Issue Date
January 26, 2007

Audit Report Number
2007-KC-0001

TO: Lily A. Lee, Acting Deputy Assistant Secretary for Single Family Housing, HU

//signed//
FROM: Ronald J. Hosking, Regional Inspector General for Audit, 7AGA

SUBJECT: HUD Adequately Addressed the Increased Risk Associated with 20-year Loans Approved by Automated Underwriting Systems

HIGHLIGHTS

What We Audited and Why

We conducted a review of the U.S. Department of Housing and Urban Development's (HUD) oversight of 20-year insured loans. Our objective was to determine if HUD has adequately addressed the increased risk associated with 20-year loans approved by an automated underwriting system. We initiated this review based on the high default rate of these loans.

What We Found

HUD has adequately addressed the increased risk associated with 20-year automated loans. In December 2004, HUD changed the way it processes these loans. Since this change, the default rate decreased dramatically to less than 3 percent for loans closed in fiscal year 2006.

What We Recommend

Based on the results of our review, we do not recommend corrective action.

Auditee's Response

We provided the draft audit report to HUD on January 11, 2007, and received its written response on January 24, 2007. HUD agreed with our report.

The complete text of HUD's response can be found in appendix A of this report.

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BACKGROUND AND OBJECTIVES

HUD first acknowledged automated underwriting systems and artificial intelligence as a means of approving HUD-insured mortgages in 1995. Over the next several years, HUD approved the use of several privately developed systems, each employing its own mortgage scorecard. Automated loans represent a large portion of HUD-insured mortgages today, with more than 1.7 million loans closed in the last five fiscal years.

Our region initiated this review of 20-year loans approved by automated underwriting systems based on their high default rate. More than 37 percent of 25,001 20-year automated loans closed in the last five fiscal years have defaulted, 2,546 of which resulted in claims against the insurance fund. While 20-year automated loan approvals and defaults began significantly declining for loans closed in fiscal year 2005, our objective was to determine if HUD has adequately addressed the increased risk associated with 20-year loans approved by an automated underwriting system.

RESULTS OF AUDIT

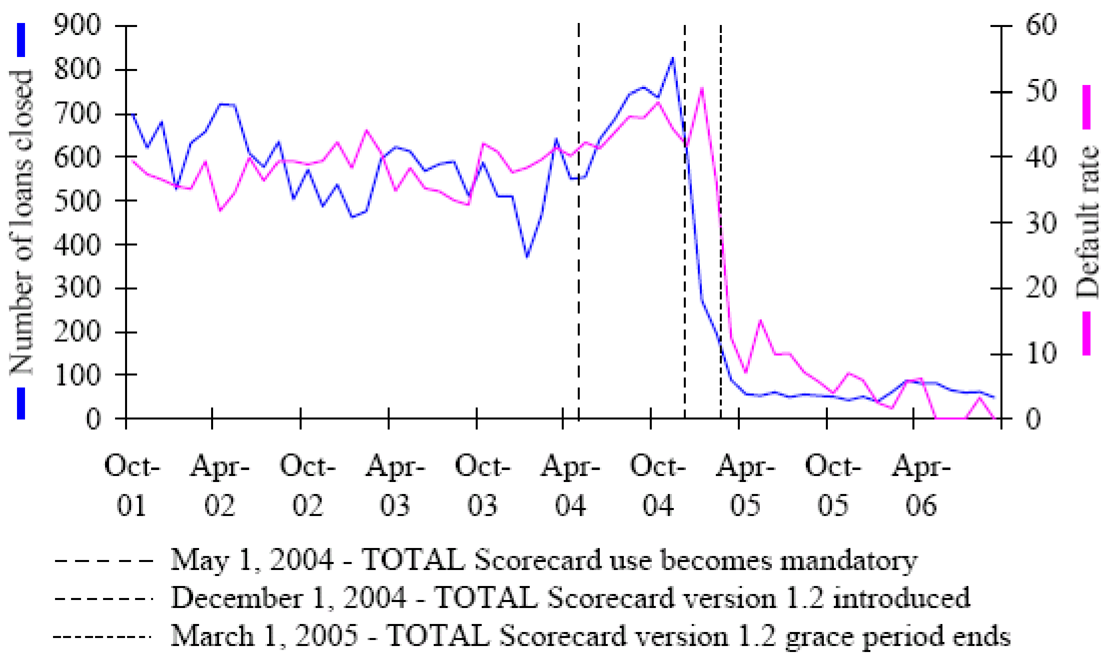
HUD has adequately addressed the increased risk associated with 20-year automated loans.

In 2000, HUD announced its intention to deploy TOTAL Scorecard, a mathematical equation developed to assess the credit worthiness of borrowers. Developed by HUD, TOTAL Scorecard would replace the proprietary mortgage scorecards then used by automated underwriting systems. One reason for developing TOTAL Scorecard was to enhance HUD's ability to assess and manage risk and preserve the soundness of its mortgage insurance fund.

While the default rate for 20-year automated loan closings remained high when HUD first required use of TOTAL Scorecard in 2004, HUD quickly addressed the issue with version 1.2, which was introduced seven months later. This version processes loans with 20-year terms as though they have 30-year terms.

Our analysis of default records from HUD's Single Family Data Warehouse confirms the effectiveness of the change implemented with version 1.2 of TOTAL Scorecard. The number of 20-year automated approval loan closings began rapidly declining in December 2004. The corresponding default rate for these loans began sharply declining at the end of the 90-day final scoring grace period.

Analysis of 20-year automated loans closed Oct-01 through Sep-06



As of November 10, 2006, less than 3 percent of the 20-year automated loans closed in fiscal year 2006 had defaulted. This confirms that HUD has adequately addressed the increased risk associated with 20-year automated loans.

SCOPE AND METHODOLOGY

The original review period covered October 2004 through September 2006. We later revised the review period to include a default analysis of loans closed from October 2001 through September 2006. We performed our review from the St. Louis location of HUD's Office of Inspector General during November and December 2006.

To accomplish the objective, we reviewed applicable laws, regulations, and other requirements. We interviewed and obtained information from key headquarters staff of HUD's Office of Single Family Housing, including internal emails and related documentation.

We relied upon data from HUD's Single Family Data Warehouse to corroborate the documentation provided. We used the data to perform a default analysis of 20-year automated loans. Based on a preliminary assessment of the system, we believe the data is sufficiently reliable to meet our review objective.

We performed our review in accordance with generally accepted government auditing standards.

Appendix A

AUDITEE COMMENTS

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

OFFICE OF HOUSING

JAN 22 2007

MEMORANDUM FOR: Ronald J. Hosking, Regional Inspector General for Audit, 7AGA

FROM: Lily A. Lee, Acting Deputy Assistant Secretary for Single Family Housing, HU

SUBJECT: Review of HUD's Efforts to Address Increased Risk Associated with 20-Year Loans Approved by Automated Underwriting Systems

Thank you for the opportunity to respond to the audit report conducted by your office regarding 20-year mortgages approved by automated underwriting systems. I appreciate both the professionalism of your staff as well as your recommendation of no corrective action.

What your audit revealed is exactly how Assistant Secretary for Housing-Federal Housing Commissioner Brian Montgomery expects my office to operate, i.e., once a possible risk to the FHA insurance program is revealed, resources are devoted to study the issue and, if the results indicate a problem, corrective action is taken. This is what transpired on the 20-year loans that were the subject of your audit. As you know, just eight months after the TOTAL Mortgage Scorecard became mandatory, FHA discovered, investigated, and corrected the anomaly that was increasing FHA's insurance risk on these types of insured mortgages.

Should you or your staff have need for any further information, please contact Jim Beavers, Deputy Director, Office of Single Family Program Development, at 202-402-2205.

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