



Audit Report

Financial Audits Division Office of Audit

Report: 99-FO-171-0001

Issued: March 5, 1999

TO: George S. Anderson, Executive Vice President, Government National Mortgage Association, T

FROM: James A. Heist, Director, Financial Audits Division, GAF

SUBJECT: Audit of the Government National Mortgage Association's Fiscal Year 1998 Financial Statements

This report presents the results of the KPMG LLP's (KPMG) audit of the Government National Mortgage Association's (Ginnie Mae) financial statements for the year ended September 30, 1998. We concur with KPMG's opinion, that the financial statements present fairly, in all material respects, Ginnie Mae's financial position as of September 30, 1998 and results of its operations and its cash flows for the year then ended, in conformity with generally accepted accounting principles.

Audit Scope and OMB Audit Requirements

This audit was performed pursuant to the requirements of the Chief Financial Officers Act and Office of Management and Budget (OMB) Bulletin 98-08, *Audit Requirements for Federal Financial Statements*. To complete this audit, we contracted with the independent certified public accounting firm of KPMG. We approved the scope of the audit work, monitored its progress at key points, reviewed their working papers, and performed other procedures we deemed necessary. OMB's audit requirements in Bulletin 98-08, as amended, exceed *Government Auditing Standards*, primarily in three areas. These relate to:

- expanding the review of Ginnie Mae's internal controls,
- reviewing performance measures contained in Ginnie Mae's annual report, and
- reporting under the Federal Financial Managers Improvement Act (FFMIA) of 1996.

To address the first additional OMB requirement, we engaged KPMG to expand their review of Ginnie Mae's internal controls. The section discussing internal controls presents the results of this work. To address the second additional requirement, the Office of Inspector General (OIG) performed the procedures required by OMB Bulletin 98-08. With respect to FFMIA, the reporting requirements do not apply to the Ginnie Mae audit, but will be reported at the HUD consolidated level.

Results of KPMG's Audit

In addition to KPMG's unqualified opinion on Ginnie Mae's financial statements, the audit results indicate that there were no material weaknesses or reportable conditions with Ginnie Mae's internal controls, or material instances of non-compliance with laws and regulations. Furthermore, KPMG's assessment of Ginnie Mae's efforts to address recommendations from prior years indicated that, while some efforts are incomplete, the outstanding issues are not material to the financial statements, requiring reporting in the audit report. Instead, these outstanding issues are being reported separately to Ginnie Mae management.

OIG Review of Ginnie Mae's Performance Measures

Ginnie Mae's performance measures are incorporated in both the "Overview" and "Management's Discussion and Analysis of Financial Position and Results of Operations" (D&A) sections of Ginnie Mae's Fiscal Year 1998 annual report prepared under the requirements of the CFO Act. In accordance with OMB Bulletin 98-08, we obtained an understanding of certain aspects of Ginnie Mae's internal controls and assessed control risk relative to the policies and procedures adopted by management to provide reasonable assurance that data supporting reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information.

For purposes of this report, we classified the significant D&A internal control policies and procedures relative to the production of performance measures into the following categories:

- Operations
- Risk Management
- Liquidity and Capital Adequacy

We reviewed Ginnie Mae's process for developing and supporting performance measures included in the Overview and D&A sections of its annual report. We noted that for some performance measures, the data used were as of periods prior to the end of the fiscal year because this was considered by Ginnie Mae to be the best available information. In addition, working with KPMG, we determined that the financial data presented were not inconsistent with the financial statements. Our review disclosed that for the financial performance measures assessed, Ginnie Mae complied with OMB requirements to document and support financial and statistical information presented in the D&A.

In prior years, we have reported that Ginnie Mae needs to build on efforts already completed to improve performance measures. Currently, Ginnie Mae's senior management has developed performance measures in support of the Secretary of Housing and Urban Development's Strategic Plan for fiscal years 1998-2003 to comply with current guidance under the Government Performance and Results Act. Ginnie Mae also developed four measures or indicators for HUD's fiscal year 1999 Annual Performance Plan to achieve the HUD goal to "Maintain liquidity in the market for mortgage credit."

Comments of Ginnie Mae Officials

On February 26, 1999 we provided a draft of KPMG's report to Ginnie Mae officials for their review and comment. The draft was subsequently discussed with Ginnie Mae officials. Ginnie Mae largely agreed with the results of the audit. Ginnie Mae's comments were considered in developing the final version of this report.

We appreciate the courtesies and cooperation extended to the KPMG and OIG audit staff during the conduct of the audit.

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INDEPENDENT AUDITORS' REPORT

To the Inspector General,
U.S. Department of Housing and Urban Development:

We have audited the 1998 and 1997 financial statements of the Government National Mortgage Association (Ginnie Mae). The objective of our audits was to express an opinion on the fair presentation of Ginnie Mae's financial statements based on our audits. In connection with our audits we also considered Ginnie Mae's internal control over financial reporting and tested Ginnie Mae's compliance with provisions of applicable laws and regulations that could have a direct and material effect on its financial statements.

In our opinion, Ginnie Mae's 1998 and 1997 financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles.

We noted no matters involving internal control over financial reporting and its operations that we consider to be material weaknesses.

The results of our tests of compliance disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards* and Office of Management and Budget (OMB) Bulletin No. 98-08, *Audit Requirements for Federal Financial Statements*, as applicable to government corporations.

Our opinion on Ginnie Mae's financial statements, our consideration of internal control over financial reporting, our tests of Ginnie Mae's compliance with certain laws and regulations and our responsibilities are discussed in the remainder of our report.

OPINION ON FINANCIAL STATEMENTS

We have audited the accompanying balance sheets of Ginnie Mae, as of September 30, 1998 and 1997, and the related statements of revenues and expenses and changes in investment of U.S. government and cash flows for the years then ended. These financial statements are the responsibility of Ginnie Mae's management. Our responsibility is to express an opinion on these financial statements based on our audits.

In our opinion, the accompanying 1998 and 1997 financial statements present fairly, in all material respects, the financial position of Ginnie Mae as of September 30, 1998 and 1997, and the results of its operations and its cash flows for the years then ended, in conformity with generally accepted accounting principles.

INTERNAL CONTROLS OVER FINANCIAL REPORTING

We noted no matters involving internal control over financial reporting and its operation that we consider to be material weaknesses under standards established by the American Institute of Certified Public Accountants (AICPA) and OMB Bulletin No. 98-08, as applicable to government corporations.

Material weaknesses are 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. Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses under standards issued by the AICPA and OMB Bulletin 98-08, as applicable to government corporations.

Although not considered material weaknesses, we noted other matters involving internal controls and their operation during our audit which have been reported to Ginnie Mae's management in a separate letter.

COMPLIANCE WITH LAWS AND REGULATIONS

The results of our tests, performed as part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards* and OMB Bulletin No. 98-08, as applicable to government corporations.

RESPONSIBILITIES

Management's Responsibility. The Chief Financial Officers (CFO) Act of 1990 requires federal agencies to report annually to Congress on their financial status and any other information needed to fairly present the agencies' financial position and results of operations. To meet the CFO Act reporting requirements, Ginnie Mae prepares annual financial statements. Ginnie Mae is an agency operated by the U.S. Department of Housing and Urban Development (HUD).

Management has the responsibility for:

- preparing the financial statements in conformity with generally accepted accounting principles;
- establishing and maintaining internal controls over financial reporting; and
- complying with applicable laws and regulations.

In fulfilling these responsibilities, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies and procedures. The objectives of internal control over financial reporting are to provide management with reasonable, but not absolute, assurance that:

- transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in conformity with generally accepted accounting principles;

- assets are safeguarded against loss from unauthorized acquisition, use or disposition; and
- transactions are executed in accordance with laws governing the use of budget authority and other laws and regulations that could have a direct and material effect on the financial statements.

Auditors' Responsibility. Our responsibility is to express an opinion on the 1998 and 1997 financial statements of Ginnie Mae based on our audits. We conducted our audits in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin No. 98-08, as applicable to government corporations. Those standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement and presented fairly in accordance with generally accepted accounting principles. We believe that our audits provide a reasonable basis for our opinion. Our audits were not designed to test the requirements of OMB Bulletin No. 98-08 relating to the *Federal Financial Management Improvement Act* (FFMIA), which is not considered applicable at the Ginnie Mae level. FFMIA requirements will be reviewed and reported on at the HUD consolidated level. Our audits were also not designed to test the requirements of OMB Bulletin No. 98-08 relating to the Credit Reform Act of 1990, because Ginnie Mae's financial statements were prepared in conformity with generally accepted accounting principles.

In planning and performing our audit of the financial statements of Ginnie Mae, we considered internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on internal control over financial reporting. Consequently, we do not provide an opinion on internal controls.

As part of obtaining reasonable assurance about whether Ginnie Mae's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations. However, providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit, and accordingly, we do not express such an opinion.

In order to fulfill these responsibilities, we:

- examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- assessed the accounting principles used and significant estimates made by management;
- evaluated the overall financial statement presentation; and
- tested compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts.

With respect to internal control, we obtained an understanding of Ginnie Mae's significant internal controls, determined whether these internal controls had been placed in operation, assessed control risk, and performed tests of controls.

Because of inherent limitations in internal control, fraud may nevertheless occur and not be detected. Also, projection of an evaluation of internal controls over financial reporting to future periods is subject to the risk that internal control procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

Independent Auditors' Report

This report is intended solely for the information and use of the HUD Office of the Inspector General, the management of HUD and Ginnie Mae, OMB, and Congress and is not intended to be and should not be used by anyone other than those specified parties.

February 12, 1999
Washington, D.C.

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION
BALANCE SHEETS

	September 30,	
	1998	1997
	(In thousands)	
Assets:		
Funds in U.S. Treasury	\$ 778,700	\$ 155,800
U.S. Government securities-Note B	5,448,300	5,382,000
Mortgages held for sale, net-Note C.....	4,900	3,800
Properties held for sale, net-Note D	1,500	3,000
Accrued interest and other receivables	103,600	101,700
Advances against defaulted Mortgage- Backed Security pools, net-Note E.....	29,400	29,100
Claims against HUD/FHA and VA	-	7,500
Total Assets.....	\$ 6,366,400	\$ 5,682,900
Liabilities and Investment of U.S. Government		
Liabilities:		
Reserve for loss on Mortgage-Backed Securities Program-Note F.....	\$ 511,200	\$ 507,700
Deferred revenue	24,000	19,200
Deferred liabilities and deposits.....	1,100	1,700
Accounts payable and accrued liabilities	20,800	19,700
Total Liabilities.....	557,100	548,300
Commitments and Contingencies- Note I		
Investment of U.S. Government	5,809,300	5,134,600
Total Liabilities and Investment of U.S. Government ...	\$ 6,366,400	\$ 5,682,900

See accompanying notes to financial statements.

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION

**STATEMENTS OF REVENUES AND EXPENSES AND
CHANGES IN INVESTMENT OF U.S. GOVERNMENT**

	Year ended September 30,	
	1998	1997
	(In thousands)	
Revenues:		
Mortgage-Backed Securities Program income.....	\$ 392,300	\$ 353,800
Interest income.....	362,700	318,200
Other income, net.....	12,400	14,700
Total Revenues.....	767,400	686,700
Expenses:		
Mortgage-Backed Securities Program expenses	36,300	29,400
Administrative and other expenses	9,300	9,300
Total Expenses	45,600	38,700
Provision for loss on Mortgage-Backed Securities Program – Note F	47,100	46,800
Excess of Revenues Over Expenses	674,700	601,200
Investment of U.S. Government at Beginning of Year	5,134,600	4,533,400
Excess of revenues over expenses	674,700	601,200
Investment of U.S. Government at End of Year	\$ 5,809,300	\$ 5,134,600

See accompanying notes to financial statements.

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION
STATEMENTS OF CASH FLOWS

	Year ended September 30,	
	1998	1997
	(In thousands)	
Cash flows from operating activities:		
Interest received	\$ 362,200	\$ 301,800
Mortgage-Backed Securities Program fees	390,900	352,400
Advances against defaulted Mortgage-Backed Security pools	(25,800)	(5,100)
Mortgage-Backed Program losses and expenses	(41,600)	(36,300)
Other income received	17,200	23,300
Administrative expenses	(9,300)	(9,300)
Purchases of mortgages/properties net of disposal	(8,400)	(15,900)
Recoveries from FHA and VA	4,000	10,600
Net Cash provided by operating activities	689,200	621,500
Cash flows from investing activities:		
Purchase of U.S. Treasury Securities, net	(66,300)	(596,900)
Net cash used by investing activities	(66,300)	(596,900)
Net increase in cash	622,900	24,600
Funds in U.S. Treasury at beginning of year	155,800	131,200
Funds in U.S. Treasury at end of year	\$ 778,700	\$ 155,800

See accompanying notes to financial statements

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION

STATEMENTS OF CASH FLOWS

	Year ended September 30,	
	1998	1997
	(In thousands)	
Net excess of revenue over expenses.....	\$ 674,700	\$ 601,200
Adjustments to reconcile net excess of revenue over expenses to net cash provided by operating activities:		
Provision for loss on Mortgage-Backed Securities Program	47,100	46,800
Increase in accrued interest and other receivables.....	(400)	(16,400)
(Increase) decrease in advances against defaulted Mortgage-Backed Securities pools	(300)	400
Decrease in deposit liabilities.....	(600)	(100)
Increase (decrease) in accounts payable and accrued liabilities.....	1,100	(1,000)
Increase in deferred revenue	4,800	4,400
Decrease in Mortgage-Backed Securities reserve relating to operating activities.....	(37,200)	(13,800)
Total adjustments	14,500	20,300
Net cash provided by operating activities	\$ 689,200	\$ 621,500

See accompanying notes to financial statements

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION
NOTES TO THE FINANCIAL STATEMENTS

NOTE A--ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING
POLICIES

The Government National Mortgage Association (Ginnie Mae) was created in 1968 through amendment of Title III of the National Housing Act as a Government corporation within the Department of Housing and Urban Development (HUD).

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

These MBS securities are not assets of Ginnie Mae, nor are the related outstanding securities liabilities; accordingly, neither is reflected on the accompanying balance sheets.

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

U.S. Government Securities: Ginnie Mae classifies its investments in U.S. Government Securities based on its ability and positive intent to hold them to maturity. Therefore, Ginnie Mae's investment in U.S. Government securities is recorded at amortized cost. Discounts and premiums are amortized, on a level yield basis, over the life of the related security.

Mortgage Loans Held for Sale: Mortgage loans held for sale are carried at the lower of cost or fair value, with any unrealized losses included in current period earnings. The related allowance for loss is established to reduce the carrying value of mortgages held for sale to their estimated fair value which is based on the amount Ginnie Mae expects to realize in cash upon sale of the mortgages.

Properties Held for Sale: Foreclosed assets are recorded at the lower of cost or fair value less estimated costs to sell. The related allowance for loss is established to reduce the property carrying value to fair value less costs to sell. Property related expenses incurred during the holding period are included in Mortgage-Backed Securities program expenses.

Advances Against Defaulted Mortgage-Backed Security Pools: Advances against defaulted mortgage-backed security pools represent payments made to fulfill Ginnie Mae's guaranty of timely principal and interest payment to the MBS security holders. Such advances are reported net of an allowance for doubtful recoveries to the extent management believes they will not be recovered. The allowance for doubtful recoveries is estimated based on actual and expected recovery experience and is adjusted for FHA, VA and RHS claims that have been filed.

Reserve for Loss on MBS Program: In the operation of its MBS programs, Ginnie Mae estimates the cost of liquidating its existing portfolio of mortgage servicing rights acquired from defaulted issuers and expected future issuer defaults. Reserves are established to the extent management believes issuer defaults are probable and FHA, VA and RHS insurance or guaranty are insufficient to recoup Ginnie Mae expenditures. The reserves are increased

by provisions charged as an expense in the Statements of Revenues and Expenses and reduced by charge-offs, net of recoveries.

Recognition of Revenues and Expenses: Ginnie Mae receives monthly guaranty fees for each MBS mortgage pool based on a percentage of the pool's outstanding balance. Fees received for Ginnie Mae's guaranty of mortgage-backed securities are recognized as earned. Fees received for commitments to guaranty mortgage-backed securities are recognized when the commitments are granted. Ginnie Mae recognizes as income the major portion of fees related to the issuance of multiclass securities in the period the fees are received, with the balance deferred and amortized over the weighted averaged life of the underlying mortgages to match the recognition of related administrative expenses. Losses on assets acquired through liquidation and claims against HUD/FHA and VA are recognized when they occur.

Use of Estimates: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and 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 could differ from those estimates.

NOTE B--U.S. GOVERNMENT SECURITIES

The U.S. Government Securities portfolio is held in special market based U.S. Treasury securities that are bought and sold at composite prices received from the Federal Reserve Bank of New York. These securities are maintained in book entry form at the Bureau of Public Debt. The coupon rates of Ginnie Mae's current holdings range from 5.0 percent to 8.0 percent. The amortized cost and fair values as of September 30, 1998 were as follows:

<i>Dollars in thousands</i>	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury Overnight Certificates	\$ 115,300	\$ -	\$ -	\$ 115,300
U.S. Treasury Notes	<u>5,333,000</u>	<u>384,600</u>	<u>-</u>	<u>5,717,600</u>
	<u>\$ 5,448,300</u>	<u>\$ 384,600</u>	<u>\$ -</u>	<u>\$ 5,832,900</u>

The amortized cost and fair values as of September 30, 1997 were as follows:

<i>Dollars in thousands</i>	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury Overnight Certificates	\$ 217,800	\$ -	\$ -	\$ 217,800
U.S. Treasury Notes	<u>5,164,200</u>	<u>87,600</u>	<u>24,100</u>	<u>5,227,700</u>
	<u>\$ 5,382,000</u>	<u>\$ 87,600</u>	<u>\$ 24,100</u>	<u>\$ 5,445,500</u>

The amortized cost, fair value and annual weighted average interest rates of debt securities at September 30, 1998, by contractual maturity date, are as follows:

<i>Dollars in thousands</i>	Amortized Cost	Fair Value	Weighted Average Interest Rate
Due within one year	\$ 628,500	\$ 633,400	4.62%
Due after one year through five years	2,754,800	2,864,000	4.37%
Due after five years through ten years	<u>2,065,000</u>	<u>2,335,500</u>	4.40%
	<u>\$ 5,448,300</u>	<u>\$ 5,832,900</u>	4.41%

The amortized cost, fair value and annual weighted average interest rates of debt securities at September 30, 1997, by contractual maturity date, were as follows:

<i>Dollars in thousands</i>	Amortized Cost	Fair Value	Weighted Average Interest Rate
Due within one year	\$ 498,000	\$ 497,300	5.72%
Due after one year through five years	2,536,900	2,549,700	5.88%
Due after five years through ten years	<u>2,347,100</u>	<u>2,398,500</u>	6.13%
	<u>\$ 5,382,000</u>	<u>\$ 5,445,500</u>	5.98%

NOTE C--MORTGAGES HELD FOR SALE, NET

Ginnie Mae acquires certain mortgages from defaulted issuers' portfolios to bring the pools into conformity with MBS program requirements. Mortgages ineligible to remain in pools when servicing-rights are sold are acquired by Ginnie Mae. Mortgages held for sale were as follows:

<i>Dollars in thousands</i>	September 30,	
	1998	1997
Unpaid principal balance	\$ 7,100	\$ 7,000
Allowance for losses	<u>(2,200)</u>	<u>(3,200)</u>
Mortgages held for sale, net	<u>\$ 4,900</u>	<u>\$ 3,800</u>

NOTE D--PROPERTIES HELD FOR SALE, NET

Ginnie Mae acquires residential properties by foreclosure out of the defaulted issuer portfolios in order to comply with MBS program requirements. Balances and activity in the properties held for sale were as follows:

<i>Dollars in thousands</i>	September 30,	
	1998	1997
Cost of properties, beginning of year	\$ 4,700	\$ 8,100
Additions	16,000	23,000
Dispositions and losses	<u>(17,400)</u>	<u>(26,400)</u>
Cost of properties, end of year	3,300	4,700
Allowance for losses and cost to sell	<u>(1,800)</u>	<u>(1,700)</u>
Properties held for sale, net	<u>\$ 1,500</u>	<u>\$ 3,000</u>

NOTE E--ADVANCES AGAINST DEFAULTED MORTGAGE-BACKED SECURITY POOLS

Under its MBS guaranty, Ginnie Mae advanced \$127.6 million in 1998 and \$93.0 million in 1997 against defaulted mortgage-backed security pools to ensure timely pass-through payments. Recoveries of advances, either from late payment remittances or through FHA insurance or VA guaranty proceeds, were \$97.8 million in 1998 and \$84.4 million in 1997. Advances of \$3.8 million were written off in 1998; there were \$2.9 million of write-offs in 1997.

Unrecovered advances outstanding against defaulted mortgage-backed security pools, net of allowance for doubtful recoveries, were as follows:

<i>Dollars in thousands</i>	September 30,	
	1998	1997
Advances against defaulted pools	\$ 350,500	\$ 324,500
Allowance for losses	<u>(321,100)</u>	<u>(295,400)</u>
Advances against defaulted pools, net	<u>\$ 29,400</u>	<u>\$ 29,100</u>

NOTE F--RESERVE FOR LOSS ON MBS PROGRAM

Ginnie Mae establishes a reserve for losses through a provision charged to operations when, in management's judgment, defaults of issuers of mortgage-backed securities become probable. The reserve for losses is based on an analysis of the MBS portfolio outstanding. In estimating losses, management utilizes a statistically based model that evaluates numerous factors, including, but not limited to, general and regional economic conditions, mortgage characteristics, and actual and expected future default and loan loss experience. Management also considers uncertainties related to estimations in the reserve setting process. The reserve is relieved as losses are realized from the disposal of the defaulted issuers' portfolios. Ginnie Mae recovers part of its losses through servicing fees on the

performing portion of the portfolios and the sale of servicing rights which inure to Ginnie Mae upon the default of the issuer. Ginnie Mae management believes that its reserve is adequate to cover probable losses from defaults by issuers of Ginnie Mae guaranteed mortgage-backed securities. Changes in the reserve were as follows:

<i>Dollars in thousands</i>	Single-Family	Multifamily	Manufactured Housing	Total
September 30, 1996	\$ 150,000	\$ 56,700	\$ 265,000	\$ 471,700
Recoveries	13,100	11,100	18,500	42,700
Realized losses	(23,900)	(900)	(28,700)	(53,500)
Provision	<u>57,000</u>	<u>(10,200)</u>	<u>-</u>	<u>46,800</u>
September 30, 1997	<u>\$ 196,200</u>	<u>\$ 56,700</u>	<u>\$ 254,800</u>	<u>\$ 507,700</u>
September 30, 1997	\$ 196,200	\$ 56,700	\$ 254,800	\$ 507,700
Recoveries	6,000	700	10,200	16,900
Realized Losses	(35,100)	(600)	(24,800)	(60,500)
Provision	<u>32,500</u>	<u>-</u>	<u>14,600</u>	<u>47,100</u>
September 30, 1998	<u>\$ 199,600</u>	<u>\$ 56,800</u>	<u>\$ 254,800</u>	<u>\$ 511,200</u>

Ginnie Mae incurs loss when insurance and guarantees do not cover expenses that result from issuer defaults. Such expenses include (1) unrecoverable losses on individual mortgage defaults because of coverage limitations on mortgage insurance or guarantees, (2) ineligible mortgages included in defaulted Ginnie Mae pools, (3) improper use of proceeds by an issuer, and (4) non-reimbursable administrative expenses and costs incurred to service and liquidate portfolios of defaulted issuers.

The reserve for losses is relieved as estimated losses are realized. To the extent realized losses differ from those previously estimated, Ginnie Mae may elect to increase or decrease its reserve depending on its assessment of risks and losses associated with probable issuer defaults. For fiscal year 1998 Ginnie Mae increased its provision for losses for its single-family portfolio to reflect increased risk with respect to recovery of certain losses and expenses associated with issuer defaults.

At September 30, 1998, the balances of Ginnie Mae managed portfolios were \$478.1 million in single-family, \$0 in multifamily, and \$149 million in manufactured housing, and in fiscal year 1997, \$606.7 million in single-family, \$0 in multifamily and \$220.3 million in manufactured housing. As Ginnie Mae's defaulted issuer portfolio decreases, original estimates are compared with actual results over time and the adequacy of the reserve is assessed and if necessary, the reserve is adjusted.

NOTE G--FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

Ginnie Mae is subject to credit risk for financial instruments not reflected in its balance sheet in the normal course of operations. These financial instruments include guarantees of mortgage-backed securities and commitments to guaranty mortgage-backed securities. The Ginnie Mae guaranteed security is a pass through security whereby mortgage principal and interest payments, except for servicing and guaranty fees, are passed through to the security holders monthly. Mortgage prepayments are also passed through to security holders. As a result of the structure of the security, Ginnie Mae bears no interest rate or liquidity risk. Ginnie Mae's exposure to credit loss is

contingent on the event of non-performance by other parties to the financial instruments. Other than those issuers considered in the reserve for loss on the MBS program (see Note F), Ginnie Mae does not anticipate non-performance by the counterparties.

Ginnie Mae guarantees the timely payment of principal and interest to mortgage-backed security holders should the issuers fail to do so. The securities are backed by pools of insured or guaranteed FHA, RHS, or VA mortgage loans. On September 30, 1998 the amount of securities outstanding which are guaranteed by Ginnie Mae was \$542.2 billion; however, Ginnie Mae's potential loss is considerably less because the underlying mortgages serve as primary collateral and the FHA, RHS, and VA insurance or guaranty indemnify Ginnie Mae for most losses.

During the mortgage closing period and prior to granting its guaranty, Ginnie Mae enters into commitments to guaranty mortgage-backed securities. The commitment ends when the securities are issued or the commitment period expires. Ginnie Mae's risk related to outstanding commitments is much less than for outstanding securities due, in part, to Ginnie Mae's ability to limit commitment authority granted to individual issuers of mortgage-backed securities.

Outstanding MBS securities and commitments were as follows:

<i>Dollars in billions</i>	September 30,	
	1998	1997
Outstanding MBS securities	\$ 542.2	\$ 530.6
Outstanding MBS commitments	\$ 22.2	\$ 31.0

NOTE H--CONCENTRATIONS OF CREDIT RISK

Concentrations of credit risk exist when a significant number of counterparties (e.g., issuers and borrowers) engage in similar activities or are susceptible to similar changes in economic conditions that could affect their ability to meet contractual obligations. Generally, Ginnie Mae's MBS pools are diversified among issuers and geographic areas. No significant geographic concentrations of credit risk exist; however, to a limited extent, securities are concentrated among issuers as noted below as of September 30, 1998:

<i>Dollars in billions</i>	Single-Family		Multifamily		Manufactured	
	Number of Issuers	Remaining Principal Balance	Number of Issuers	Remaining Principal Balance	Number of Issuers	Remaining Principal Balance
Largest performing issuers	15	\$ 344.3	10	\$ 10.2	1	\$ 0.7
Other performing issuers	287	181.7	116	4.4	5	0.2
Defaulted issuers	11	0.5	-	-	23	0.1

During fiscal year 1998, Ginnie Mae acquired one single-family issuer portfolio with a remaining principal balance of \$8.3 million and one manufactured housing issuer portfolio with a remaining principal balance \$328 thousand.

In fiscal year 1998, Ginnie Mae issued a total of \$36.9 billion in its multiclass securities program. The estimated outstanding balance at September 30, 1998 was \$83.4 billion. These guaranteed securities do not subject Ginnie Mae to additional credit risk beyond that assumed under the MBS program.

NOTE I--COMMITMENTS AND CONTINGENCIES

As of September 30, 1998, Ginnie Mae was named in several legal actions, virtually all of which involved claims under the guaranty program. It is not possible to predict the eventual outcome of the various actions; however, in the opinion of management and counsel the resolution of these claims will not result in adverse judgments to such an extent they would materially affect the financial position or results of operations of Ginnie Mae.

NOTE J--RELATED PARTIES

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

HUD provides Ginnie Mae, without charge, use of office space and equipment. Ginnie Mae reimbursed HUD \$9.3 million in 1998 and \$9.3 million in 1997 for administrative expenses allocated to Ginnie Mae including payroll and payroll related costs.

Payroll related costs for which Ginnie Mae reimbursed HUD included matching contributions to the Civil Service Retirement System (CSRS) and the Federal Employees Retirement System (FERS). Although Ginnie Mae funds a portion of pension benefits under these programs, it has no liability for future payments to employees under these programs and does not account for the assets of CSRS or FERS nor does it have actuarial data with respect to accumulated plan benefits or the unfunded pension liability relative to its employees. These amounts are reported by the Office of Personnel Management (OPM) and are allocated to HUD. OPM also accounts for the health and life insurance programs for Federal employees and retirees and funds the non-employee portion of the costs of such program.

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

NOTE K--FAIR VALUE OF FINANCIAL INSTRUMENTS

The following table shows the fair value of financial instruments to which Ginnie Mae has a contractual obligation to deliver or a contractual right to receive cash from another entity as of September 30, 1998 and 1997:

<i>Dollars in thousands</i>	Fair Value	
	1998	1997
U.S. Government Securities	\$ 5,832,900	\$ 5,445,500
Funds in U.S. Treasury	778,700	155,800
Advances against MBS Pools	29,400	29,100
Other Assets	108,500	113,000
Unrecognized Financial Instruments	1,007,481	1,132,300
Other Liabilities	45,900	40,600

The fair value of Ginnie Mae's largest asset, U.S. Government Securities, is estimated based on quoted market prices for securities of similar maturity. The fair values of Funds in U.S. Treasury, Advances against MBS Pools, Other Assets and Other Liabilities are not materially different from their carrying values.

Unrecognized financial instruments comprise the net fair value of the fee Ginnie Mae receives for the guaranty of timely payment of principal and interest. The value was derived by discounting the estimated future net cash flows relating to Ginnie Mae guaranteed mortgage-backed securities outstanding. The assumptions and estimates used in calculating the fair value of unrecognized financial instruments are based on management's evaluation of economic conditions and, therefore, are not subject to precise quantification. These discounted cash flows consist of estimated future guaranty fees, taking into account estimated prepayments, in excess of 1) projected losses relating to the MBS program, including projected losses on defaulted pools of mortgage-backed securities, and 2) projected administrative expenses. The discount rate approximates an interest rate for risk-free instruments of a tenor and duration similar to the Ginnie Mae guaranty. The fair value of Ginnie Mae's guaranty recognizes the present value of future fees which are not recognized under generally accepted accounting principles since to do so would record revenue prior to realization. The decrease in the fair value of unrecognized financial instruments from 1997 to 1998 is primarily attributable to the impact of interest rate volatility.

Ginnie Mae's standing as a Federal government corporation whose guaranty carries the full faith and credit of the U.S. Government makes it difficult to determine what the fair value of its financial instruments would be in the private market. Accordingly, the amount Ginnie Mae would realize upon sale of its financial instruments could differ, perhaps materially, from the amounts shown above.

NOTE L--CREDIT REFORM

The primary purpose of the Federal Credit Reform Act of 1990, which became effective on October 1, 1991, is to more accurately measure the cost of Federal credit programs and to place the cost of such credit programs on a basis equivalent with other Federal spending. Credit Reform focuses on those credit programs that operate at a loss by providing for appropriated funding, within budgetary limitations, to subsidize the loss element of the credit program. Negative subsidies, calculated for credit programs operating at a profit, normally result in the return of funds to Treasury. OMB specifies the methodology an agency is to follow in accounting for the cash flows of its credit programs.

Ginnie Mae's credit activities have historically operated at a profit. Ginnie Mae has not incurred borrowings or received appropriations to finance its credit operations, nor does it anticipate the need to receive such funding. As of September 30, 1998, Ginnie Mae had an investment in U.S. Government of \$5.8 billion after establishing reserves for potential losses on its credit activities. Pursuant to the statutory provisions under which Ginnie Mae operates, its net earnings are used to build sound reserves. In the opinion of management, Ginnie Mae is in compliance with OMB implementation requirements for the Federal Credit Reform Act, as applicable to government corporations.

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