducing batch and online processing times for key business activities
- Continued support of integration of legacy systems into the FHASL by documenting as-is and to-be business processes, identifying how program office functionality will be implemented in the FHASL, and, when necessary, developing customizations to support unique business requirements of the program offices.

The associated project activities to date successfully eliminated a long-standing material weakness and FHA now meets the requirements of OMB Circular A-127.

In August 2006, the FHA Subsidiary Ledger system started receiving daily interfaces of accounting data for multifamily notes and property management, thereby improving funds control. The project also made progress in 2006 towards integrating insurance operations with the core financial system, in the areas of Single Family premium refunds, Multifamily premium billing and collection, and Multifamily claims. This effort was hampered by insufficient infrastructure. The Department approved additional infrastructure in September 2006. The infrastructure is expected to be in place to meet a go-live date of December 2007 for these components.

Fiscal Year 2006 Material Weaknesses

FHA has eliminated the fiscal year 2005 material weaknesses noted below. FHA has no material weaknesses for fiscal year 2006.

Elimination of Fiscal Year 2005 Material Weaknesses

Fiscal Year 2005 Material Weakness No. 1: *FHA must incorporate better risk factors and monitoring tools into its single family insured mortgage program risk analysis and liability estimation process. Due to significant changes in the home mortgage-lending environment in recent years, the composition and credit worthiness of borrowers in FHA's single family insured loan portfolio has changed. The result has been an increase in mortgage defaults and insurance claims. However, FHA has not developed a formal process to effectively evaluate the impact in its portfolio of certain loan factors, such as borrower credit scores, down payment assistance sources, and other portfolio characteristics. The impact of certain loan factors such as loan-to-value, down payment assistance sources, loan size and product type is evaluated as part of the legislatively mandated actuarial study of the Mutual Mortgage Insurance fund. However, sufficient historical data is required for these factors to be effectively identified and analyzed, resulting in delays between when changes occur and the impact on the portfolio identified and assessed. The effects of these factors are aggregated for purposes of determining one overall conditional claim rate table, which is used in management's insured loan guarantee liability calculation. Separate and timely identification of the impact of each of loan factors should be incorporated in the insured loan guarantee liability calculation to help FHA management better estimate and manage the MMI fund's future performance.*

FHA eliminated this material weakness for fiscal year 2006 reporting. For the FY 2006 FHA added new assumptions to account for the increased risk associated with borrowers who receive gift letters and borrower credit scores. This significantly narrowed the gap that had developed over the past few years between projected and actual claim experience, thus, making the models more reliable and accurate.

Fiscal Year Material Weakness No. 2: *FHA management should strengthen its review over the Loan Guarantee Liability Credit Reform estimation process. During fiscal year 2005 we noted FHA continued to make improvements to the cash flow models used to estimate the resulting Loan Guarantee Liability. Most notably was the development of a data validation process where fiscal year 2004 actual transaction data was compared to the fiscal year 2004 projected data from the fiscal year 2003 model. However, FHA management did not effectively perform sufficient analytical reviews of the various model calculations to identify anomalous data relationships for the Home Equity Conversion Mortgage (HECM) and Mark-to-Market restructuring program model outputs.*

FHA eliminated this material weakness by substantially improving the models relating to HECM and Mark-to-Market. Additionally, FHA expanded the validation process to use the prior year comparisons of projected and actual cash flows to develop management's independent expectations for gross cash flows and other key ratios used in the estimation process.

FHA Compliance with OMB Circular A-123, Management's Responsibility for Internal Control

OMB's revised Circular A-123, dated December 21, 2004 (A-123) states that Management is responsible for establishing and maintaining internal control to achieve the objectives of effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations. When assessing the effectiveness of internal control over financial reporting and compliance with financial-related laws and regulations, management must follow the assessment process contained in Appendix A of A-123. In addition to the annual statement of assurance as to the overall adequacy and effectiveness of agency internal control, for fiscal year 2006 management is required to provide a separate assurance regarding the effectiveness of internal control over financial reporting. This assurance should be based on the results of management's assessment conducted in accordance with the requirements of Appendix A of OMB A-123.

Fiscal Year 2006

Annual Assurance Statement on Internal Control over Financial Reporting

The Federal Housing Administration (FHA) management is responsible for establishing and maintaining effective internal control over financial reporting, which includes safeguarding of assets and compliance with applicable laws and regulations. FHA conducted its assessment of the effectiveness of the FHA internal control over financial reporting in accordance with OMB Circular A-123, Management's Responsibility for Internal Control. Based on the results of this evaluation, FHA can provide reasonable assurance that internal control over financial reporting as of June 30, 2006 was operating effectively and no material weaknesses were found in the design or operation of the internal controls over financial reporting.

Brian D. Montgomery
Assistant Secretary for Housing, Federal Housing Commissioner

Improper Payments Information Act of 2002

FHA Accomplishments

In accordance with the Improper Payments Information Act, enacted on November 26, 2002, and the OMB Memorandum M-03-13, dated May 21, 2003, FHA continued to comply with the requirements of the Act and determined which of its activity inventory required review this year. Following the procedures that were used in 2005 with fiscal year 2004 data, the dollar amount of each disbursement system's total disbursements were compared to the $40,000,000 threshold. In fiscal years 2005 and 2006, however, the disbursements from PMS fell well below the threshold. The other four systems listed below exceeded the threshold.

- Single Family Insurance Claims System (SFIC)
- Multifamily Claims
- Single Family Distributive Shares and Premium Refunds
- Single Family Acquired Asset Management System (SAMS)

In fiscal year 2006, limited Risk Assessments were made on all of the above systems to assure that there were no changes that might contribute to vulnerability to improper payments. In addition, FHA's internal control review triggered by OMB Circular A-123, Appendix A, Management's Responsibility for Internal Control, dated August 1, 2005 concluded that each of these systems has adequate internal controls that are fully documented and implemented to control fraud, waste and abuse.

SFIC Improper Payment Analysis

The OIG Audit of May 12, 2005 stated the management and system controls of the Single Family Insurance Claims system (SFIC) are adequate and effective in ensuring that only eligible and adequately supported costs are accepted and paid, and that there was no significant risk of improper payments. Since there has been no significant change in volume of claims, total dollars dispersed or program requirements, the SFIC system remains a low risk system.

Multifamily Claims and Distributive Shares

In fiscal year 2006, as in fiscal year 2005, the dollar amounts of disbursements in both the Multifamily Claims and the Distributive Shares systems exceeded the $40 million threshold and warranted a risk assessment. Our risk assessments revealed that there were no significant changes to the volumes of business or the processes by which the disbursements were processed, leading us to conclude that the systems are still not susceptible to improper payments.

Single Family Premium Refunds and Distributive Shares

In fiscal year 2006, as in fiscal year 2005, the dollar amounts of disbursements in the Single Family Premium Refunds and Distributive Shares system exceeded the $40 million threshold and warranted a risk assessment. Our risk assessments revealed that there were no significant changes to the volume of business or the processes by which the disbursements were processed, leading us to conclude that the systems are still not susceptible to improper payments**.**

Property Management System (PMS) Improper Payment Analysis

At the end of fiscal year 2006, there were no HUD owned properties in the inventory, and four MIPs. Based on the diminished activity in this system and the failure to meet the $10 million

OMB threshold for two years, this activity was dropped from the list of high-risk activities in fiscal year 2004.

The total disbursement for fiscal year 2006 from PMS was $2,716,614.53.

Single Family Acquired Asset Management System (SAMS) Improper Payment Analysis

SAMS manages property management expenses for the single family properties that have been foreclosed upon and are now owned by HUD. The disbursements include invoice payments, taxes and Management & Marketing (M&M) fees. In fiscal year 2005, we again determined that SAMS was not susceptible to improper payments and this activity was dropped from the list of high-risk activities.

LIMITATIONS OF FINANCIAL STATEMENTS

The following limitations apply to the preparation of the fiscal year 2006 financial statements:

- The financial statements have been prepared to report the financial position and results of operations of the entity, pursuant to the requirements of 31 U.S.C. 3515(b).
- While the statements have been prepared from the books and records of the entity in accordance with the formats prescribed by OMB, the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.
- The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity. One implication of this is that liabilities cannot be liquidated without legislation that provides resources to do so.

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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, 2006 and 2005
(Dollars in Millions)

	2006	2005
ASSETS		
Intragovernmental		
Fund Balance with U.S. Treasury (Note 3)	$ 10,568	$ 9,705
Investments (Note 4)	22,012	22,745
Other Assets (Note 7)	24	54
Total Intragovernmental	32,604	32,504
Investments (Note 4)	98	201
Accounts Receivable, Net (Note 5)	168	302
Loans Receivable and Related Foreclosed Property, Net (Note 6)	4,283	4,057
Other Assets (Note 7)	140	97
TOTAL ASSETS	**$ 37,293**	**$ 37,161**
LIABILITIES		
Intragovernmental		
Borrowings from U.S. Treasury (Note 9)	$ 6,258	$ 7,548
Other Liabilities (Note 10)	2,486	772
Total Intragovernmental	8,744	8,320
Accounts Payable (Note 8)	396	597
Loan Guarantee Liability (Note 6)	3,482	4,584
Debentures Issued to Claimants (Note 9)	95	132
Other Liabilities (Note 10)	577	373
TOTAL LIABILITIES	**13,294**	**14,006**
NET POSITION		
Unexpended Appropriations (Note 16)	594	609
Cumulative Results of Operations	23,405	22,546
TOTAL NET POSITION	23,999	23,155
TOTAL LIABILITIES AND NET POSITION	**$ 37,293**	**$ 37,161**

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, 2006 and 2005

(Dollars in Millions)

	2006	2005
MMI/CMHI PROGRAM COSTS		
Intragovernmental Gross Costs (Note 12)	$ 387	$ 405
Less: Intragovernmental Earned Revenue (Note 13)	1,334	1,344
Intragovernmental Net Costs	(947)	(939)
Gross Costs with the Public (Note 12)	1,135	1,243
Less: Earned Revenue from the Public (Note 13)	94	41
Net Costs with the Public	1,041	1,202
NET MMI/CMHI PROGRAM COST (SURPLUS)	**$ 94**	**$ 263**
GI/SRI PROGRAM COSTS		
Intragovernmental Gross Costs (Note 12)	$ 147	$ 127
Less: Intragovernmental Earned Revenue (Note 13)	188	147
Intragovernmental Net Costs	(41)	(20)
Gross Costs with the Public (Note 12)	(2,049)	(989)
Less: Earned Revenue from the Public (Note 13)	85	322
Net Costs with the Public	(2,134)	(1,311)
NET GI/SRI PROGRAM COST (SURPLUS)	**(2,175)**	**(1,331)**
NET COST (SURPLUS) OF OPERATIONS	**$ (2,081)**	**$ (1,068)**

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, 2006 and 2005
(Dollars in Millions)

	2006 Cumulative Results of Operations	2006 Unexpended Appropriations	2005 Cumulative Results of Operations	2005 Unexpended Appropriations
BEGINNING BALANCES	**$ 22,546**	**$ 609**	**$ 20,470**	**$ 699**
BUDGETARY FINANCING SOURCES				
Appropriations Received (Note 16)	-	1,281	-	1,987
Other Adjustments (Note 16)	-	(83)	-	(81)
Appropriations Used (Note 16)	1,178	(1,178)	1,859	(1,859)
Transfers-Out (Note 15 and 16)	(731)	(35)	(577)	(137)
OTHER FINANCING SOURCES				
Transfers-Out (Note 15)	(1,692)	-	(297)	-
Imputed Financing (Note 12)	23	-	23	-
Other (Note 15)	-	-	-	-
TOTAL FINANCING SOURCES	**(1,222)**	**(15)**	**1,008**	**(90)**
NET (COST) SURPLUS OF OPERATIONS	**2,081**	-	**1,068**	-
ENDING BALANCES	**$ 23,405**	**$ 594**	**$ 22,546**	**$ 609**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
COMBINED STATEMENTS OF BUDGETARY RESOURCES
For the periods ended September 30, 2006 and 2005
(Dollars in Millions)

	2006 Budgetary	2006 Non-Budgetary	2005 Budgetary	2005 Non-Budgetary
BUDGETARY RESOURCES				
Unobligated Balance, brought forward, October 1	$ 23,602	$ 5,891	$ 23,978	$ 4,609
Recoveries of prior year unpaid obligations	97	6	20	39
Budget Authority:				
Appropriations	1,281	-	1,987	-
Borrowing authority	9	888	(9)	1,175
Spending authority from offsetting collections (gross):				
Earned	-	-	-	-
Collected	2,636	11,470	2,757	11,722
Change in receivables from Federal sources	(55)	(46)	13	(87)
Change in unfilled customer order w/o advance	-	-	-	-
Anticipated for rest of year, without advance	-	-	-	-
Permanently not available	(152)	(2,186)	(311)	(1,215)
TOTAL BUDGETARY RESOURCES	$ 27,418	$ 16,023	$ 28,435	$ 16,243
STATUS OF BUDGETARY RESOURCES				
Obligations incurred, Direct	$ 5,028	$ 8,990	$ 4,833	$ 10,352
Unobligated balance-Apportioned	161	2,132	77	2,649
Unobligated balance-Not available	22,229	4,901	23,525	3,242
TOTAL STATUS OF BUDGETARY RESOURCES	$ 27,418	$ 16,023	$ 28,435	$ 16,243
Change in Obligated Balances				
Obligated balance, net:				
Unpaid obligations, brought forward, October 1	$ 1,067	$ 1,263	$ 991	$ 1,264
Uncollected customer payments from Federal sources,	(262)	(52)	(248)	(139)
Total, unpaid obligated balance, brought forward, net	805	1,211	743	1,125
Obligations incurred	5,028	8,990	4,833	10,352
Gross outlays	(5,018)	(8,871)	(4,737)	(10,314)
Recoveries of prior-year unpaid obligations, actual	(97)	(6)	(20)	(39)
Change in uncollected customer payments-Federal sources	55	46	(13)	87
	773	1370	806	1,211
Obligated balance, net, end of period:				
Unpaid obligations	980	1,377	1,067	1,263
Uncollected customer payments from Federal sources	(207)	(7)	(261)	(52)
Total, unpaid obligated balance, net, end of period	773	1370	806	1,211
Net outlays:				
Gross outlays	5,018	8,871	4,737	10,314
Offsetting collections	(2,636)	(11,470)	(2,757)	(11,722)
Less: Distributed offsetting receipts	677	-	474	-
NET OUTLAYS	$ 1,705	$ (2,599)	$ 1,506	$ (1,408)

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENT OF FINANCING
For the periods ended September 30, 2006 and 2005
(Dollars in Millions)

	2006	2005
RESOURCES USED TO FINANCE ACTIVITIES		
Obligations Incurred	$ 14,018	$ 15,185
Spending Authority from Offsetting Collections and Recoveries	(14,108)	(14,464)
Offsetting Receipts	(677)	(474)
Transfers Out	(1,692)	(297)
Imputed Financing from Costs Absorbed by Others	23	23
Other	-	-
TOTAL RESOURCES USED TO FINANCE ACTIVITIES	**$ (2,436)**	**$ (27)**
RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST (SURPLUS) OF OPERATIONS		
Change in Budgetary Resources Obligated for Goods and Services Ordered but not yet Provided	$ (124)	$ (57)
Resources that Fund Expenses Recognized in Prior Periods	(3,768)	(3,161)
Budgetary Offsetting Collections and Receipts that Do Not Affect the Net Cost (Surplus) of Operations	13,104	13,158
Resources that Finance the Acquisition of Assets	(6,994)	(10,114)
Transfer Out to HUD without Reimbursement Related to Salary and Expense Payments	(234)	(233)
Other Resources or Adjustments that do not Affect the Net Cost (Surplus) of Operations	(40)	(165)
TOTAL RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST (SURPLUS) OF OPERATIONS	**$ 1,944**	**$ (572)**
TOTAL RESOURCES USED TO FINANCE THE NET COST (SURPLUS) OF OPERATIONS	**$ (492)**	**$ (599)**
COMPONENTS OF THE NET COST (SURPLUS) OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD		
Upward Reestimate of Credit Subsidy Expense	$ 2,683	$ 2,552
Downward Reestimate of Credit Subsidy Expense	(2,268)	(402)
Changes in Loan Loss Reserve Expense	(739)	(1,138)
Changes in Bad Debt Expenses Related to Uncollectible Pre-Credit Reform Receivables	(5)	(200)
Reduction of Credit Subsidy Expense from Endorsements and Modifications of Loan Guarantees	(1,380)	(1,304)
Gains or Losses on Sales of Credit Program Assets	54	276
Other	66	(253)
TOTAL COMPONENTS OF THE NET COST (SURPLUS) OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD	**$ (1,589)**	**$ (469)**
NET COST (SURPLUS) OF OPERATIONS	**$ (2,081)**	**$ (1,068)**

The accompanying notes are an integral part of these statements.

NOTES TO FINANCIAL STATEMENTS
September 30, 2006

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, and manufactured homes. 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 basic 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 and nonprofit hospitals. 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 Statement of Budgetary Resources, is based on concepts and guidance provided by the Office of Management and Budget (OMB) Circular A-11, *Preparation, Submission, and Execution of the Budget*. The format of the SBR is derived from the SF 133 Report on Budget Execution and Budgetary Resources. Beginning with fiscal year 2006, OMB revised its format of the SF 133 as described in

OMB Circular No. A-11. The corresponding changes to the SBR format resulted in the reclassification of the prior period comparative data.

Basis of Consolidation

The accompanying principal financial statements include all Treasury Account Fund Symbols (TAFSs) designated to FHA, which consist of two principal general 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, statements of changes in net position and statements of financing. The statements of budgetary resources are prepared on a combined basis as allowed by OMB Circular A-136 *Financial Reporting Requirements*.

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 the allowance for subsidy related to net loans receivable and related foreclosed property and the loan guarantee liability represent FHA's best estimates based on pertinent information available. To calculate these estimates, FHA uses cash flow models with various assumptions to make reasonable projections of future performance. These assumptions are calculated using historical data, as well as estimated using current and forecasted program and economic assumptions.

Certain programs have higher risks due to inherent programmatic risk factors as well as 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.

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).

Credit Reform Accounting

The Federal Credit Reform Act of 1990 (FCRA) establishes the use of the program, financing, general fund receipt and capital reserve accounts for tracking activity related to loan guarantees committed and direct loans obligated after September 30, 1991 (Credit Reform). It also establishes 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 is a budget account that 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 at the time the loan is disbursed or guaranteed. 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, premiums, recoveries, claims, borrowing from the U.S. Treasury, interest, negative subsidy and the subsidy cost received from the program account.

The general fund receipt account is a budget account 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.

In order to resolve the different requirements between the FCRA and the National Affordable Housing Act of 1990 (NAHA), OMB instructed FHA to create the capital reserve account to record the MMI/CMHI negative subsidy and subsequent downward reestimates. Specifically, the NAHA required that FHA's MMI fund achieve a Capital Ratio of 2.0 percent by fiscal year 2000. The Capital Ratio is defined as the ratio of economic net worth (current cash plus the present value of all future net cash flows) of the MMI fund to unamortized insurance in force (the unpaid balance of insured mortgages). Therefore, to ensure that the calculated Capital Ratio reflects the actual strength of the MMI fund, the resources of the capital reserve account, which are considered FHA assets, are included in the calculation of the MMI fund's economic net worth. At the end of fiscal year 1995, FHA met and has since maintained the Capital Ratio requirement. FHA's actuary estimated the fiscal year 2006 Capital Ratio to be 6.82 percent. The fiscal year 2005 Capital Ratio was projected to be 6.02 percent.

The liquidating account is a budget account that is used to record activity related to 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.

Investments

FHA investments include investments in U.S. Treasury securities 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 resources in excess of its current needs (in MMI/CMHI funds) 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.

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 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).

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.

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 outflows less cash inflows), 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.

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 $23 million for both fiscal years 2006 and 2005, and is 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 and the Consolidated Statements of Financing.

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, 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.

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, 2006 and 2005 are as follows:

(Dollars in millions)		2006		2005
Intragovernmental:				
Fund Balance with U.S. Treasury	$	731	$	1,272
Investments in U.S. Treasury Securities		5		4
Total Intragovernmental		736		1,276
Other Assets		111		95
Total Non-entity Assets		847		1,371
Total Entity Assets		36,446		35,790
Total Assets	$	**37,293**	$	**37,161**

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, 2006 and 2005:

(Dollars in millions)		2006		2005
Fund Balances:				
Revolving Funds	$	9,393	$	8,044
Appropriated Funds		408		460
Other Funds		767		1,201
Total	$	**10,568**	$	**9,705**
Status of Fund Balance with U.S. Treasury:				
Unobligated Balance:				
Available		2,292		2,724
Unavailable		5,919		4,651
Obligated Balance not yet Disbursed		2,357		2,330
Total	$	**10,568**	$	**9,705**

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 that portion of the 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, 2006 were as follows:

(Dollars in millions)

	Cost	Par Value	Unamortized Premium (Discount), Net	Investment, Net	Market Value
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	-
Total	**$ 21,721**	**$ 22,036**	**$ (223)**	**$ 22,012**	**$ 21,993**

The cost, par value, net unamortized discount, net investment, and market values as of September 30, 2005 were as follows:

(Dollars in millions)

	Cost	Par Value	Unamortized Premium (Discount), Net	Investment, Net	Market Value
MMI/CMHI Investments	$ 22,346	$ 22,642	$ (161)	$ 22,481	$ 22,957
GI/SRI Investments	4	4	-	4	4
Subtotal	22,350	22,646	(161)	22,485	22,961
MMI/CMHI Accrued Interest	-	-	-	260	-
Total	**$ 22,350**	**$ 22,646**	**$ (161)**	**$ 22,745**	**$ 22,961**

Investments in Private-Sector Entities

The following table presents financial data on FHA's investments in private-sector entities as of September 30, 2006 and 2005:

(Dollars in millions)

	Beginning Balance	New Acquisitions	Share of Earnings or Losses	Return of Investment	Other Adjustments	Ending Balance
2006	$ 201	$ 49	$ 15	$ (167)	$ -	$ 98
2005	$ 122	$ 252	$ 58	$ (231)	$ -	$ 201

The condensed, audited financial information related to these private-sector entities as of December 31, 2005 and 2004 are as follows:

(Dollars in millions)	**2006**	**2005**
Total assets, primarily mortgage loans	$ 422	$ 499
Liabilities	3	3
Partners' capital	419	496
Total liabilities and partners' capital	$ 422	$ 499
Revenues	184	235
Expenses	(20)	(31)
Net Income	$ 164	$ 204

Note 5. Accounts Receivable, Net

Accounts receivable, net, as of September 30, 2006 and 2005 are as follows:

	Gross		**Allowance**		**Net**	
(Dollars in millions)	**2006**	**2005**	**2006**	**2005**	**2006**	**2005**
From the Public:						
Receivables related to credit program assets	$ 73	$ 30	$ (4)	$ (4)	$ 69	$ 26
Premiums receivable	50	119	-	-	50	119
Miscellaneous receivables	127	235	(78)	(78)	49	157
Total	**$ 250**	**$ 384**	**$ (82)**	**$ (82)**	**$ 168**	**$ 302**

Receivables Related to Credit Program Assets

These receivables represent 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 represent 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, 2006 and 2005 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)

Direct Loan Programs	Loans Receivable, Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	Value of Assets Related to Direct Loans
FY 2006:					
MMI/CMHI	$ 3	$ -	$ (2)	$ -	$ 1
GI/SRI	14	3	(5)	-	12
Total	**$ 17**	**$ 3**	**$ (7)**	**$ -**	**$ 13**
FY 2005:					
MMI/CMHI	$ 3	$ -	$ (1)	$ -	$ 2
GI/SRI	14	3	(6)	-	11
Total	**$ 17**	**$ 3**	**$ (7)**	**$ -**	**$ 13**

Direct Loans Obligated After Fiscal Year 1991:

(Dollars in millions)

Direct Loan Programs	Loans Receivable, Gross	Interest Receivable	Foreclosed Property	Allowance for Subsidy Cost	Value of Assets Related to Direct Loans
FY 2006:					
MMI/CMHI	$ 1	$ -	$ -	$ (3)	$ (2)
GI/SRI	-	-	-	-	-
Total	**$ 1**	**$ -**	**$ -**	**$ (3)**	**$ (2)**
FY 2005:					
MMI/CMHI	$ 1	$ -	$ -	$ (3)	$ (2)
GI/SRI	-	-	-	-	-
Total	**$ 1**	**$ -**	**$ -**	**$ (3)**	**$ (2)**

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

(Dollars in millions)

Direct Loan Programs		FY 2006		FY 2005
MMI/CMHI	$	3	$	2
GI/SRI		-		-
Total	**$**	**3**	**$**	**2**

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

(Dollars in millions)

Loan Guarantee Programs		Defaulted Guaranteed Loans Receivable, Gross		Interest Receivable		Allowance for Loan Losses		Foreclosed Property		Value of Assets Related to Defaulted Guaranteed Loans Receivable, Net
FY 2006:										
MMI/CMHI	$	4	$	-	$	(1)	$	6	$	9
GI/SRI		2,974		135		(818)		8		2,299
Total	$	**2,978**	$	**135**	$	**(819)**	$	**14**	$	**2,308**
FY 2005:										
MMI/CMHI	$	5	$	-	$	(1)	$	16	$	20
GI/SRI		2,968		140		(845)		8		2,271
Total	$	**2,973**	$	**140**	$	**(846)**	$	**24**	$	**2,291**

Defaulted Guaranteed Loans from Post-1991 Guarantees:

(Dollars in millions)

Loan Guarantee Programs		Defaulted Guaranteed Loans Receivable, Gross		Interest Receivable		Foreclosed Property		Allowance for Subsidy Cost		Value of Assets Related to Defaulted Guaranteed Loans Receivable, Net
FY 2006:										
MMI/CMHI	$	341	$	-	$	2,539	$	(1,257)	$	1,623
GI/SRI		576		48		350		(633)		341
Total	$	**917**	$	**48**	$	**2,889**	$	**(1,890)**	$	**1,964**
FY 2005:										
MMI/CMHI	$	343	$	1	$	2,405	$	(1,441)	$	1,308
GI/SRI		655		60		387		(655)		447
Total	$	**998**	$	**61**	$	**2,792**	$	**(2,096)**	$	**1,755**

Guaranteed Loans Outstanding:

(Dollars in millions)

Loan Guarantee Programs	Outstanding Principal of Guaranteed Loans, Face Value	Amount of Outstanding Principal Guaranteed
FY 2006		
Guaranteed Loans Outstanding:		
MMI/CMHI	$ 346,658	$ 317,249
GI/SRI	87,412	78,522
Total	**$ 434,070**	**$ 395,771**
FY 2005		
Guaranteed Loans Outstanding:		
MMI/CMHI	$ 364,444	$ 335,568
GI/SRI	89,928	80,893
Total	**$ 454,372**	**$ 416,461**
FY 2006		
New Guaranteed Loans Disbursed:		
MMI/CMHI	$ 51,780	$ 50,585
GI/SRI	9,846	9,140
Total	**$ 61,626**	**$ 59,725**
FY 2005		
New Guaranteed Loans Disbursed:		
MMI/CMHI	$ 55,287	$ 54,823
GI/SRI	11,004	10,950
Total	**$ 66,291**	**$ 65,773**

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

(Dollars in millions)

			Cumulative	
Loan Guarantee Programs		**Current Year Endorsements**	**Current Outstanding Balance**	**Maximum Potential Liability**
FY 2006	GI/SRI	$ 17,994	$ 18,295	$ 35,878
FY 2005	GI/SRI	$ 8,925	$ 10,615	$ 20,760

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
FY 2006:			
MMI/CMHI	$ 51	$ 2,828	$ 2,879
GI/SRI	447	156	603
Total	**$ 498**	**$ 2,984**	**$ 3,482**
FY 2005:			
MMI/CMHI	$ 53	$ 1,803	$ 1,856
GI/SRI	1,164	1,564	2,728
Total	**$ 1,217**	**$ 3,367**	**$ 4,584**

Subsidy Expense for Loan Guarantees by Program and Component:

(Dollars in millions)

Subsidy Expense for New Loan Guarantees	Defaults	Fees and Other Collections	Other	Total
FY 2006:				
MMI/CMHI	$ 818	$ (2,076)	$ 378	$ (880)
GI/SRI	647	(1,138)	-	(491)
Total	$ **1,465**	$ **(3,214)**	$ **378**	$ **(1,371)**
FY 2005:				
MMI/CMHI	$ 1,201	$ (2,516)	$ 271	$ (1,044)
GI/SRI	709	(891)	-	(182)
Total	$ **1,910**	$ **(3,407)**	$ **271**	$ **(1,226)**

(Dollars in millions)

Subsidy Expense for Modifications and Reestimates	Total Modifications	Technical Reestimates
FY 2006:		
MMI/CMHI	$ (9)	$ 1,531
GI/SRI	-	(1,110)
Total	**$ (9)**	**$ 421**
FY 2005:		
MMI/CMHI	$ -	$ 1,933
GI/SRI	(78)	(12)
Total	**$ (78)**	**$ 1,921**

(Dollars in millions)

Total Loan Guarantee Subsidy Expense	2006	2005
MMI/CMHI	**$** 642	$ 889
GI/SRI	(1,601)	(271)
Total	**$ (959)**	**$ 618**

Subsidy Rates for Loan Guarantees by Program and Component:

(Percentage)	Defaults	Fees and Other Collections	Other	Total
Budget Subsidy Rates for Loan Guarantees of FY 2006 Cohort:				
MMI/CMHI	1.58	(4.01)	0.73	(1.70)
GI/SRI	2.32	(4.09)	-	(1.77)
Budget Subsidy Rates for Loan Guarantees of FY 2005 Cohort:				
MMI/CMHI	2.05	(4.30)	0.46	(1.79)
GI/SRI	3.51	(4.41)	-	(0.90)

Schedule for Reconciling Loan Guarantee Liability Balances:

(Dollars in millions)	2006 LLR	2006 LLG	2005 LLR	2005 LLG
Beginning Balance of the Loan Guarantee Liability	**$ 1,217**	**$ 3,367**	**$ 2,349**	**$ 2,725**
Add: Subsidy Expense for guaranteed loans disbursed during the reporting fiscal years by component:				
Default Costs (Net of Recoveries)	-	1,465	-	1,910
Fees and Other Collections	-	(3,214)	-	(3,407)
Other Subsidy Costs	-	378	-	271
Total of the above subsidy expense components	**-**	**(1,371)**	**-**	**(1,226)**
Adjustments:				
Fees Received	-	2,819	-	2,483
Foreclosed Property and Loans Acquired	-	4,011	-	5,753
Claim Payments to Lenders	-	(6,296)	-	(8,503)
Interest Accumulation on the Liability Balance	-	35	-	(57)
Other	-	13	-	42
Ending Balance before Reestimates	**1,217**	**2,578**	**2,349**	**1,217**
Add or Subtract Subsidy Reestimates by Component:				
Technical/Default Reestimate:				
Subsidy Expense Component	(719)	(677)	(1,132)	1,921
Interest Expense Component	-	(269)	-	199
Adjustment of prior years' credit subsidy reestimates		1,352		30
Total Technical/Default Reestimate	**(719)**	**406**	**(1,132)**	**2,150**
Ending Balance of the Loan Guarantee Liability	**$ 498**	**$ 2,984**	**$ 1,217**	**$ 3,367**

Administrative Expense:

(Dollars in millions)

	2006	2005
MMI/CMHI	$ 227	$ 208
GI/SRI	274	265
Total	**$ 501**	**$ 473**

Other Information on Foreclosed Property:

Additional information on FHA foreclosed property as of September 30, 2006 and 2005 is as follows:

	2006	2005
Number of property in foreclosure process	120	30
Number of property held	37,569	26,751
Average holding period for property held	6 months	6 months

Pre-Credit Reform Valuation Methodology

A separate analysis was conducted to adjust the loan loss estimate for anticipated reductions in project-based Section 8 rental assistance subsidies administered by the Office of Affordable Housing Preservation (OAHP) since it is attributable to approximately 98 percent of the total LLR. 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 the projects were grouped into the following three categories:

No action: Projects that could continue to pay their operating expenses and mortgage payment.

Partial claim: Projects that could pay their operating expenses but could not make a full mortgage payment.

Full Claim: Projects that could no longer meet their mortgage payment and operating expenses.

Based on this analysis, appropriate adjustments were made to each project's loan loss estimate. No changes were made for projects requiring no action. For those classified as a partial claim, a new sustainable mortgage amount was calculated. The loss estimated on loans classified as partial claims was based on the amount of the claim payment. For loans classified as full claim, the loss estimate was set to 100 percent of the project's unpaid principal balance.

Credit Reform Valuation Methodology

For post-1991 cohorts FHA values its Credit Reform Liability for Loan Guarantee (LLG) and related assets (notes and properties) in inventory at the net present value of their estimated future cash flows. 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.

To apply the present value computations, FHA divides the loans into cohorts. Individual cohorts are defined by year of insurance activity and program type. 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 both the MMI and the GI/SRI funds. 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.

- 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 Insight (formerly DRI) forecasts of U.S. annual economic figures. The liability for loan guarantee estimate is likely to change depending on the time at which the economic forecasts are collected. 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.

Because of uncertainties inherent in the loan performance assumptions underlying the LLG and related receivables on notes and properties in inventory, actual cash flows will vary from the estimates over time. A reestimate process each year allows for estimates to be adjusted.

Discussion 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 most recent 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 2006 cohort in fiscal year 2004. 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 compared to the credit subsidy rates estimated at the end of 2006. The two rates can be reconciled through credit subsidy reestimates, which 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 2006 new 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 subsidies reestimate. Overall, FHA's liability decreased by $1.1 billion from the fiscal year 2005 estimates.

Mutual Mortgage Insurance (MMI) - The MMI fund provides insurance for private lenders against losses on single family mortgages. The fund protects lenders against loan default on mortgages for properties that meet certain minimum requirements. This allows lenders to provide credit to borrowers who might not meet conventional underwriting requirements.

Due to the magnitude of the MMI fund, program changes can significantly affect the overall LLG and subsidy expense recorded in the financial statements. During fiscal year 2006, FHA continued to experience higher overall claim rates from the increasing insurance of loans with down payment assistance. The majority of this change is due to the revised assumption on anticipated loss rates on foreclosed properties. Loss rates have increased as proceeds received from the sale of foreclosed properties have declined. The decline is largely associated with loans where borrowers received down payment assistance from seller-financed nonprofits. A recent Internal Revenue Service ruling has withdrawn nonprofit status from such nonprofits, and the incidence of such loans is expected to decline over the next couple of years. However, loss rates may continue to be elevated as already endorsed loans experience claim and conveyance, reducing anticipated cash flows from recoveries in future years and hence increasing the overall liability.

GI/SRI Home Equity Conversion Mortgage (HECM) - The FHA insured reverse mortgage (HECM) is used by senior homeowners age 62 and older to convert the equity in their home into monthly streams of income and/or a line of credit to be repaid when they no longer occupy the home. Unlike ordinary home equity loans, a HUD reverse mortgage does not require repayment as long as the home is the borrower's principal residence. Based on the projected cash flows for all active insurance in force, FHA estimates a liability of $123 million for the HECM program.

Since the inception of the program, FHA has insured 237,586 HECM loans with a maximum claim amount of $44 billion. Of these 237,586 HECM loans insured by FHA, 177,485 loans with a maximum claim amount of $36 billion are still active. As of end of fiscal year 2006 the insurance in force of these active loans was $18 billion. The insurance in force for FHA is the outstanding balance on the active loans. The insurance in force includes balance drawn by the mortgagee; interest accrued on the balance drawn, service charges, and mortgage insurance premium. The maximum claim amount is the dollar ceiling to which the outstanding loan balance can grow before being assigned to FHA. Even though the HECM volume increased significantly during fiscal year 2006, the HECM liability only increased from $111 million in fiscal year 2005 to $123 million in fiscal year 2006.

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 fiscal year 2006 and was impacted by two major changes.

First, since 1991, FHA has realized a decrease in the length of time assets are held in inventory after assignment and acquisition. In fiscal year 2006, FHA reduced the holding period assumption for assets recovered via property disposition, which resulted in a decrease to the 221(d)(4) liability estimate.

Second, FHA excluded the assumption used to capture administrative expenses at time of claim. In fiscal year 2006, 1.5% of the claim amount was excluded from the cost estimate of the 221(d)(4) program. The administrative expense is a cost of the program account rather than the financing account and should not be included as a cash outflow. This resulted in a decrease to the 221(d)(4) liability estimate.

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 OAHP. OAHP 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 2006 as a result of five major changes to estimation procedures. These changes were necessary to improve the MTM estimations to more closely approximate MTM actual program activity.

- The MTM program was initially implemented for projects with 20-year Section 8 contracts, therefore only loans that originated in the pre-Credit Reform liquidating account would be eligible for MTM restructuring. Post-Credit Reform financing account loans are only eligible for MTM restructuring if they originated in the liquidating account and refinanced into the financing account. As a result, only loans pursuant to Sections of the Act (SOA) assigned to the 223(a)(7) and 223(f) refinancing risk categories are analyzed to determine MTM eligibility. By limiting the eligible universe to these two risk categories, the financing account MTM liability estimate is more in representative of actual MTM program activity.

- Historical data shows that the majority of the MTM restructurings occurred for projects with rents greater than or equal to 100% of fair market rent. As a result, projects with rents below market levels were excluded from the MTM analysis.

- Projects that are not required to submit an annual financial statement and those projects that failed to submit a financial statement within the past two years were determined to be ineligible for MTM restructuring.

- Loans endorsed prior to fiscal year 2005 and subject to prepayment lockout restrictions are excluded from the MTM analysis. A mortgagee letter sent out by the Commissioner on October 12, 2004 waives the 5-year prepayment lockout restriction for loans that will go through the MTM restructuring process. As a result, FHA excludes loans in the 223(a)(7) and 223(f) risk categories that originated prior to the release of the letter. Loans that originated subsequent to the memo are not subject to the prepayment lockout and are eligible for the MTM program.

- Lastly, the projected time horizon for projects eligible for the MTM program was reduced from 10 years to 5 years. Five years is more appropriate for the remaining OAHP pipeline.

GI/SRI Section 234(c) - The Section 234(c) program insures a loan for as many as 30 years to purchase a unit in a condominium building. 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. The Section 234(c) program is FHA's largest Single Family program in the GI/SRI fund. Historically, the program generates a reduction in credit subsidy expense. 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. This has resulted in an increase in the total liability. Though the liability is still negative it has become less negative after the effect of this increase in projected losses from future foreclosures.

GI/SRI Section 203(k) - The section 203(k) program allows a homebuyer to finance the purchase and rehabilitation of a Single Family property with a mortgage loan insured by FHA. Though the down payment assistance loans do not have a major impact on loss rates the decrease in proceeds from sales of foreclosed properties has significantly increase the anticipated losses. To address this increase in loss rates FHA this year used fiscal year 2006 year's (one year) actual loss rate instead of an average loss rate of last three years. This change in assumption calculation resulted in a higher projected loss rates for future years resulting in a higher liability.

Additionally, in the past, this program encountered incidents of fraud and FHA explicitly accounts for these risks through its LLG estimates. Based on management's judgment on claim costs and the additional rehabilitation costs an $81 million liability is included in the LLG associated with these fraud cases

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.

Single Family Hurricane Cost
FHA evaluated all open default cases from the hurricane-impacted areas as of July 31, 2006. The various status categories found for these default cases and the methodology used to estimate claims and cost for each category are described below.

- Loans in foreclosure processing: All cases currently in foreclosure processing or pre-foreclosure sale attempts were taken to full claim in this analysis.

- Loans awaiting help from state, local and or other sources: Cases awaiting help were assigned to partial claim solutions depending on the property location state. Loans in Louisiana and Mississippi are given a 60% chance of getting assistance as Louisiana and Mississippi are still processing requests for assistance. In other states, the probability of assistance assumed is 25%. These probabilities are judgments made by the program office. For cases receiving assistance, HUD used failure rate of loss mitigation actions from actual experience in the national portfolio.

- Loans of borrowers that have not reported to their loan servicers and have delinquency periods exceeding 5 months: All such cases were assigned to full claim status in fiscal year 2007 and fiscal year 2008.

- Loans in workouts: For cases where servicers are actively working with borrowers to affect a reinstatement cure (special forbearance, repayment plan, mortgage modification, or partial claim) HUD assigned success and failure rates based on historical experience in the national portfolio.

- Other open default cases: The final group of hurricane impacted cases includes delinquencies less than or equal to 5 months where there is no defined lender actions. These are considered non-disaster related and are distributed to resolutions according to normal expectations- 35% workouts, 35% cures, and 30% foreclosures.

- Failures of loss mitigation actions: A claim must occur by the end of fiscal year 2008 for there to be a "failure" counted as hurricane cost. All claims are distributed in fiscal year 2007 and fiscal year 2008 according to historical average times for failed loss mitigation actions that result in full claims.

Based on the above methodology, HUD estimated 11,468 total claims (including failed loss mitigation actions) with unpaid principal balance of $902.6 million. HUD 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 the above methodology and assumptions the estimated net present value hurricane cost is $623.26 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. Damage assessments were rated on a scale of 1-9. A damage assessment of 1 related to a power outage with no dislocation of tenants. A damage assessment of 9 related to severe damage with demolition of the property possible. If a property had a damage assessment of 7 or greater, the possibility of default was determined to be high and these properties were included in the hurricane cost estimate. Impacted properties were identified and claims are anticipated to occur in fiscal years 2007 and 2008. For multifamily properties, a liability was estimated on those properties impacted by Hurricane Katrina. The claim amount is assumed a complete write-off with zero recoveries and zero premiums collected. The Multifamily hurricane cost is estimated to be $63.2 million. Impacts from Hurricanes Rita and Wilma were immaterial and no cost was estimated related to these hurricanes.

Note 7. Other Assets

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

(Dollars in millions)

		2006		2005
Intragovernmental:				
Advances to HUD for Working Capital Fund Expenses	$	24	$	54
Total	**$**	**24**	**$**	**54**
With the Public:				
Escrow Monies Deposited at Minority-Owned Banks	$	110	$	95
Undistributed Charges		30		2
Total	$	**140**	$	**97**

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 are as follows:

(Dollars in millions)

		2006		2005
With the Public:				
Claims Payable	$	206	$	281
Premium Refunds and Distributive Shares Payable		84		112
Disbursements in Transit		46		41
Miscellaneous Payables		60		163
Total	$	**396**	$	**597**

Claims 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 represent 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, 2006:

(Dollars in millions)	2005			2006	
	Beginning Balance	**Net Borrowing**	**Ending Balance**	**Net Borrowing**	**Ending Balance**
Agency Debt:					
Debentures Issued to Claimants	$ 187	$ (55)	$ 132	$ (37)	$ 95
Other Debt:					
Borrowings from U.S. Treasury	7,635	(87)	7,548	(1,290)	6,258
Total	**$ 7,822**	**$ (142)**	**$ 7,680**	**$ (1,327)**	**$ 6,353**

	2006	**2005**
Classification of Debt:		
Intragovernmental Debt	$ 6,258	$ 7,548
Debt held by the Public	95	132
Total	**$ 6,353**	**$ 7,680**

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 percent to 12.875 percent in both fiscal years 2006 and 2005. 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 $95 million in fiscal year 2006 and $129 million in fiscal year 2005. The fair values for fiscal years 2006 and 2005 were $143 and $181 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 2006, FHA’s U.S. Treasury borrowings carried interest rates ranging from 2.41 percent to 7.36 percent. In fiscal year 2005 the carried interest rates ranged from 2.41 percent to 7.34 percent. Fiscal year 2006 maturity dates occur from September 2009 – September 2024. 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, 2006 and 2005:

(Dollars in millions)	Current		Non-Current		Total	
	2006	**2005**	**2006**	**2005**	**2006**	**2005**
Intragovernmental:						
Special Receipt Account Liability	$ 2,486	$ 772	$ -	$ -	$ 2,486	$ 772
Total	**$ 2,486**	**$ 772**	**$ -**	**$ -**	**$ 2,486**	**$ 772**
With the Public:						
Trust and Deposit Liabilities	$ 170	$ 170	$ -	$ -	$ 170	$ 170
Unearned Premiums	21	27	120	(50)	141	-23
Undistributed Credits	50	58	-	-	50	58
Miscellaneous Liabilities	216	168	-	-	216	168
Total	**$ 457**	**$ 423**	**$ 120**	**$ (50)**	**$ 577**	**$ 373**

Special Receipt Account Liability

The special receipt account liability is created from negative subsidy endorsements and downward credit subsidy reestimates 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 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 one of these legal actions and claims will have a material affect on FHA's consolidated financial statements as of, and for, the period ending September 30, 2006. FHA has recognized an estimated amount of $24 million as a contingent liability due to the probable, or likely, adverse judgment in this case. Additionally, there is one case where judgment against FHA is considered reasonably possible with a potential loss estimated at $18 million.

Pending or Threatened Litigation Against FHA

(Dollars in millions)

Expected Outcome	Estimated Loss	Number of Cases
Probable	$ 24	1
Reasonably Possible	$ 18	1
Remote	$ -	5

Note 12. Gross Costs

Gross costs incurred by FHA for the fiscal years ended on September 30 are as follows:

(Dollars in millions)	2006		2005	
	MMI/CMHI	**GI/SRI**	**MMI/CMHI**	**GI/SRI**
Intragovernmental:				
Interest Expense	$ 342	101	$ 373	94
Imputed Cost	10	13	10	13
Other Expenses	35	33	22	20
Total	**$ 387**	**147**	**$ 405**	**127**
With the Public:				
Salary and Administrative Expense	$ 192	241	$ 186	245
Subsidy Expense	642	(1,601)	889	(271)
Interest Expense	284	(248)	178	14
Bad Debt Expense	20	(24)	(37)	(163)
Loan Loss Reserve	(3)	(734)	(32)	(1,106)
Other Expenses	-	317	59	292
Total	**$ 1,135**	**(2,049)**	**$ 1,243**	**(989)**

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. 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. Additionally, future funded expenses result from the recognition of contingent liabilities recorded by FHA for past events that warrant a probable, or likely, future outflow of measurable economic resources.

Note 13. Earned Revenue

Earned revenues generated by FHA for the fiscal years ended on September 30 are as follows:

(Dollars in millions)	2006 MMI/CMHI	2006 GI/SRI	2005 MMI/CMHI	2005 GI/SRI
Intragovernmental:				
Interest Revenue from Deposits at U.S. Treasury	$ 293	$ 188	$ 265	$ 147
Interest Revenue from MMI/CMHI Investments	1,041	-	1,079	-
Total	**$ 1,334**	**$ 188**	**$ 1,344**	**$ 147**
With the Public:				
Premium Revenue	$ 86	$ 36	$ 40	$ 56
Interest Revenue	-	49	-	76
Other Revenue	8	-	1	190
Total	**$ 94**	**$ 85**	**$ 41**	**$ 322**

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 2006 were:

	Premium Rate
Single Family	1.50%
Multifamily	0.50 %, 0.77%, 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 2006 for Single Family and Multifamily were:

	Mortgage Term 15 Years or Less	Mortgage Term More Than 15 Years
Single Family	0.25 %	0.50 %
Multifamily	0.50 %, 0.77%, or 0.80%	0.50 %, 0.77%, 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 2005 and 2006, 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 on September 30 are as follows:

(Dollars in millions)	U.S. Treasury	HUD	Total
Budgetary Financing Sources	$ 532	$ 234	$ 766
Other Financing Sources	1,692	-	1,692
FY 2006 Total	**$ 2,224**	**$ 234**	**$ 2,458**
Budgetary Financing Sources	$ 481	$ 233	$ 714
Other Financing Sources	297	-	297
FY 2005 Total	**$ 778**	**$ 233**	**$ 1,011**

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 monthly 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, 2006 and 2005 are as follows:

(Dollars in millions)	Beginning Balance	Appropriations Received	Other Adjustments	Appropriations Used	Transfers-Out	Ending Balance
Positive Subsidy	$ 58	$ 9	$	$ (3)	$	$ 64
Administrative Expenses	450	728	(83)	(730)		365
Reestimates	-	361		(361)		
GI/SRI Liquidating	101	183		(84)	(35)	165
FY 2006 Total	**$ 609**	**$ 1,281**	**$ (83)**	**$ (1,178)**	**$ (35)**	**$ 594**
Positive Subsidy	$ 84	$ 10	$ (30)	$ (6)	$ -	$ 58
Administrative Expenses	458	748	(51)	(705)	-	450
Reestimates	-	767	-	(767)	-	-
GI/SRI Liquidating	157	462	-	(381)	(137)	101
FY 2005 Total	**$ 699**	**$ 1,987**	**$ (81)**	**$ (1,859)**	**$ (137)**	**$ 609**

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: 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

FHA has two program, two liquidating, and four financing appropriations. 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. Obligated balances at the end of year consist of accounts payable, undelivered orders, and federal accounts receivable. Included in the undelivered orders balance, FHA has identified approximately $107 million of unliquidated contract balances that are being reviewed for contract close out and subsequent deobligation.

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.

Financing sources for repayments are from premiums earned, and the maturity dates on these borrowings are generally 20 years or more. The balances of the Permanently Not Available line item in the Statements of Budgetary Resources as of September 30, 2006 and year 2005 are $2,336 million and $1,526 million respectively. In fiscal year 2006, the $2,336 million amount is composed of a repayment of $82 million for debentures, anticipated repayment of $2,137 million for borrowing from the U.S. Treasury, a return to U.S. Treasury of $83 million for rescinded and cancelled appropriations, and a transfer to the U.S. Treasury of $35 million of unobligated balances that remained in the GI/SRI liquidating account at the end of fiscal year 2005.

The SF-133 and the Statement of Budgetary Resources for fiscal year 2005 has been reconciled to the fiscal year 2005 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 2006 Statement of Budgetary Resources will be presented in the fiscal year 2008 Budget of the U.S. Government. The Budget will be transmitted to Congress on the first Monday in February 2008 and will be available from the Government Printing Office at that time.

Required Supplementary Information

Schedule A: Intragovernmental Assets

FHA's intragovernmental assets, by federal entity, are as follows for on September 30, 2006 and 2005:

(Dollars in millions)

Agency	Fund Balance with U.S. Treasury	Investments in U.S. Treasury Securities	Other Assets
U.S. Treasury	$ 10,568	$ 22,012	$ -
HUD	-	-	24
FY 2006 Total	**$ 10,568**	**$ 22,012**	**$ 24**
U.S. Treasury	$ 9,705	$ 22,745	$ -
HUD	-	-	54
FY 2005 Total	**$ 9,705**	**$ 22,745**	**$ 54**

Schedule B: Intragovernmental Liabilities

FHA's intragovernmental liabilities, by federal entity, are as follows on September 30, 2006 and 2005:

(Dollars in millions)

Agency	Borrowings from U.S. Treasury	Other Liabilities
U.S. Treasury	$	$
FY 2006 Total	**$** 6,258	**$** 2,486
U.S. Treasury	$	$
FY 2005 Total	**$** 7,548	**$** 772

Required Supplementary Information

Schedule C: Comparative Combining Statement of Budgetary Resources by FHA Program

(Dollars in millions)	MMI/CMHI		GI/SRI		Total	
	2006	2005	2006	2005	2006	2005
BUDGETARY RESOURCES						
Unobligated Balance Carried Forward						
Beginning of period	$ 26,746	$ 27,041	$ 2,747	$ 1,546	$ 29,493	$ 28,587
Recoveries of Prior Year Obligations	56	47	47	12	103	59
Budget Authority:						
Appropriations received	418	434	863	1,553	1,281	1,987
Borrowing Authority	536	403	361	763	897	1,166
Spending Authority from Offsetting Collections:						
Earned						
Collected	11,660	11,587	2,446	2,892	14,106	14,479
Receivable from Federal Sources	(62)	(119)	(39)	45	(101)	(74)
Unfilled Customer Orders	-	-	-	-	-	-
Anticipated for rest of year	-	-	-	-	-	-
Net Transfers	-	-	-	-	-	-
Permanently Not Available	(1,769)	(1,015)	(569)	(511)	(2,338)	(1,526)
TOTAL BUDGETARY RESOURCES	**$ 37,585**	**$ 38,378**	**$ 5,856**	**$ 6,300**	**$ 43,441**	**$ 44,678**
STATUS OF BUDGETARY RESOURCES						
Obligations Incurred	$ 11,218	$ 11,633	$ 2,800	$ 3,552	$ 14,018	$ 15,185
Unobligated Balance-Apportioned	1,082	2,222	1,211	504	2,293	2,726
Unobligated Balance Not Available	25,285	24,523	1,845	2,244	27,130	26,767
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 37,585**	**$ 38,378**	**$ 5,856**	**$ 6,300**	**$ 43,441**	**$ 44,678**
CHANGE IN OBLIGATED BALANCES						
Obligated Balance, Net, Beginning of Period:						
Unpaid Obligations Carried Forward	$ 1,442	$ 1,330	$ 888	$ 924	$ 2,330	$ 2,254
Receivable from Federal Sources Carried Forward	(262)	(381)	(52)	(6)	(314)	(387)
Obligations Incurred	11,218	11,633	2,800	3,552	14,018	15,185
Gross Outlays	(11,129)	(11,474)	(2,760)	(3,577)	(13,889)	(15,051)
Obligated Balance Transfers, Net:	-	-	-	-	-	-
Recoveries of Prior Year Obligations	(56)	(47)	(47)	(12)	(103)	(59)
Change in Receivable from Federal Sources	62	119	39	(45)	101	74
Obligated Balance, Net, End of Period:						
Unpaid Obligations	1,477	1,442	880	888	2,357	2,330
Receivable from Federal Sources	(203)	(262)	(11)	(51)	(214)	(313)
Outlays:						
Disbursements	11,129	11,474	2,760	3,577	13,889	15,051
Collections	(11,660)	(11,587)	(2,446)	(2,892)	(14,106)	(14,479)
Subtotal	(531)	(113)	314	685	(217)	572
Less: Offsetting Receipts	-	-	677	474	677	474
NET OUTLAYS	**$ (531)**	**$ (113)**	**$ (363)**	**$ 211**	**$ (894)**	**$ 98**

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 & 86x4242	86x0236	MMI/CMHI Total
BUDGETARY RESOURCES					
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	-	-	-	-	-
Anticipated for rest of year	-	-	-	-	-
Net Transfers	3,404	-	-	(3,404)	-
Permanently Not Available	(22)	-	(1,747)	-	(1,769)
TOTAL BUDGETARY RESOURCES	**$ 3,861**	**$ 130**	**$ 11,635**	**$ 21,959**	**$ 37,585**
STATUS OF BUDGETARY RESOURCES					
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
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 3,861**	**$ 130**	**$ 11,635**	**$ 21,959**	**$ 37,585**
CHANGE IN OBLIGATED BALANCES					
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	-	-	-	-	-
NET OUTLAYS	**$ 3,818**	**$ 26**	**$ (2,213)**	**$ (2,162)**	**$ (531)**

Required Supplementary Information

Schedule D: Comparative Combining Budgetary Resources by Appropriation for the MMI/CMHI Program–Fiscal Year 2005

(Dollars in millions)	86 0183	86x4070	86x4587 & 86x4242	86x0236	MMI/CMHI Total
BUDGETARY RESOURCES					
Unobligated Balance Carried Forward					
Beginning of period	$ 49	$ 12	$ 3,461	$ 23,519	$ 27,041
Recoveries of Prior Year Obligations	8	2	37	-	47
Budget Authority:					
Appropriations received	434	-	-	-	434
Borrowing Authority	-	-	403	-	403
Spending Authority from Offsetting Collections:					
Earned					
Collected	-	81	9,338	2,168	11,587
Receivable from Federal Sources	-	-	(132)	13	(119)
Unfilled Customer Orders	-	-	-	-	-
Anticipated for rest of year	-	-	-	-	-
Net Transfers	2,394	44	-	(2,438)	-
Permanently Not Available	(15)	-	(1,000)	-	(1,015)
TOTAL BUDGETARY RESOURCES	**$ 2,870**	**$ 139**	**$ 12,107**	**$ 23,262**	**$ 38,378**
STATUS OF BUDGETARY RESOURCES					
Obligations Incurred	$ 2,820	$ 101	$ 8,712	$ -	$ 11,633
Unobligated Balance-Apportioned	5	36	2,181	-	2,222
Unobligated Balance Not Available	45	2	1,214	23,262	24,523
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 2,870**	**$ 139**	**$ 12,107**	**$ 23,262**	**$ 38,378**
CHANGE IN OBLIGATED BALANCES					
Obligated Balance, Net, Beginning of Period:					
Unpaid Obligations Carried Forward	$ 81	$ 276	$ 973	$ -	$ 1,330
Receivable from Federal Sources Carried Forward	-	-	(133)	(248)	(381)
Obligations Incurred	2,820	101	8,712	-	11,633
Gross Outlays	(2,799)	(109)	(8,566)	-	(11,474)
Obligated Balance Transfers, Net:	-	-	-	-	-
Recoveries of Prior Year Obligations	(8)	(2)	(37)	-	(47)
Change in Receivable from Federal Sources	-		132	(13)	119
Obligated Balance, Net, End of Period:					
Unpaid Obligations	94	266	1,082	-	1,442
Receivable from Federal Sources	-	-	(2)	(260)	(262)
Outlays:					
Disbursements	2,799	109	8,566	-	11,474
Collections	-	(81)	(9,338)	(2,168)	(11,587)
Subtotal	2,799	28	(772)	(2,168)	(113)
Less: Offsetting Receipts	-	-	-	-	-
NET OUTLAYS	**$ 2,799**	**$ 28**	**$ (772)**	**$ (2,168)**	**$ (113)**

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 & 86x4105		GI/SRI Total
BUDGETARY RESOURCES								
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		-		-		-		-
Anticipated for rest of year		-		-		-		-
Net Transfers		-		-		-		-
Permanently Not Available		(59)		(68)		(442)		(569)
TOTAL BUDGETARY RESOURCES	**$**	**849**	**$**	**619**	**$**	**4,386**	**$**	**5,856**
STATUS OF BUDGETARY RESOURCES								
Obligations Incurred	$	668	$	459	$	1,673	$	2,800
Unobligated Balance-Apportioned		22		138		1,051		1,211
Unobligated Balance Not Available		161		22		1,662		1,845
TOTAL STATUS OF BUDGETARY RESOURCES	**$**	**851**	**$**	**619**	**$**	**4,386**	**$**	**5,856**
CHANGE IN OBLIGATED BALANCES								
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
NET OUTLAYS	**$**	**652**	**$**	**48**	**$**	**(386)**	**$**	**(363)**

Required Supplementary Information

Schedule E: Comparative Combining Budgetary Resources by Appropriation for the GI/SRI Program–Fiscal Year 2005

(Dollars in millions)	86 0200	86x4072	86x4077 & 86x4105	GI/SRI Total
BUDGETARY RESOURCES				
Unobligated Balance Carried Forward				
Beginning of period	$ 261	$ 138	$ 1,147	$ 1,546
Recoveries of Prior Year Obligations	8	2	2	12
Budget Authority:				
Appropriations received	1,091	462	-	1,553
Borrowing Authority	-	(9)	772	763
Spending Authority from Offsetting Collections:				
Earned				
Collected	-	507	2,385	2,892
Receivable from Federal Sources	-	-	45	45
Unfilled Customer Orders	-	-	-	-
Anticipated for rest of year	-	-	-	-
Net Transfers	-	-	-	-
Permanently Not Available	(66)	(231)	(214)	(511)
TOTAL BUDGETARY RESOURCES	**$ 1,294**	**$ 869**	**$ 4,137**	**$ 6,300**
STATUS OF BUDGETARY RESOURCES				
Obligations Incurred	$ 1,078	$ 834	$ 1,640	$ 3,552
Unobligated Balance-Apportioned	19	16	469	504
Unobligated Balance Not Available	197	19	2,028	2,244
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 1,294**	**$ 869**	**$ 4,137**	**$ 6,300**
CHANGE IN OBLIGATED BALANCES				
Obligated Balance, Net, Beginning of Period:				
Unpaid Obligations Carried Forward	$ 91	$ 543	$ 290	$ 924
Receivable from Federal Sources Carried Forward	-	(1)	(5)	(6)
Obligations Incurred	1,078	834	1,640	3,552
Gross Outlays	(1,060)	(768)	(1,749)	(3,577)
Obligated Balance Transfers, Net:	-	-	-	-
Recoveries of Prior Year Obligations	(8)	(2)	(2)	(12)
Change in Receivable from Federal Sources	-	-	(45)	(45)
Obligated Balance, Net, End of Period:				
Unpaid Obligations	99	608	181	888
Receivable from Federal Sources	-	(1)	(50)	(51)
Outlays:				
Disbursements	1,060	768	1,749	3,577
Collections	-	(507)	(2,385)	(2,892)
Subtotal	1,060	261	(636)	685
Less: Offsetting Receipts	-	-	-	474
NET OUTLAYS	**$ 1,060**	**$ 261**	**$ (636)**	**$ 211**

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OIG
REPORT

This report is a condensed version of a more detailed report issued separately on November 8, 2006 by HUD, OIG entitled, "Audit of the Federal Housing Administration's Financial Statements for Fiscal Years 2006 and 2005" (2007-FO-0002). The report is available at HUD, OIG's Internet site at http://www.hud.gov/offices/oig/.

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Issue Date
November 8, 2006
Audit Case Number
2007-FO-0002

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

FROM: Randy W. McGinnis, Director, Financial Audits Division, GAF

SUBJECT: Audit of the Federal Housing Administration's Financial Statements for Fiscal Years 2006 and 2005

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 to audit the fiscal years 2006 and 2005 financial statements of the Federal Housing Administration (FHA). The contract required that the audit be performed according to generally accepted government auditing standards.

Urbach Kahn and Werlin LLP is responsible for the attached auditors' report dated October 30, 2006 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.

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 2006 that conforms to FASAB standards.

The report contains three reportable conditions and one instance of non-compliance with certain provisions of applicable Laws and Regulations. For tracking purposes, Exhibit 1, Schedule of Questioned Costs and Funds Put to Better Use, is also attached to capture the dollar amount recommended for contract closeout and deobligation in recommendation 1b. Five recommendations are new to this year's report. Based on the information provided in management's response to Urbach Kahn and Werlin's audit, we will record management decisions in the department's Audit Resolution and Corrective Action Tracking System for these five new recommendations.

We appreciate the courtesies and cooperation extended to the Urbach Kahn, and Werlin and OIG audit staffs during the conduct of the audit.

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INDEPENDENT AUDITOR'S REPORT

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INDEPENDENT AUDITOR'S REPORT

Inspector General
US 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, 2006 and 2005, and the related consolidated statements of net cost, changes in net position, and financing, 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, regulations, contracts, and grant agreements that could have a direct and material effect on its financial statements.

Introduction

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 reportable conditions:

- FHA should improve its funds control processes.
- FHA must enhance the controls around the User Access Request (UAR) process.
- FHASL needs to be managed as a mission critical system at the HITS data center.

We found one reportable instance of noncompliance with certain provisions of applicable laws, regulations, contracts and grant agreements. FHA and certain of its allotment holders did not have an approved Funds Control Plan as required by HUD policy.

These results and our findings are discussed more fully below.

Management Responsibilities

Management is responsible for the information in the Annual Management Report, including the: (1) 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 and maintaining internal controls over financial reporting and complying with laws, regulations, contracts, and grant agreements, including the Federal Financial Management Improvement Act of 1996 (FFMIA).

Auditor Responsibilities

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 Office of Management and Budget (OMB) Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*. These standards and OMB Bulletin No. 06-03 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 includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of FHA's internal control over financial reporting. Accordingly, we express no such opinion. 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 audit provides a reasonable basis for our opinion.

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, 2006 and 2005, and its net cost, changes in net position, combined budgetary resources, and reconciliation of budgetary obligations to net cost for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

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.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered FHA's internal control over financial reporting by obtaining an understanding of FHA's internal control, determined whether internal controls had been placed into 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. 06-03 and *Government Auditing Standards*. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982, such as those controls relevant to ensuring efficient operations. The objective of our audit was not to provide assurance on internal control. Consequently, we do not provide an opinion on internal control.

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control that, in our judgment, could adversely affect FHA's ability to record, process, summarize, and report financial data consistent with the assertions by management in the Principal Financial Statements.

Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in internal controls, misstatements, losses, or noncompliance may nevertheless occur and not be detected.

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 reportable conditions:

- ***FHA should improve its funds control processes***.

  HUD's Administrative Control of Funds Policies and Procedures Handbook No. 1830.2 REV-5 requires each allotment holder submit an acceptable Funds Control Plan, review open obligations that are over certain threshold limits, and ensure that disbursements do not exceed obligations. FHA and certain of its allotment holders have been operating without an approved Funds Control Plan for the past three fiscal years, have not reviewed unliquidated obligations annually and in certain instances, authorized expenditures in excess of obligations. Without proper funds control procedures, FHA management cannot ensure that its budgetary resources are effectively managed and obligations and expenditures will not exceed authorized limits of the funds allotted.

- ***FHA must enhance the controls around the User Access Request (UAR) process*.**

  FHA's Office of Housing maintains eleven separate application systems for managing its Single Family Insurance programs and four applications for managing its Multifamily programs. Several of these applications are interfaced with FHA's core financial management system, the FHA Subsidiary Ledger (FHASL). HUD has a centralized process to ensure users are given proper access to needed applications. We found that a significant number of user access request forms that were requested during our audit for one system were either unavailable or were incomplete. Most of the missing forms related to system access requests that were issued prior to FY2005. Without proper tracking of account access approvals, management cannot ensure that access rights are based on the control concept of least privilege that were authorized by the appropriate parties.

- ***FHASL needs to be managed as a mission critical system at the HITS data center.***

  The FHASL application is maintained at the HUD Information Technology Services (HITS) Data Center facility in Charleston, West Virginia. FHASL was not contractually considered a mission critical system by the HITS data center. Accordingly, FHASL was not included in the disaster recovery backup plans for mission critical systems covered by the data center contract. Given that the systems backup tapes are stored offsite, any disruption in service could have had a significant impact on system access and downtime. The data center contract for FY2007 will include FHASL as a mission critical system for disaster recovery planning purposes.

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. 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.

With respect to certain key performance measures reported in Management's Discussion and Analysis, we obtained an understanding of the design of significant internal controls related to the existence and completeness assertions, as required by OMB Bulletin No. 06-03. Our procedures were not designed to provide assurance on internal control over reported performance measures, and, accordingly, we do not provide an opinion on such controls.

We also noted other less significant matters involving the internal control and its operation, which we have reported to the management of FHA in a separate letter, dated October 30, 2006.

Compliance with Laws and Regulations

As part of obtaining reasonable assurance about whether FHA's Principal Financial Statements are free of material misstatements, we performed tests of FHA's compliance with certain provisions of applicable laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain other laws and regulations specified in OMB Bulletin No. 06-03.

Our audit procedures were not designed to test the requirements of OMB Bulletin No. 06-03 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, regulations, contracts and grants applicable to FHA. Providing an opinion on compliance with certain provisions of laws, regulations, contracts and grants was not an objective of our audit and, accordingly, we do not express such an opinion.

The results of our tests of compliance with the laws, regulations, contracts and grants described above, exclusive of FFMIA, disclosed a potential instance of noncompliance that is required to be reported under *Government Auditing Standards* and OMB Bulletin No. 06-03, as described below.

- **FHA and certain of its allotment holders did not have an approved Funds Control Plan as required by HUD policy.**

  As discussed in the first reportable condition above, FHA and certain of its allotment holders did not have an approved Funds Control Plan for FY2006. The HUD Appropriation Law for FY2003 (Public Law 108-7) requires HUD and its allotment holders maintain an adequate system of accounting for its appropriations and other available funds. HUD requires each allotment holder to evidence this system of budgetary and accounting control through the submission of an Annual Funds Control Plan to HUD's Chief Financial Officer for review and monitoring.

Specific conditions and recommended remedial actions attributable to this noncompliance are more fully described in the first reportable condition above and in Appendix A. The FHA Office of the Comptroller is responsible for the Funds Control Plans relating to FHA budget authority.

Additionally, 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.

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 30, 2006

Appendix A
Reportable Conditions and Material Weaknesses

The following internal control matters are considered Reportable Conditions:

1. *FHA should improve its funds control processes.*

FHA needs to improve controls over its funds control processes in order to effectively monitor and control budgetary resources and to ensure full compliance with HUD's funds control requirements. The HUD Administrative Control of Funds Policies and Procedures Handbook No. 1830.2 REV-5 (HUD Handbook) requires each FHA allotment holder to submit to the Office of the Chief Financial Officer (OCFO) an acceptable Funds Control Plan each year, review open obligations that are over certain threshold limits, and ensure that disbursements do not exceed contract obligations. FHA has been operating without an approved Funds Control Plan for the past three fiscal years, unliquidated obligations were not reviewed annually and in some instances, expenditures exceeded obligations.

FHA's Comptroller noted FHA was conditionally approved by the Chief Financial Officer (CFO) based on a July 2003 memo and, therefore, not required to submit an annual funds control plan pending completion of FHA Subsidiary Ledger (FHASL) Project. We reviewed the July 31, 2003 memo and HUD's policies for funds control, and determined that while the CFO conditionally approved FHA's FY 2003 Fund Control Plan based upon FHA's interim control processes put in place pending completion of the FHA Subsidiary Ledger Project, FHA was still required to submit its Funds Control Plans for subsequent periods. The July 31, 2003 memo stated that the CFO's approval of the FY 2003 Funds Control Plan was conditional upon:

- A continuation of FHA's interim control processes with further documentation of those interim controls in FHA's 2004 plans;
- Continued progress in developing and implementing improved funds control capabilities under the FHASL Project; and
- Establishment of a working group of FHA and OCFO staff to assess best practices for providing funds control over credit subsidy programs, with feedback to the on-going FHASL Project.

The HUD Handbook also requires FHA to annually review obligations over a certain threshold limit to ensure excess obligations are deobligated for budgeting purposes. We noted that although FHA reviewed contract obligations in fiscal year 2006, no reviews were conducted in the previous two fiscal years.

We sampled 95 contracts with undisbursed balances totaling $410,853,985 as of June 30, 2006, and noted that 51 contracts totaling $121,985,561 should have been administratively closed out one to three fiscal years ago based on the lack of recent activity. As of September 30, 2006, FHA deobligated $14,808,965 relating to the contracts we reviewed, leaving a balance of $107,176,596 to be deobligated in fiscal year 2007.

One of the essential functions of funds control is to prevent authorizing or making expenditures exceeding the amount obligated for a particular contract or grant activity. As of June 2006, we reviewed 47 Management and Marketing contracts and noted that management controls were not sufficient to identify and correct for two contracts when the obligations were insufficient to cover the expenditures. Management has since obligated the additional required funds.

Because of a lack of a Funds Control Plan to annually review the validity of open obligations, excess funding was not deobligated timely and thus, FHA was unable to put these funds to better use to support other FHA program activities. FHA should establish interim funds control policies and procedures while the funds control module in the FHASL Project is being enhanced to ensure funds are properly managed and controlled at a transaction level in compliance with HUD's funds control policies.

Recommendations to address the above include:

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. (New)

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. (New)

2. FHA must enhance the controls around the User Access Request (UAR) process.

To manage its complex mortgage insurance business, FHA requires large amounts of financial and non-financial data from lenders, borrowers and trading partners such as multifamily project owners, vendors, agents, etc. FHA's Office of Housing maintains eleven separate application systems for managing its Single Family Insurance programs and four Multifamily insurance application systems. Several of these applications are interfaced with FHA's core financial management system, the FHA Subsidiary Ledger (FHASL). These applications are maintained at the HUD Information Technology Services (HITS) Data Center facility in Charleston, West Virginia.

HUD has a centralized process to ensure users are given proper access to needed application systems. All users must complete a standard user access request form which is signed by the immediate supervisor or contract Government Technical Representative before forwarding it to ADP Security for account initiation. According to the HUD Information Technology Security Policy, Program Office/System Owners shall ensure that user access is reviewed once a year. These access lists should then be validated with ADP Security.

We requested 27 UAR forms for a sample listing of system administrators and users for the SAMS application (A80S) at the HITS Data Center facility to determine if a management approved access request form was on file. HUD was able to locate 13 of the 27 contractor request forms and none of the four request forms for HUD employees. Most of the missing system access requests forms were approved prior to the change to the current HITS contractor. Without proper tracking of account access approvals, management cannot ensure that access rights are based on the control concept of least privilege for users that were authorized by the appropriate parties. Additionally, there is an increased risk that unauthorized individuals could access and use the system without a demonstrable chain of management approval to do so.

Recommendations to address the above include:

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. (New)

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. (New)

3. FHASL is not managed as a mission critical system at the HITS data center.

FHASL is not considered a mission critical system by the HITS data center due to the fact that it was not in the critical system list when the contract was awarded. Accordingly, it is not included in the disaster recovery backup plans for mission critical systems covered by the data center contract. Due to HITS contractual issues, the FHASL application and data were not being replicated and might not be able to be recovered in a timely manner in the event of a data center or data communications disruption. The data center contract for FY2007 will include FHASL as a mission critical system for disaster recovery planning purposes.

Our recommendation to address the above follows:

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. (New)

Appendix B
Management's Response to Recommendations

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

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

October 25, 2006

MEMORANDUM FOR: Urbach Kahn & Werlin LLP

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

SUBJECT: Response to UKW's Fiscal Year 2006 FHA Audit Report

I am pleased to present Federal Housing Administration (FHA) management's responses to your audit report on the fiscal year 2006 FHA financial statements.

General Comments

FHA is pleased that UKW has noted progress in many areas, especially in regards to the improvements made to FHA's risk assessment and Loan Guarantee Liability estimation processes. FHA is pleased to note that we have no material weaknesses. The third reportable condition relating to the FHASL's mission critical status has been resolved subsequent to the identification of this finding, therefore we believe this finding should be eliminated. Additionally, FHA has taken considerable steps to address prior systems findings and will continue to make additional improvements.

Report on Internal Controls – Reportable Conditions

1. FHA should improve its funds control processes.

FHA does have funds control procedures to ensure obligations and expenditures do not exceed authorized limits. The FHA Subsidiary Ledger is being implemented with funds controls being a main priority and focus. The Subsidiary Ledger is currently working as designed with appropriate funds controls in place. We have implemented daily funds control at the allotment level. FHA's funds control processes were documented during FY 2006 with flowcharts that identify all points of fund control. As FHA's implementation progresses, efforts are continuing to update FHA's previous plans.

FHA completed a review of unliquidated obligations in FY 2006. Through this review, FHA identified numerous contracts potentially eligible for contract closeout. In response to our review, certain contract balances were closed out and deobligated through the required process. FHA has taken steps to improve the timely review of unliquidated contract balances. Additionally, FHA participates in the CFO's annual review of unliquidated balances. This review includes all administrative contracts and grants in HUDCAPS and PAS/LOCCS.

As part of the unliquidated obligations review, FHA identified two contracts awarded in 1999 where the expenditures may have exceeded the obligations. These were presented to the program area for analysis. Upon further research, it was determined that the expenditures did not exceed the obligations.

In response to recommendation number 1.a, FHA does have funds control policies and procedures to ensure funds are properly managed and controlled. As the primary funds control mechanism, FHA uses Commitment Control within the FHA Subsidy Ledger to ensure that transactions are "budget checked" daily. During FY 2007, FHA will update its funds control plans to incorporate these policies and procedures.

In response to recommendation 1.b., FHA will work with the Office of the Chief Procurement Officer to identify contracts eligible for closeout. Annually, FHA will conduct a review of unliquidated obligations in accordance with FHA's "Procedures for Annual Review of Unliquidated Obligations not covered under the Office of the CFO's Annual Review."

2. FHA must enhance the controls around the User Access Request (UAR) process.

Each Housing data system installed on HUD's infrastructure has a Security Administrator (SA). This person is a Housing employee within the office that owns and sponsors the system. Each User Access Request (UAR) form is submitted via e-mail to the SA who reviews the request. As an employee working in the specific program area supported by the system, the SA is in a position to confirm the individual has a business need for access to the system and to evaluate the range of permissions requested. The SA may reject the request or modify the permissions requested. Upon approval and concurrence, the SA forwards the e-mail along with his or her concurrence to ADP security. ADP security controls the creation and modification of the user ID/password and profiles for each system.

In addition, the Department is working to implement an improved system for User Access Requests. The basic process begins with a web form that is transferred to ServiceDesk and then tracked to closure. Using the ServiceDesk platform will not only improve tracking, retention, and retrieval of the UARs, it will also "lock down" the UAR as Service Desk tickets can not be altered.

The requirement for system owners to review and update their UAR forms on an annual basis and communicate any change to the HITS contractor is documented in the HUD IT Security Handbook.

Regarding recommendation 2.a., Effective immediately, HUD CIO will ensure that ADP security maintain records of User Access Request forms for all FHA application systems.

Regarding recommendation 2.b., The FHA Comptroller will ensure that each FHA application owner reviews and updates the user access list annually and reconciles the records with ADP Security.

3. FHASL needs to be managed as a mission critical system at the HITS data center.

Subsequent to when this finding was submitted, the condition changed. On September 30, 2006 HUD accepted a technical and cost proposal to modify the HUD Information Technology Services contract to provide, among other things, backup support at the SunGard facility as part of the disaster recovery backup plan for critical systems. As a consequence, we believe this finding was eliminated in FY2006.

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

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

November 6, 2006

MEMORANDUM FOR: Urbach Kahn & Werlin LLP

Ronald Y. Spraker

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

SUBJECT: Subsequent Response to UKW's Fiscal Year 2006 FHA Audit Report

This memo is submitted in response to FHA's Fiscal Year 2006 Compliance with Laws and Regulations received subsequent to FHA's original response dated October 25, 2006.

Compliance with Laws and Regulations

The "Compliance with Laws and Regulations" section of the draft report states that FHA is not in compliance with laws and regulations because it did not follow the requirements for a system of funds control as outlined in HUD's FY 2003 Appropriations Act (Public Law 108-7). FHA has provided for an adequate system of funds control for its appropriated and other budgetary resources. While the reportable condition separately identified opportunities to improve and strengthen the contract close-out process and funds control documentation, the nature of the issues identified do not warrant reporting the current processes as non-compliant with laws or regulations. FHA, therefore, disagrees and requests reconsideration and deletion of this non-compliance. The referenced statute states:

Provided further, that no official or employee of the Department shall be designated as an allotment holder unless the Office of the Chief Financial Officer (OCFO) has determined that such allotment holder has implemented an adequate system of funds control and has received training in funds control procedures and directives.

The statute gives the authority to the CFO to determine whether or not an allotment holder has adequate systems of funds control. The CFO reviewed FHA's funds control systems and determined that they were adequate, that until FHA moved further along with systems implementation the requirement for annual funds control plans would be waived and FHA would operate under interim funds control processes. The FY 2003 Appropriations Act provides the CFO with the authority to make such determinations.

The HUD Handbook requires that each allotment holder annually recertify funds control systems. While FHA has not submitted updated funds control plans for the past two years and may not be in

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compliance with the Handbook – the requirements of which FHA believes the CFO has the authority to waive – this does not constitute non-compliance with laws and regulations. Therefore, FHA respectfully requests that the OIG reported lack of FHA's funds control plans be removed from the Compliance with Laws and Regulations section.

Appendix C
UKW's Assessment of Management's Response to Recommendations

UKW has obtained and reviewed FHA management's response to the findings and recommendations made in connection with our audit of FHA's 2006 Principal Financial Statements, which is included as Appendix B. Our assessment of management's responses is discussed below.

Assessment of management's response to reportable condition No. 1:

We believe management's proposed actions are responsive to our recommendations. However management should enhance the specific components of its transaction level funds control procedures as outlined in its response and highlight how and where (i.e. FHASL) the key funds control points are at the various levels (e.g. obligation level, commitment level, allotment level, etc.) and how the control of funds is reported.

Assessment of management's response to reportable condition No. 2:

We believe management's proposed actions are responsive to our recommendations.

Assessment of management's response to reportable condition No. 3:

Although FHA did provide UKW with evidence of the contract modifications to the HITS contract to be effective for FY2007, UKW has indicated to FHA management that since the system backup plans were inadequate for the full fiscal year under audit that the finding cannot be considered to be resolved. We have, however, revised our recommendation to address the implementation of the contract modification for FY2007.

Assessment of management's response to reported instance of non-compliance with laws and regulations:

We acknowledge the provision of the Appropriation Act that allowed FHA to operate under the interim funds control processes. However, we do not believe this waiver was intended to be in effect beyond FY2003. We also appreciate the efforts undertaken by FHA to improve its funds control procedures. However, we do not believe these efforts have been part of a coordinated comprehensive annual plan to meet the funds control improvement objectives as anticipated by the FY2003 Appropriations Act. Given the significance of the potential impact of potential Anti-deficiency Act violations, we continue to believe this matter is reportable.

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:

Prior Finding/Recommendation	***Type***	***Fiscal Year 2006 Status***
1a. The Director of the FHA Office of Evaluation should evaluate the information provided from the TOTAL scorecard process and the current actuarial review relating to down payment assistance and determine the impact of incorporating these additional loan risk attributes directly into the MMI fund cash flow modeling process to ensure future changes to the composition of borrowers result in a corresponding timely change in projected claim rates.	2005 Material Weakness	Resolved. FHA has incorporated down payment assistance as a risk factor in the 2005 MMI fund Actuarial Review. FHA also incorporated a sample of borrower credit history (FICO credit scores) into the claims and prepayment rate calculations in the FY 2006 MMI Fund Actuarial Review and Loan Guarantee Liability calculation.
1b. The Director for the Housing Office of Single Family Program Development, in coordination with the Director of the Office of Evaluation, should determine whether poor underwriting ratings correlate to higher claim rates for those lenders under the revised PETR monitoring process.		Resolved. FHA determined that there was no correlation between the propensity to receive unacceptable PETR ratings and default claim rates. In FY 2006, FHA revised the PETR rating process using a more risk-based approach which incorporates added subjective factors than previously used. FHA has significantly enhanced the documented guidance provided to PETR contractors in FY 2006, although there are still inconsistencies in ratings between the PETR contractors and FHA's Quality Assurance Processing and Underwriting Division. Issue has been included in the FY2006 Management Letter.
2a. FHA Director of the Office of Evaluation should expand the validation process developed in 2005 to use the prior year comparisons of projected and actual cash flows to develop management's expectations for gross cash flows and other key ratios to be produced by the upcoming reestimation process.	2005 Material Weakness	Resolved. FHA amended the Cash Flow Model Configuration Management Plan and revised the validation reports to assess the accuracy of the projected cash flow estimates. The Mark-to-Market Model has been modified to improve estimates of future cash flows.

2b. FHA Director of the Office of Evaluation should expand the information on the results of the Mark-to-Market modeling process provided to approving officials to improve their ability to evaluate the reasonableness of the resulting calculations. At a minimum, such information should include: (a) the number and unpaid principal balance of projects eligible for Mark-to-Market restructuring, (b) the number and amount of projects resulting in full or partial claims, (c) the net present values of those claims, (d) the related premium and recovery amounts that make up the net liability and (e) key ratios to assist management in evaluating the reasonableness of the components of the calculated liability as well as the net balance.		Resolved. See 2a above.
2c. The FHA Director of the Office of Evaluation should expand the information on the results of the HECM modeling process provided to approving officials to improve their ability to evaluate the reasonableness of the resulting calculations. At a minimum, such information should include: (a) summary information on each type of cash flow, (b) the effect of changes in sensitive model assumptions on each type of cash flow, (c) the net present value of each of these types of cash flows, and (d) key ratios to assist management in evaluating the reasonableness of the components of the calculated liability as well as the net balance.		Resolved. See 2a above. The expanded validation report included an analysis of the results of the HECM modeling process.
2d. The FHA Director of the Office of Evaluation, in coordination with the Deputy Assistant Secretary for Finance and Budget, should expand the year-end model review process to include a comparison		Resolved. FHA performed validation testing using FY2005 data to support the assumptions and results. Any discrepancies in prior year assumptions are investigated and corrected by

and analysis of management's expectations developed above with the results of the current year modeling process and prior year cash flow calculations. This, would, at a minimum, include reviewing the effect of current year changes to the data model, sensitive assumptions, gross cash flow information and results and documentation of management's explanation for any significant variances between the expected balances and the current model calculations.		management.
3. FHA must continue to enhance the management of controls over its portfolio of integrated insurance and financial systems.	2005 Reportable Condition	See 2006 Reportable Condition Finding No. 2. Certain issues have been included in the FY2006 Management Letter.
3a. Ensure the HITS contract is updated to include FHASL as a mission critical application.		Repeat finding. See Reportable Condition No.3.
3b.Ensure the updated Security Plan for FHASL contains appropriate data integrity, availability and confidentiality classifications as required by OMB and NIST standards.		Resolved.
3c. Develop an FHASL Risk Assessment document in compliance with NIST guidance.		Resolved.
3d. Develop a contingency plan for the FHASL application and test the plan on an annual basis.		Resolved.
3e. Ensure that the data center security plan is updated to reflect the current operating environment.		Resolved.
3f. Ensure the security logs for systems managed under the HITS contract are reviewed and properly documented.		Resolved.
3g. Ensure the FY2006 FHA systems project plan is consistent with the HUD Enterprise Architecture integration plan.		Resolved. Issue has been included in the FY2006 Management Letter.