AUDIT REPORT

SINGLE FAMILY PRODUCTION
HOME OWNERSHIP CENTERS

ATLANTA, GEORGIA
DENVER, COLORADO
SANTA ANA, CALIFORNIA

00-SF-121-0001

MARCH 30, 2000

OFFICE OF AUDIT, PACIFIC/HAWAII
SAN FRANCISCO, CALIFORNIA

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audit report
OFFICE OF INSPECTOR GENERAL

Issue Date
March 30, 2000
Audit Case Number
00-SF-121-0001

TO: William Apgar, Assistant Secretary for Housing, Federal Housing Commissioner, H

Roger E. Niesen

FROM: Roger E. Niesen, Acting District Inspector General for Audit, 9AGA

SUBJECT: Single Family Production
Home Ownership Centers
Atlanta, GA, Denver, CO, and Santa Ana, CA

We have completed an audit of the single family loan production activities of HUD's home ownership centers. The audit was undertaken because of significant changes in the past few years affecting single family loan origination activities. The changes included: (1) loan underwriting requirements, (2) the establishment of Home Ownership Centers, and (3) the transfer of virtually all aspects of single family production and program monitoring from HUD staff to lenders and contractors under the oversight of the Home Ownership Centers. This report contains five findings with recommendations for improving single family operations.

Within 60 days, please furnish us, for each recommendation in this report, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Also, please furnish us copies of any correspondence or directives issued because of the audit.

If you have any questions, please contact David McCargar, Assistant District Inspector General for Audit, or myself at (415) 436-8101.

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Executive Summary

Procedures and practices pertaining to HUD's single family loan origination program have undergone considerable change in the last decade and particularly in the last five years. The changes have been both programmatic and organizational, including significant changes in loan underwriting requirements and the transfer of virtually all aspects of single family production and program monitoring from HUD staff to lenders and contractors under the oversight of HUD's home ownership centers. We performed an audit of HUD's single family loan origination program to determine how these changes have affected the program's susceptibility to waste, fraud and abuse. More specifically, we wanted to determine whether HUD's management controls are adequate and are being properly utilized to limit risk in the single family origination process.

The audit disclosed significant problems in the post technical reviews of lender loan underwriting and property appraisals, monitoring of lenders by the home ownership centers Quality Assurance Divisions, oversight of pre-endorsement contractors, and accuracy of information in the automated tracking system. These weaknesses increase HUD's risk of losses.

Improvements are needed to HUD's current procedures

HUD appears to have recognized some of the risks associated with the outsourcing and changes in underwriting requirements and has implemented, or plans to implement, new systems and procedures intended to manage these risks. Our audit did not include detailed coverage of all these systems and procedures but did disclose that HUD's current procedures for monitoring both lenders and contractors have been less than effective, resulting in an increased risk of fraud, waste and abuse for the single family loan origination program.

FHA loan delinquency and foreclosure rates have risen dramatically

Our concern is borne out by Mortgage Bankers Association data[1] which shows an increase of over 50 percent in Federal Housing Administration loan foreclosure rates over the last five years from 1.45 percent in 1994 to 2.20 percent through three quarters of 1999. Similarly, Mortgage Banker Association data shows an increase of over 18 percent in Federal Housing Administration delinquency rates (from 7.26% to 8.57%) during the same period.

In our opinion, these disconcerting trends in Federal Housing Administration foreclosure and delinquency rates are attributable to inadequate management controls to mitigate the

[1] Mortgage Bankers Association National Delinquency Survey historical data through the 3rd quarter of 1999.

increased risk resulting from the 2020 Management Reform - specifically, the outsourcing of virtually all aspects of the single family loan origination process under substantially liberalized underwriting standards.[2] Unless corrected, these control weaknesses could seriously affect the continued health of the single family insurance program, especially if or when the economy takes a downturn.

Post-endorsement technical reviews need improvement

One means by which HUD monitors the quality of the direct endorsement lender loan underwriting and property appraisal procedure is the post-endorsement technical review process. This involves reviewing a sample of cases (after insurance endorsement) to ensure compliance with HUD underwriting and appraisal requirements. We found substantial problems with HUD's controls over the quality of both the underwriting (Finding 1) and appraisal (Finding 3) procedures of direct endorsement lenders. We found that in 70, (46 percent), of the 151 cases we reviewed, substantial underwriting errors were not detected by the post-endorsement technical review process and 32 cases (21 percent) with significant fraud indicators were not identified. Additionally, even when significant problems were noted during the technical review process, little, if any, corrective action was taken.

Quality Assurance Division monitoring had limited effectiveness

HUD's Quality Assurance Divisions perform on-site monitoring reviews of direct endorsement lenders to identify and correct poor origination practices. We found that the on-site mortgagee monitoring reviews were unduly influenced by the Business Operating Plan numeric goals, thereby limiting their effectiveness for managing risks to the single family insurance fund (Finding 2). Often, the reviews were actually targeted to low risk lenders to facilitate accomplishment of the Business Operating Plan goals. As a result, many of the worst performing (highest risk) lenders were not reviewed. Other factors limiting the effectiveness of Quality Assurance Division monitoring reviews included staff qualification or experience shortfalls related to the 2020 reorganization, travel funding limitations, and insufficient communications between Home Ownership Center divisions.

[2] We do not believe the foreclosure/delinquency rate increases for Federal Housing Administration loans could likely be related to external factors during a period of a healthy expanding economy when conventional foreclosure/delinquency rates have remained relatively constant or have declined.

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Oversight of pre-endorsement contractors needs improvement

Contractors working for HUD are required to ensure that Federal Housing Administration loan file documents are both accurate and complete prior to issuing Mortgage Insurance Certificates to the originating lenders. We found that HUD has not provided adequate direction and oversight of endorsement contractors (Finding 4), resulting in an increased risk that unacceptable loans have been and will be insured.

HUD did not place poorly performing lenders on pre-closing status

When new lenders apply for direct endorsement approval, they are initially placed on "pre-closing" status and their loan packages are reviewed by HUD prior to loan closing so that HUD can determine whether the lenders have the capacity to properly originate and underwrite loans in accordance with Federal Housing Administration guidelines. Although we did not review this management control in detail during this audit, we did identify weaknesses in the control. We found that HUD has not taken advantage of its authority to place poorly performing direct endorsement lenders as identified from post-endorsement technical reviews back on pre-closing status.

HUD's tracking system for QAD reviews was inaccurate

The Approval/Re-certification/Review Tracking System (ARRTS) database used to track the status and results of Quality Assurance Division reviews contained significant errors and therefore did not provide sufficient accountability for audit and staff evaluation purposes as intended by the Quality Assurance Division Guide. We attributed this deficiency to a lack of uniform procedures and controls. ARRTS contained a significant number of errors at the Atlanta and Santa Ana Home Ownership Centers relating to the reported number of indemnification agreements, number of loans reviewed, and letters sent to lenders. As a result of these inaccuracies, clear and accurate data was not available to monitor the scope and results of reviews and their effectiveness may have been overstated.

We believe the deficiencies discussed in Findings 1, 2, and 3 of this report constitute material control weaknesses under the Federal Managers' Financial Integrity Act. As such, these weaknesses should be disclosed in the Department's annual assurance statement to the President and Congress. The weaknesses should be reported in the Federal Management Integrity Act process until they have been corrected.

We provided the draft audit report to the Office of Housing on February 9, 2000. We requested written comments be provided by March 13, 2000 and we extended that date to March 20. We also scheduled an exit conference to discuss the draft report. The Office of Housing did not provide any written comments to the draft report and canceled the scheduled exit conference two times. As a result of this scope limitation, this report does not reflect their comments (see Appendix A).

Recommendations

We have made recommendations to improve the targeting, monitoring and use of post-endorsement technical reviews and field reviews of appraisals; to update and clarify handbook instructions relative to post-endorsement technical reviews; and to include results based, as well as, numeric objectives in Business Operating Plan goals. Our recommendations relative to Quality Assurance Division monitoring reviews parallel those pertaining to post-endorsement technical reviews. We have also made recommendations to improve HUD's monitoring of direct endorsement contractors and to ensure the accuracy of information in the Approval/Re-certification/Review Tracking System (ARRTS).

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Introduction

The National Housing Act, as amended, established the Federal Housing Administration, an organizational unit within the Department of Housing and Urban Development (HUD). The Federal Housing Administration provides insurance for private mortgagees against loss on home mortgages. The basic home mortgage insurance program is authorized under Title II, section 203 (b) of the National Housing Act and is primarily governed by regulations contained in 24 CFR parts 202 and 203.

The Direct Endorsement Program began in 1983

Prior to 1983, HUD staff reviewed and approved (underwrote) most loans prior to insurance endorsement. In 1983, HUD implemented the Direct Endorsement program whereby lenders became responsible for virtually all aspects of the loan origination, underwriting and closing process. In order to limit the risks inherent in transferring so much responsibility to lenders (who have a significant financial interest in loan approval), HUD implemented new procedures to monitor the direct endorsement lenders primarily through pre-endorsement loan screening, post-endorsement technical review, and on-site lender monitoring. In our initial audit report on the Direct Endorsement program (Report No. 93-HQ-121-0012) dated April 30, 1993, we cited significant weaknesses in the post-endorsement review process and in the use of available sanctions to protect HUD from participants who abused the program.

1993 reinvention efforts included the establishment of home ownership centers

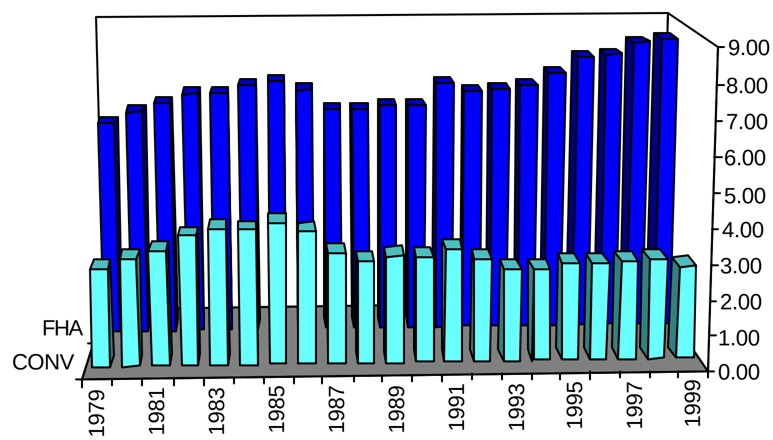
In February 1993, HUD initiated a reinvention effort that included significant staff reductions and the consolidation of mortgage insurance processing and other activities from 81 Field Offices into four Home Ownership Centers. HUD has continued the reinvention effort and made additional significant changes in the management of the single family insurance program in recent years under the auspices of the 2020 Management Reform Plan. The transfer of single family functions from field offices to the Home Ownership Centers has been a complicated and arduous process. Some procedural changes to accommodate the organizational restructuring occurred or were planned during our review.

In the interim, in 1995, HUD issued Mortgagee Letter 95-7 that significantly liberalized the direct endorsement lender underwriting requirements. According to HUD, the changes were made to "....enhance the homebuying opportunities for a substantial number of American families."

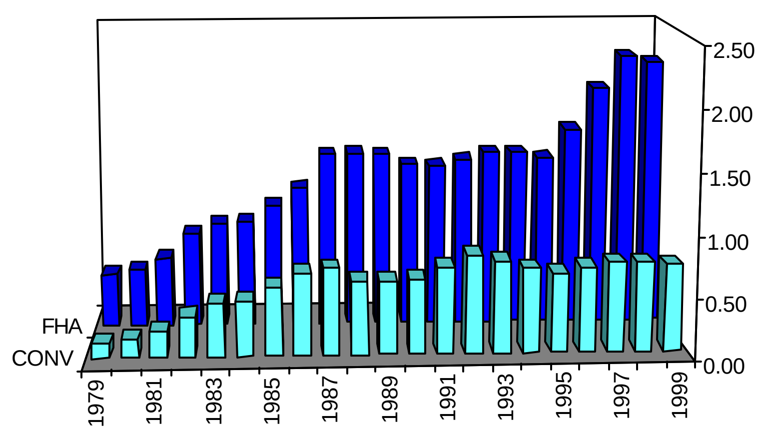
FHA delinquencies and foreclosures have increased significantly

Statistics we obtained from the Mortgage Bankers Association[3] show that the implementation period of the above described initiatives and changes in HUD's single family insurance program have been accompanied by an increase in Federal Housing Administration mortgage loan delinquency and foreclosure rates. As the following charts demonstrate, Federal Housing Administration loan delinquency and foreclosure rates have been increasing for years and have risen significantly in the last five years. The rise of the delinquency/foreclosure rates in recent years seems counterintuitive during a period of a healthy expanding economy when conventional loan delinquency/-foreclosure rates have remained constant or have decreased.

Percent of Loans Delinquent



Percent of Loans In Foreclosure



[3] Mortgage Bankers Association National Delinquency Survey historical data through the 3rd quarter of 1999.

Audit Objectives

Our overall audit objective was to determine how programmatic and organizational changes have affected the single family origination program's susceptibility to waste, fraud and abuse. More specifically, we attempted to determine whether HUD's management controls are adequate and are being properly used to limit risk in the single family origination process.

Scope and Methodology

To accomplish these objectives, we:

- Identified recent program and organizational changes.
- Obtained information on the status of the single family insurance program in terms of default/claim patterns and trends.
- Identified and evaluated the systems and procedures available to HUD for identifying and managing risks to the single family loan origination process.
- Identified and evaluated systems and procedures actually in use at three of the four Home Ownership Centers for managing these risks. In that regard, we made site visits to the Home Ownership Centers in Denver, Atlanta and Santa Ana. Although we did not visit the center in Philadelphia, we included cases processed by Philadelphia in our review of defaulted loans.
- Reviewed 151 case files in order to evaluate the effectiveness of post-endorsement technical reviews. Eighty five of the cases (default cases) were selected on the basis of (1) having undergone post-endorsement technical review, (2) having experienced a default within 12 months after endorsement, and (3) having few or no violation codes reported for the post-endorsement review. Default cases were also selected in numbers so as to provide equitable coverage of each of the four Home Ownership Centers. The remaining 66 cases were selected and reviewed while on-site at each of the three centers we visited. These were non-statistical random selections from recent return shipments from post-endorsement technical review contractors.

Some of HUD's recent, ongoing or planned single family initiatives were not covered or received limited coverage during this review. These included the Credit Watch Program, the Mortgage Credit Scorecard Project, automated underwriting, and the transfer of appraisal review responsibility from the Home Ownership Centers to the Real Estate Assessment Center as part of the Secretary's Homebuyer Protection Plan. We did not review these because they were not fully implemented and we had limited information concerning them.

We performed our on-site survey and audit work at HUD Headquarters and the Home Ownership Centers between March and November 1999. We conducted the audit in accordance with generally accepted governmental auditing standards, except that the report does not reflect the views of the Office of Housing concerning the report's findings, conclusion, and recommendations. We provided the draft audit report to the Office of Housing on February 9, 2000. We requested written comments by March 13, 2000 and extended that date to March 20. We also scheduled an exit conference to discuss the draft report. The Office of Housing did not provide any written comments to the draft report and canceled the scheduled exit conference two times. As a result, this report does not reflect their comments (see Appendix A, Scope Limitation).

Controls Over Lender Loan Processing Were Inadequate to Protect HUD's Interests

Quality controls over lender loan processing were not adequate to protect HUD's interest on loans processed and closed by direct endorsement approved lenders and their loan correspondents. As a result, HUD had no assurance that loans processed and approved by lenders met HUD requirements and apparent fraudulent loan transactions were not identified and resolved. Accordingly, the default and claim risk on Federal Housing Administration insured loans was unnecessarily increased. In this regard, since 1995, during a period of a healthy economy, the default and foreclosure rates on Federal Housing Administration insured loans have been steadily increasing (see page 2). There are numerous areas which need enhancement if HUD is to improve its controls over lender and appraiser activities through the post-endorsement technical review process. These include:

- **Better targeting of loans subject to post-endorsement technical reviews**. Current targeting does not consistently target high risk lenders or high risk loans, is ineffective, and does not take advantage of new technology. Instead, emphasis has been on meeting quantitative review goals.

- **Improved performance of contractors who perform the majority of HUD's post-endorsement technical reviews.** Contractors' reviews were inconsistent in identifying significant lender underwriting errors and potentially fraudulent transactions. During our review we re-examined 151 files which had undergone post-endorsement reviews and found that in 70 instances the reviewers had failed to identify material underwriting errors. Additionally, in 32 instances significant fraud indicators in the files were not recognized. HUD's monitoring does not ensure that contractors conduct their technical reviews in accordance with contractual requirements. HUD primarily only monitors contractor reviews which resulted in poor ratings rather than monitoring a representative sampling of the contractors' total work product.

- **Using the results of the post-endorsement technical reviews to take immediate and appropriate action against lenders and others who violate HUD requirements.** We found that very little action was taken when technical reviews indicated there were problems in the loan origination or appraisal process.

- **Targeting remedial actions/sanctions as may be warranted based upon the results of post-endorsement technical reviews to both sponsor lenders and loan correspondents.** Currently, remedial actions are targeted to only the sponsor lender who underwrote the loan and do not reflect back on the loan correspondent who may have performed the loan processing. Although the sponsor lender is responsible for final underwriting, problems with loan processing or fraud often can result from actions the loan correspondent took or failed to take and accordingly the loan correspondent should be held accountable for these actions.

- **Closer coordination with the Quality Assurance Division both in the targeting of post-endorsement technical reviews and acting on the results of the reviews**. Currently, there is very little coordination between the Processing and Underwriting and Technical Service Branches responsible for monitoring the Direct Endorsement loan origination process and the Quality Assurance Division, which has responsibility for conducting on-site monitoring reviews of lenders participating in the Federal Housing Administration insurance program.

The adequacy of post-endorsement technical reviews has been a long standing concern,[4] and with the implementation of the Home Ownership Center structure in 1997 and 1998, the previously reported inadequacies were exacerbated as the Home Ownership Centers attempted to implement their new structure and establish new operating procedures. During this implementation period, the post-endorsement review process, in many cases, simply became a paper process with no meaningful results. Causes for this included staffing problems resulting from HUD's restructuring that resulted in inexperienced staff being assigned to the various single family control positions and increased loan volume (FY 1999 endorsement volume was 63 percent higher than FY 1997 endorsement volume); failure to develop clear operating policies and procedures for the Home Ownership Centers' operations; emphasis on quantitative goals rather than quality; financial disincentives which affected the quality of post-endorsement technical reviews performed by contractors; and outdated handbooks which did not reflect current program requirements and operating procedures. The Home Ownership Centers are attempting to address many of these problems and, even during the course of our audit, some positive changes were noted in their operations. However, additional changes need to be made to make the post-endorsement review process more consistent and effective and to take advantage of modern technology.

How the post endorsement review process works

Under HUD's Direct Endorsement program, lenders who have received direct endorsement approval can select property appraisers and process, underwrite, and close Federal Housing Administration insured loans without prior HUD review and approval. In order to monitor the quality of direct endorsement lenders' loan processing and underwriting and the quality of the appraisals received, HUD has implemented a post-endorsement technical review process. Under this process, which is considered critical to the success of the Direct Endorsement

[4] See Office of Inspector General audit report number 93-HQ-121-0012, Audit of the Direct Endorsement Program, April 30, 1993 and Federal Housing Administration - Audit of Fiscal Year 1998 Federal Basis Financial Statements, audit report number 99-FO-131-0002, March 12, 1999.

Program, HUD selects 10 percent of the loans it endorses for post-endorsement technical review of the lenders' loan underwriting and the property appraisal. These technical reviews are to determine whether processing met HUD requirements and to allow HUD to take remedial action if problems are found (reference HUD Handbook 4000.4 REV-1 paragraph 4-9). The majority of these technical reviews are performed by contractors, and HUD staff are responsible for checking the adequacy of the contractors' work, monitoring the results of the work, and taking appropriate action when significant problems are noted.

Based on the results of these individual technical reviews, the underwriter and appraiser involved in the loan process are given a rating reflecting the quality of their work. The underwriter and appraiser are given a rating of good, fair, or poor. Poor means, that due to underwriting or appraisal deficiencies, HUD's risk is substantially increased for the rated loan. Additionally, appraisals are subject to field reviews to determine the soundness of the appraisal. Based on the results of the field reviews, the appraisers are given a numerical rating on their appraisal from 1 to 5 with scores of 1 and 2 representing significant problems. Underwriter and desk appraisal ratings are entered into HUD's Computerized Homes Underwriting Management System but are not communicated to the underwriter or the appraiser. Semiannually HUD provides lenders with summary reports of the technical review results. These summary reports are "information only" type reports which are not accompanied by any requirements for corrective action. HUD holds the lender, not its underwriter, accountable for the underwriting of the loans and the lender is expected to continually monitor its loan origination activities and to take action to improve its underwriting when it identifies problems and if the semiannual report indicates problems.

Additionally, HUD should be monitoring the results of these reviews in order to take immediate action when serious problems are identified. These actions could include, but are not limited to, providing guidance and training to lenders and underwriters when appropriate, requiring the lender to indemnify HUD for any improperly originated loans, placing the lender back on pre-closing review, and taking debarment or Limited Denial of Participation action against those who have intentionally violated HUD requirements. Appraisers who receive a rating of 1 or 2 as a result of the field appraisal review, are sent a copy of the review and asked to respond. If the appraiser receives a series of substantiated poor ratings, action can be taken to remove her/him from the roster of approved appraisers through Limited Denial of Participation action.

Loan selection for post-endorsement reviews can be improved

The selection process for post-endorsement technical reviews as currently implemented does not consistently target high risk lenders or high risk loans. Instead Home Ownership Centers primarily attempt to ensure that their post endorsement technical review goal of 10 percent of endorsements is met. The 10 percent review goal has translated to almost 130,000 technical reviews performed by HUD annually. However, because of poor targeting, HUD does not obtain the maximum potential benefit that it should receive from such a large quantity of reviews. This level of review effort should, but has not served to, provide HUD with an effective enforcement and quality control tool to protect HUD and borrowers who obtain Federal Housing Administration insured loans.

HUD's primary method of targeting loans for technical reviews is through its Computerized Homes Underwriting Management System. This system can be set-up to flag, at the time of insurance endorsement, a fixed percentage of a lender's loans for post-endorsement technical underwriting review. These review percentages can range from zero to 100 percent. In accordance with paragraph 4-9 of HUD Handbook 4000.4 REV-1 CHG-2, Single Family Direct Endorsement Program, HUD is to generally select for review from 5 to 10 percent of a lender's endorsed loans if the lender's performance meets the norm for the area. The percentage is to be increased all the way up to 100 percent depending upon default and claim rates, review ratings of the lender's underwriter(s), complaints, etc. Additionally, the HUD office is to target high risk cases for review; such as high ratio loans, loans involving borrowers with limited credit history, 2-4 unit dwellings, Real Estate Owned sales, 203(k) loans, etc.

We found that the Home Ownership Centers were meeting their numeric technical review goals specified in the Business Operating Plan as 10 percent of endorsements. However, in doing so there was only limited targeting of high risk lenders and targeting of high risk loans was done only sporadically. Essentially, the centers simply allowed the Computerized Homes Underwriting Management System to select loans for them or selected loans for review on a block basis in order to meet review goals. As a result, many high volume lenders had no, or only very limited numbers, of their loans reviewed. Other lenders had reviews of up to 100 percent of the loans they originated, even though they were not identified as high risk lenders. The only individual loan targeting we identified was Loan Prospector and Section 203(k) loans at the Santa Ana and Atlanta centers, and manufactured home loans at the Denver center.

Home Ownership Center staff at all three Centers we visited informed us that their primary emphasis was to ensure that their center wide review goal of 10 percent was met. There were no goals for the targeting of loans or lenders for post-endorsement technical reviews and accordingly there was little emphasis on such targeting. Center staff stated that they sometimes target certain lenders for an increased percentage of post-technical reviews, but we did not find any consistent pattern to this. Additionally, we found no set procedures at the centers for periodically reviewing lenders' performance and determining whether any particular lender warranted a higher level of review. In fact, no one seemed to know why most lenders' review goals were set at the percentages they were. Often, these percentages were set by individual field offices prior to the Home Ownership Center implementation. No one knew why they were set or whether they were still appropriate. Apparently, once a review percentage was set, it was seldom changed. Staff indicated that because of their workload they have not had time to analyze the performance of the thousands of lenders under the centers' jurisdiction in order to adjust review percentages based on actual performance.

Additionally, it was noted that even the loans selected by the computerized system were often not reviewed. This was a result of various factors including a lack of contractors and contract funds which limited the number of reviews that could be accomplished during the first part of fiscal year 1999. In order to meet review goals for the year the Home Ownership Centers had to change loan selection procedures. For example, rather than reviewing loans selected by the Computerized Homes Underwriting Management System, one Housing Ownership Center simply selected every third loan endorsed until their review percentages were back to an acceptable level. Further, the computerized system selected loan reviews were overridden when review goals had been met.

When a new direct endorsement lender is granted unconditional approval, HUD instructions contained in HUD Handbook 4000.4 Rev-1, Single Family Direct Endorsement Program, state that "all of the lender's loans should be reviewed for the first six months or through the first 50 cases." We noted differing applications of these instructions at the Home Ownership Centers. At the Atlanta center one team placed new lenders on 100 percent post-endorsement technical review, but the other team normally placed new lenders on only 10 percent review. The Santa Ana center claimed to place all new lenders on 100 percent review as did Denver. However, we were unable to determine the accuracy of the claims as the centers did not maintain adequate historical records of their new lender approvals and their monitoring efforts. No one at the centers knew for sure who all the new lenders were; therefore, they did not consistently monitor their post-technical review results to determine whether the lenders were satisfactorily underwriting loans. The centers also could not determine which new lenders should have their review percentage increased, reduced or which were having problems and should be placed back on pre-closing review. During the course of our review, the centers recognized the importance of this review responsibility and began developing procedures to consistently monitor newly approved direct endorsement lenders.

The Denver and Santa Ana centers adopted additional procedures for determining which of the initially selected loans will actually be sent to the contractors for in depth technical reviews:

- In Denver, all initially selected loans undergo a cursory review to determine whether the loans will undergo a detailed technical review. These cursory reviews are performed by staff of the endorsement support contractor. Those loans which pass the cursory reviews are assigned a "good" review rating and the rating is entered in the Computerized Homes Underwriting

Management System. Those loans failing the cursory review process are sent to the technical review contractors for in depth reviews. To assist the endorsement support contractor staff in performing these reviews, Denver has developed a cursory review checklist based on default risk factors developed by the Denver Quality Assurance Division staff.

- The Santa Ana office also performed a limited number of cursory reviews of loans to determine whether they should undergo in depth technical reviews. However, this was usually only done when the office was behind in its review goals and needed to perform a significant number of reviews to bring up its review percentage. As with Denver, loans which passed the cursory reviews were entered in the computerized system as reviews with good ratings and those loans which did not pass the tests were sent out for in depth reviews. The Santa Ana center uses many different individuals to perform these technical reviews including program assistants, program support staff, technicians, and endorsement contract staff. The Santa Ana center's cursory review checklist used a combination of risk factors and common problem underwriting areas to determine whether the loan should undergo a detailed review.

Although cursory reviews can and should be used to limit the number of detailed reviews which need to be performed, in our opinion, these types of selection limiting factors could be built into HUD's database and applied to all endorsed loans at all the centers. This would lead to a more consistent, productive and focused loan selection. If automated selection procedures are not used, a consistent cursory review checklist should be developed for use by all of the centers. Further, we do not believe that personnel with little or no background in underwriting or valuation should be determining which loans should be selected for detailed reviews if the manual cursory review selection procedure is continued.

As discussed above, the current process for selecting direct endorsement loans for review, both the selection procedures set out in HUD Handbook 4000.4 and the Home Ownership Centers' unofficial procedures, do not serve to target high risk lenders or loans, and appears to be essentially an effort to simply ensure that review goals are met. In order to improve the selection process and make it more risk based, HUD should consider revising its current selection techniques as follows:

- Develop risk based characteristics, both default and underwriting, which can be input during the loan origination process for all loans and use these characteristics to target loans for review through the use of HUD's automated data system.

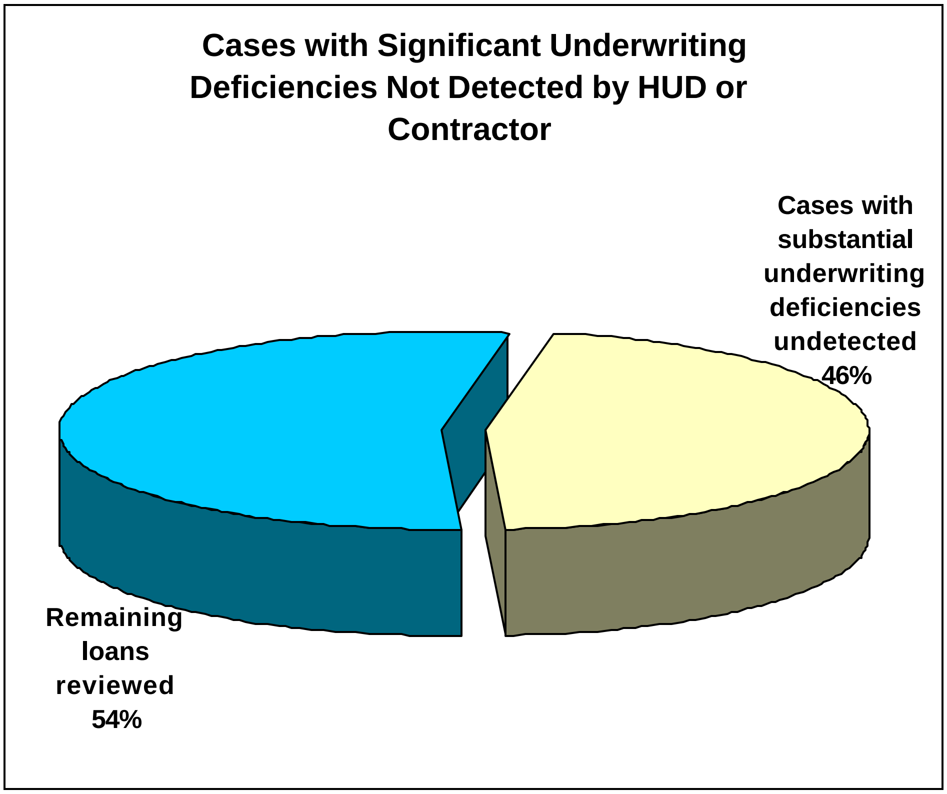
- Develop and implement specific procedures for periodic review of lenders default and claim rates, technical review results, and other available information and, based upon this information target lenders who show high risk tendencies in their loan origination.

Post endorsement reviews were inadequate

HUD's post-endorsement technical underwriting reviews were inadequate to identify significant underwriting errors and potentially fraudulent transactions. Consequently, the reviews did not serve to properly mitigate HUD's risk under the direct endorsement program.

Currently, the great majority of the post-endorsement reviews are performed by independent contractors. HUD is responsible for monitoring the quality of the contractors' work and acting on problems identified during the reviews. Additionally, a limited number of technical reviews are performed by HUD staff, often staff who remained at the local field offices when the Home Ownership Centers were established.

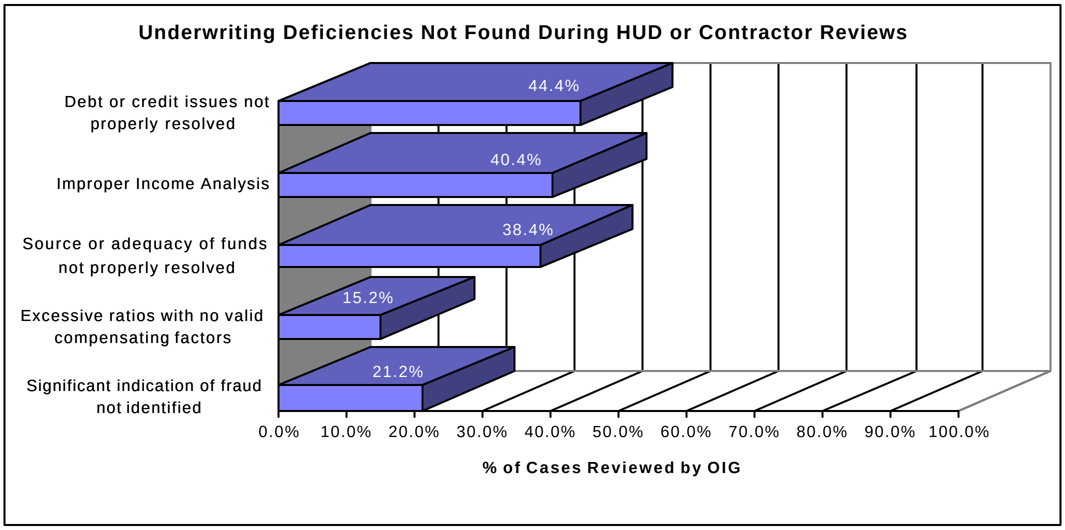
During our review we analyzed 151 endorsed loans which had undergone post-endorsement reviews and found significant problems with 70 loans (46 percent). The following chart illustrates the extent of the problems:



The deficiencies in these 70 cases had not been identified during the contractors' post-endorsement reviews. Types of unidentified problems were as follows:

Underwriting Deficiency	**Santa Ana**	**Denver**	**Atlanta**	**Phila-delphia**	**Total**
Significant indications of fraud not identified	15	6	7	4	32
Excessive ratios without adequate compensating factors	13	3	3	4	23
Source or adequacy of funds not properly resolved	25	18	9	6	58
Improper income analysis	19	18	14	10	61
Debt or credit issues not properly resolved	21	21	12	12	67

The following chart illustrates these underwriting deficiencies as a percentage of the 151 cases we reviewed.



Further detail on these deficiencies is contained in Appendices B and C. We believe adequate post-endorsement technical reviews would have detected these loan origination deficiencies.

The fact that there were problems with the post-technical reviews done by contractors is not surprising considering what HUD paid for the reviews. During the contract development for one of the post-endorsement technical review contracts, HUD estimated that an adequate post-endorsement technical review, based upon individual loan characteristics, should take from one to three hours. Senior underwriters at the centers estimated that adequate technical reviews should take from 45 minutes to three hours depending upon the complexity of the loan. Using an estimate of $35 per hour to perform a review ($25 per hour for an underwriter and an additional $10 per hour overhead) the cost per review should range from approximately $26 to $105. Yet contracts were let at the following prices per review:

- Denver HOC - 2 contracts - $15 each
- Atlanta HOC - 1 contract - $17.25
- Santa Ana - 2 contracts - $30 and $35

Based upon the above contract rates and underwriter hourly cost estimates it is estimated that the reviews would, in most instances, take no more than 15 to 30 minutes versus HUD's estimates of from 1 to 3 hours. One contractor estimated that it would take an average of 12 minutes to review the loan underwriting of an insured case. Because of this, contractors have a financial disincentive to expend more time on complicated or problem loans as the more time they spend the higher their costs without the benefit of additional compensation. Accordingly, one would expect that the reviews would primarily be superficial reviews to ensure that documents are in the file and not in depth reviews of the underwriting of the loans - essentially reviews of procedures rather than substance. Our reviews of cases which had undergone post-endorsement reviews supported this assumption. As discussed above, we found that 46 percent of the reviews we re-examined failed to identify significant underwriting errors.

During our reviews of these loans we identified 32 loans which represented potentially fraudulent transactions (page 13). None of the fraud indicators relating to these potentially fraudulent transactions had been identified during the post-endorsement technical reviews of the loans. This supports our contention that the post-endorsement technical reviews have become superficial and are not in sufficient depth to identify anything other than blatant underwriting or documentation errors. Further, one contractor informed us that identification of potentially fraudulent transactions is not required under its contract.

HUD's own reviews of contractors' work also indicated significant problems with the contractors' work product. For example, during the period November 1998 to October 1999 the Denver Home Ownership Center performed quality reviews of 1,979 cases which had undergone contractor technical reviews. In 70 percent of these cases one or more of the rating elements were changed after HUD's reviews. The Santa Ana center also stated that a significant portion of its contractors' ratings had to be changed. It did not maintain sufficient information to allow us to make a determination as to what overall percentage required changes. However, Santa Ana recently reviewed a complete weekly shipment of cases reviewed by its two post-endorsement review contractors (300 cases each) and based upon this review found incorrect review ratings for 46 percent of one contractor's reviews and 49 percent of the other contractor's reviews. In spite of these identified problems with the contractors' work product, no action was taken to ensure that the contractors improved their performance. There were various factors which resulted in the Home Ownership Centers' failure to initiate actions against poorly performing contractors. These included a lack of established procedures for acting on contract non-compliance, an unofficial acknowledgment that in depth reviews could not be done at the price HUD was paying for the reviews, and concerns that termination of the contracts would result in the centers having to do the reviews when centers had insufficient trained staff to do so.

HUD's greatest risk resulting from contractors performing its post-endorsement technical reviews is that the contractors will not identify significant lender processing and underwriting deficiencies. However, almost all of HUD's reviews of contractors' work was geared toward review of cases the contractors rated as poor rather than the contractors overall performance. The centers had different methods, which varied over time, of selecting post-endorsement reviewed loans for monitoring the quality of contractor reviews. The Atlanta and Denver centers primarily reviewed loans rated poor by contractors and marked as requiring additional HUD review because of the seriousness of problems noted or because of lender overcharges. Essentially the contractors determined which of their reviews would be subject to HUD monitoring. The Santa Ana center attempted to review all loans which received poor ratings during the post-endorsement technical reviews and a limited number of loans with good ratings. It recently changed its review procedures and now, in addition to its normal monitoring of contractor reviews, it plans on periodically reviewing complete shipments of its contractors' reviews, good, fair and poor.

Prior to recent changes, almost none of the contractors' reviews that resulted in good ratings were reviewed. Since good review ratings represent the majority of the contractors' work, failure to consistently monitor these reviews represents a serious control weakness and subjects HUD to an unreasonable risk. The effects of such risk can be demonstrated by a recent actual example of fraudulent conduct by a lender. The lender was involved in the fraudulent origination of over 400 Federal Housing Administration insured loans totaling $97 million dollars. Seventeen of these loans underwent post-endorsement technical reviews by a contractor who found no significant problems with the underwriting of the loans. Since all 17 loans received ratings of good from the contractor, none of the loans were selected by HUD for contractor monitoring and HUD did not identify the obvious problems in the loan files and the poor performance by the review contractor. An OIG review of the 17 loans identified obvious fraud indicators in the files and significant underwriting deficiencies[5].

Obvious fraud indicators in the files included:

- Simultaneous closings on the sellers' original purchase of the properties (sellers did not have title to the properties until closing of the Federal Housing Administration insured loan transactions) and the subsequent fraudulent sale to the borrowers obtaining Federal Housing Administration insured mortgages;
- High-income borrowers (the 17 borrowers had claimed incomes averaging $90,000 per year) who did not have bank accounts, savings, or credible financial history;
- Unusually large gift amounts that averaged $27,500 and were used to meet all downpayment and closing requirements;
- Claimed earnest money payments not credited to the borrowers at closing;
- Seller concessions that were greatly in excess of that set out in the purchase/sales agreements;
- Lack of realtor involvement in the sales combined with the quick resales of the properties; and
- Significant unidentified disbursements set out on the HUD-1 settlement statements.

Although these "red flag" indicators were obvious, the post-endorsement review contractor did not identify them, and a Field Office/Home Ownership Center policy of only monitoring

[5] This case occurred in 1997, prior to the implementation of the Santa Ana Home Ownership Center. However, policies and procedures in place at that time are still in place. Further, the contractor who performed the reviews is still one of the Santa Ana center's post-endorsement technical review contractors.

contractor reviews resulting in “poor” ratings allowed the fraudulent scheme to go undetected.

In addition to reviews by contractors, a limited number of post-endorsement technical reviews are also performed by HUD staff. Most of these reviews are performed by HUD staff who remained in the HUD field offices when the single family functions were transferred to the Home Ownership Centers. However, many of these staff have no prior experience in single family loan production and accordingly the quality of their reviews is questionable. For example, we noted that several individuals who had no previous single family production experience performed 258 post-endorsement technical reviews over a one year period. Every one of the reviews resulted in a good rating. It is difficult to believe that this number of reviews over a one year period would not have identified a single problem with lenders’ underwriting. HUD needs to ensure that staff assigned to perform post-endorsement technical reviews have the background and training necessary to complete quality reviews.

Technical review results should be used to manage and control the program

Once the post-endorsement reviews are performed it is imperative that the results of the reviews be closely analyzed to identify and resolve any problems noted during the reviews and determine appropriate guidance that may need to be provided to lenders. Failure to monitor and take action when problems are noted renders the reviews almost meaningless. The Home Ownership Centers were taking only limited action based upon the results of their post-technical reviews of endorsed loans, thus the reviews had become just paper reviews. During the course of our audit we noticed that Home Ownership Centers were starting to use the results of these reviews to take limited actions. However, significant changes still need to be taken to ensure that the results of post-endorsement reviews are used to their fullest potential.

If post-endorsement technical reviews identify problems with specific loans or with a lender’s underwriting, various actions can be taken. These actions could include: referring the individual loan file to the Quality Assurance Division to initiate an indemnification request or for further follow-up and resolution; increasing the percentage of loans reviewed for a particular lender to determine whether underwriting deficiencies are widespread at that lender; requiring lender underwriters to obtain additional training; initiating debarment or Limited Denial of Participation actions against individuals, or placing the lender back on pre-closing review.

Technical review results were used in only a limited way by centers

We noted only limited actions being taken as a result of the post-endorsement technical reviews and in general the results were simply used as a database to provide results to the lenders every six months. However, each Home Ownership Center used the results of the reviews in different ways and these ways are continually evolving as the centers themselves evolve and become more knowledgeable of their responsibilities and identify controls and procedures needed to meet these responsibilities.

Santa Ana

Prior to June 1999, the Santa Ana center had made very little use of the results of its post-endorsement technical reviews. No lenders had been placed back on pre-closing review, no indemnifications had been obtained, no actions were taken against any individuals who had violated HUD requirements, and only a few lenders had their post-endorsement technical review percentages increased (which had no affect on the lender). Staff were reluctant to place lenders back on pre-closing reviews because this would increase their work load to a level they believed they could not handle. A limited number of indemnification requests (28) were sent to the Quality Assurance Division to initiate indemnification. However, no action was taken. As a result, the Processing and Underwriting Division that sent the requests determined it was useless to try and obtain indemnifications. Actions against individuals had not been taken since a process had not been developed to accumulate data needed to take such actions.

However, over the last six months, the Santa Ana center has begun using its review results in a limited manner. It established a database to accumulate review results and based upon these, initiated Limited Denial of Participation actions against five direct endorsement underwriters. However, it should be noted that in 1995 when HUD granted self approval to lenders for its underwriters, it also stated that the lenders would be held accountable for the underwriters' work (reference Mortgagee

Letter 95-36). Accordingly, the Santa Ana center should have taken action against the lender not just the underwriter who is a lender employee.

The Santa Ana center also stated that it uses the results of the post-endorsement technical reviews to determine training needs for individual underwriter and lenders. However, the center did not have policies and procedures in place to allow it to periodically review underwriting problems noted during reviews and identify existing or emerging problems which would allow them to efficiently determine training needs and target them towards lenders or geographic areas.

Atlanta

The Atlanta center had not used the results of its post-endorsement technical reviews to initiate any significant actions against poor lenders or individuals who violated HUD requirements. Again, staff were reluctant to place lenders back on pre-closing review because of the increased workload for HUD staff. The center recently entered into a contract for the performance of pre-closing reviews but it is to early to tell if this will result in poorly performing lenders being placed back on pre-closing review. Further, the Atlanta center, prior to our review, had not referred any cases to the Quality Assurance Division for possible indemnification or other actions. Staff stated that they were going to start doing this and during our review made their first referrals to the Quality Assurance Division.

Denver

The Denver center was the most pro-active of the three centers reviewed in relation to using the results of its technical reviews to request indemnification from lenders whose loans failed to meet HUD underwriting requirements. For example, during Fiscal Year 1999, the Processing and Underwriting Division made 335 referrals to the Quality Assurance Division and, as a result, 23 loan indemnifications were obtained. However, the Denver center was reluctant to place lenders back on pre-closing, and had not done so. The Staff gave two reasons for this: (1) a reluctance to increase their own workload by placing lenders back on pre-closing, and (2) a perception that if they did, they would be doing the lender’s underwriting for them at no cost to the lender.

Additionally, although we noted very little potential fraud identification by the centers and their contractors during their post-endorsement technical reviews, there were no procedures for accumulating such data if and when it becomes available through improved post-endorsement technical reviews. In order to properly manage risk from individuals who abuse the program, the centers should establish a database to accumulate data on individuals who are identified as parties to potentially fraudulent transactions. Such a data base could be used to give early warning on potential problems, target lenders for increased technical reviews, provide significant information to the Quality Assurance Divisions to assist them in their reviews, and accumulate sufficient data to allow HUD to take appropriate actions against those who intentionally violate HUD requirements.

Loan correspondents should also be held accountable

Currently, when a loan is originated by a loan correspondent and underwritten by its direct endorsement sponsor, the remedial actions resulting from post-endorsement technical reviews are targeted to the sponsor and not to the loan correspondent. Although the sponsor is responsible for underwriting and final loan approval, often underwriting problems can result from deficiencies or fraud during loan processing which is performed by the loan correspondent. Accordingly, in order to effectively manage its risk, HUD needs to link results of post-endorsement technical reviews both to the loan correspondent who is responsible for loan processing and the direct endorsement sponsor who is responsible for loan underwriting. HUD could then use the results of the reviews to mitigate its risk from poorly performing loan correspondents who may use many different direct endorsement sponsors.

Closer coordination is needed between center divisions

Although the Quality Assurance, Processing and Underwriting, and Technical Service Divisions were co-located at the Home Ownership Centers, we noted that there was only very limited coordination between them. The Home Ownership Centers did not have procedures in place to ensure that Processing and Underwriting’s lender knowledge was used when determining which lender’s should be reviewed by Quality Assurance. Similarly, Processing and Underwriting received no regular communications from Quality Assurance on the lenders they

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reviewed that were having underwriting or appraisal problems. Problem lenders identified by Quality Assurance should have been reported to Processing and Underwriting so that their technical review percentages could be raised to determine whether problems continued to exist that warranted corrective action by HUD.

Additionally, Quality Assurance is responsible for determining whether poorly underwritten loans identified during post-endorsement technical reviews merit lender indemnification. However, there was a general lack of communication between Quality Assurance and the technical divisions as to what type of processing irregularities warranted indemnification and the ultimate resolution of the technical divisions referrals. As a result, the technical division in the Atlanta center made no referrals to Quality Assurance prior to our audit review and the Santa Ana center staff said they were reluctant to make referrals because they believe they were a waste of time.

In order to take advantage of the knowledge of each of the divisions, we believe procedures should be implemented to provide for periodic meetings between the staffs of each division to discuss ongoing problems with lenders or individuals. Specific guidelines relating to deficiencies in the loan origination process that merit indemnification requests should be established as should a tracking system to ensure that all recommendations from processing and underwriting are fully resolved. Further, meaningful feedback should be provided to the Processing and Underwriting Division when it is determined that its indemnification recommendations are not appropriate.

HUD handbooks are outdated

Over the last five years, HUD has made substantive changes to its Federal Housing Administration single-family insurance program, including the implementation of the Home Ownership Center structure and changes to loan origination criteria. However, the handbooks which provide guidance for program implementation have not been updated to reflect these changes. Consequently, it is difficult to determine what HUD's current requirements and operating policies are. In our opinion, this has led to confusion within HUD (especially new staff with no previous technical experience in mortgage lending), the lending community, and the contractors performing HUD's technical reviews. In order to better manage its program and assist staff, contractors, and lenders, these handbooks need to be updated to reflect current HUD structure and requirements. Principal handbooks which affect loan processing and insurance endorsement which require revision include:

- <u>4000.4 - Single Family Direct Endorsement Program</u> - Last Revision July 1994 - This handbook contains HUD's principle guidelines governing the management of the Direct Endorsement Program. However, substantial changes have been made to the program since handbook issuance, including implementation of the Home Ownership Centers which has significantly altered HUD's structure and procedures for monitoring lenders. Some other significant program changes made since handbook issuance include:
  - Implementation of on line processing through the Federal Housing Administration Connection including case number assignment;
  - Lender self approval of underwriters and branch offices;
  - Elimination of the appraiser fee panel and implementation of lender selection of appraisers;
  - Changes in documentation requirements for case binders submitted for insurance;
  - Significantly increased use of contractors to perform pre-endorsement and post-endorsement reviews; and
  - Elimination of the individual rating sheets previously provided to underwriters and lenders setting out the results of the post-endorsement technical reviews.

  Additionally, the handbook contains contradictory information relating to technical review ratings. For example, paragraphs 4-9A.4(c). and 4-9B.2(b). state that "poor" ratings should reflect deficiencies which significantly affect HUD's risk, whereas paragraph 4-9E.3 states that a "poor" rating can be given even though HUD's risk is not affected. (Note: Paragraph 4-9E.3 is improperly numbered. It should be 4-9F.3). These and similar inconsistencies need to be resolved.

- <u>4155.1 - Mortgage Credit Analysis for Mortgage Insurance on One-to-Four Family Properties</u> - Last Revision, September 1995 - This handbook contains HUD's basic underwriting requirements for Federal Housing Administration insured single family mortgage loans. Since handbook issuance, numerous changes and clarifications through mortgagee letters have been

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made that significantly affect mortgage credit analysis. For example, changes have been made relating to maximum mortgage/minimum required investment computations; mortgage insurance premium calculations; face-to-face interview requirements; ratio calculations involving adjustable rate mortgages; excessive ratios and compensating factors; use of automated underwriting systems; loans from family members for downpayments; "grossing up" of non-taxable income; and interest rate buydowns. These changes and clarifications should be incorporated into the handbook.

- 4165.1 - Endorsement for Insurance for Home Mortgage Programs (Single Family) - Last Revision April 1992 - Contains basic instructions and guidelines for mortgage insurance endorsement. Significant changes affecting the processing, endorsement, and documentation requirements have made this handbook obsolete.

- 4000.2 - Mortgagee's Handbook, Application through Insurance - Last Revision, July 1991 - Provides a general description of HUD's single family insurance program and sets out procedures required of lenders and HUD staff. Although this handbook only provides general information, significant changes in programs and HUD's single family structure have made it obsolete.

The last several years have seen a significant change in HUD's management of its single family insurance program along with a significant increase in program activity (endorsements went from 790,000 in fiscal year 1997 to 1,290,000 in fiscal year 1999). In order to manage these changes the Home Ownership Centers have established differing local policies and procedures which change on an ongoing basis as they identify new control and information demands and try to meet these demands. As a result, each center has different informal policies and procedures which they use to try and meet their responsibilities. The Home Ownership Center structure has been in place for over two years. In our opinion, it is time to reevaluate the centers and establish uniform policies and procedures necessary to effectively manage their responsibilities and ensure that staffing is adequate.

Auditee Comments

Management did not provide comments to address this finding.

Recommendation

We recommend the Assistant Secretary for Housing, Federal Housing Commissioner:

1A. Develop risk based characteristics, including default and underwriting risks, that can be input during the loan origination process and use this information to target individual loans for post-endorsement technical reviews through the use of HUD's automated data systems;

1B. Develop and implement specific policies and procedures to identify and monitor loan origination activities of newly approved direct endorsement lenders and to periodically review all other lenders' default rates, ratings, and other concerns. Based upon this information, targets post-endorsement technical reviews towards those lenders who show high risk tendencies in their loan origination activities;

1C. Develop and implement procedures that require (a) linking the results of post-endorsement technical reviews to sponsor lenders and loan correspondents, (b) monitoring of review ratings applicable to loan correspondents, and (c) taking corrective actions against loan correspondents when review results indicate origination problems applicable to them;

1D. Implement contracting and contract management policies and procedures related to post-endorsement technical review contracts that ensure: (a) contractors are clearly aware of the technical review requirements and have the professional capability to perform the reviews in accordance with contractual requirements; (b) appropriate monitoring procedures are in place to oversee the contractors total work product; and (c) appropriate corrective action is taken if contractors' reviews do not meet contract requirements;

1E. Establish clear policies and procedures to ensure appropriate actions are taken when post-endorsement technical reviews identify problems with lender loan originations. These policies and procedures should: (a) address establishment of a data base to track individuals and entities involved in potentially fraudulent transactions identified during post-endorsement reviews; (b) provide clear instructions for placing lenders back on pre-closing reviews when warranted; (c) and furnish specific instructions to assist staff in determining what type underwriting deficiencies warrant indemnification, Limited Denial of Participation, or debarment actions;

1F. Establish and implement policies and procedures that provide for periodic coordination meetings between the Processing and Underwriting and Quality Assurance Divisions, and a tracking system to ensure that referrals to the Quality Assurance Division are appropriately resolved and the results communicated back to the Processing and Underwriting Division;

1G. Revise Handbooks 4000.4, 4155.1, 4165.1, and 4000.2 to include the changes that have been made to the single family insurance program; and

1H. Evaluate and adjust staffing levels based upon current Home Ownership Center responsibilities and loan origination volume.

The Home Ownership Centers' Quality Assurance Divisions' Controls Over Lender Loan Origination Were Inadequate

The Home Ownership Centers' Quality Assurance Divisions failed to effectively implement controls over their monitoring of lenders' loan origination activities. They did not adequately consider risk factors, as required, in selecting which lenders to monitor, and selected low risk lenders to review instead of high risk ones. As a result, many of the worst performing lenders with the greatest risk of improper loan originations were not reviewed. The failure of the Quality Assurance Divisions to properly target high risk lenders allows inappropriate lending practices to continue and increases the risk to the insurance fund. When the Divisions did identify deficiencies in their reviews, they did not always follow up when the mortgagee failed to respond to findings and recommendations. As a result, there was no assurance problems were appropriately resolved. We attributed the deficiencies to a lack of clear standards and criteria for weighting risk factors in the lender targeting process; management's concern with achieving numbers goals rather than performing quality reviews; insufficient communication between Quality Assurance Division and Processing and Underwriting Division staffs; inexperienced staffs; travel fund limitations; and a lack of adequate controls to ensure appropriate follow-up action.

The Quality Assurance Division is to monitor mortgagee performance

The Quality Assurance Division is responsible for conducting on-site reviews to monitor the origination and servicing performance of HUD approved lenders. The Division had a goal of 900 lender reviews (225 per Home Ownership Center) for fiscal year 1999. The goal for fiscal year 2000 is also 900 reviews. The objectives of this monitoring as specified in HUD Handbook 4060.1 REV-1 are to: (1) assure that mortgagee practices are in compliance with applicable requirements; (2) uncover mortgage finance fraud and abuse of HUD programs; (3) identify mortgagees representing a high risk to the departments insurance fund; (4) take appropriate actions to mitigate loss; and (5) provide consistency in the resolution of problems identified. Additional objectives and the methodology by which Quality Assurance is to meet the Handbook requirements are set fourth in the Quality Assurance Division Guide.

Most reviews should focus on poor performing or high risk lenders

The Quality Assurance Division Guide states that 15 percent of reviews should be of randomly selected lenders and the remaining 85 percent should focus on the worst performing lenders based on several risk factors. Quality Assurance is to rate and prioritize lenders for review and ensure appropriate follow-up action.

The Quality Assurance Division Guide lists the following risk factors to be used in selecting lenders for review:

- early default and claim rates greater than 3 percent
- complaints and internal referrals
- late mortgage insurance premiums
- volume of business
- spikes in business
- high risk programs
- length of time since last review
- Government National Mortgage Association data

Quality Assurance staff at HUD headquarters select the 15 percent of lender reviews for random targeting. Individual field monitors target most of the remaining 85 percent of reviews (although some reviews are targeted by Quality Assurance Division management). Monitors use their own judgment to determine what factors or criteria to use in the selection decision and how much weight should be given to each factor. The selection criteria used by each monitor varies.

Field monitors did not assign appropriate weight to risk factors

Lenders were not appropriately rated and prioritized for reviews based on the specified risk factors. We reviewed the listed reason for review in a non-statistical random sample of Quality Assurance Division files at each center. We found the stated reason for review was almost always limited to a brief notation such as "4 defaults", or "met current criteria". The reason listed for the selection of low risk lenders was often that the lender exhibits some level of one or a few of the risk factors outlined in the Quality Assurance Division Guide. Many reviews of low default rate lenders cited the reason for selection as "never been reviewed" or "defaults". Any judgment used to weight risk factors and identify the highest risk lenders was not documented or evident based on information in the file. In our opinion, inadequate consideration was given to the risk factors in selecting lenders to review. This inattention to risk factors was confirmed in our discussions with Quality Assurance staff. According to the Quality Assurance Director and field monitors at the Santa Ana center, monitors intentionally avoided selecting lender reviews that would likely result in significant findings. The field monitors at Santa Ana said lenders were targeted based on low default rates, low origination volumes, and close proximity to the monitors' home. According to Branch Chiefs at the Denver center, some lenders were also selected based on a low number of defaults or close proximity to the monitors' home.

Many low risk lenders were selected for review

We selected and reviewed a non-statistical random sample of Quality Assurance review files from each of the centers visited to determine the frequency that low risk lenders were selected for review. Twenty files were selected from Atlanta, twenty one from Santa Ana and ten from Denver.

The following was noted based on this review:

	Santa Ana	Denver	Atlanta
Percent of low risk lenders selected[6]	66.7%	60%	45%

Supervisory review of monitor selections was inadequate

Quality Assurance Branch Chiefs and/or Directors approved monitor selections based on quarterly travel projections or individual travel requests submitted by each monitor. We found these documents did not contain enough information to justify a need for lender reviews based on risk. We also found the supervisory review of monitor selections did not ensure lenders were appropriately prioritized for review based on risk.

As a result of the inadequate weight given to risk factors and the tendency to review low risk lenders, some of the worst performing lenders were not selected for review as discussed below.

[6] Lenders were considered "low risk" if: 1) they had less than 3 defaults, less than a 1.25 percent early default rate, or greater than 1 percent less than average default rate for the lender's area, and 2) the file did not contain evidence of significant other risk factors that would warrant a review, and 3) the lender was not selected by HUD headquarters for a random review. Default rates are based on early default data (loans defaulting within 2 years) reported in the Neighborhood Watch System at the time of OIG file reviews.

Some of the worst performing lenders were not selected for review

In order to evaluate the effectiveness of lender targeting procedures that did not sufficiently address high risk factors, we compared an Approval/Recertification/Review/ Tracking System (ARRTS) list of Quality Assurance reviews started with a Neighborhood Watch list of lenders with the top 100 highest early default rates. This comparison was performed for each of the three centers we visited and was based on the following criteria:

- Quality Assurance reviews within the center's jurisdiction with visit start dates between 10/01/1997 and 11/01/1999.
- All active or merged lenders with greater than 100 originations.
- Loans with beginning amortization dates between 9/01/1997 and 8/31/1999.
- Default rates based on loans that went into default within two years.

The results of this comparison were as follows:

	Santa Ana	Denver	Atlanta
Number of lenders in top 100 not reviewed	66	52	45
Number of lenders in top 10 not reviewed	9	6	3

The results of this test indicate that based upon default rates, many of the highest risk lenders were not selected for review by Quality Assurance. Although there may be valid reasons for not selecting one or a few of the lenders with the highest default rates, lenders in this category generally should have been selected over others that were selected and did not exhibit similar high risk indicators (high default rates, serious referrals or complaints etc.).

The results of this test show how many of the highest default lenders received no Quality Assurance monitoring for the time periods indicated. However, the results do not necessarily indicate that the reviews done on the highest default lenders were adequate. For example, reviews that were accomplished may have only involved branch offices with the fewest defaults.

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Quality Assurance staff agreed improvements were needed

The Quality Assurance Branch Chiefs and the Director in Denver acknowledged that additional documentation is needed to show the reason each lender is selected for review and that Branch Chiefs need to do a more careful review of lender selections prior to approval. Quality Assurance recently discussed the possibility of establishing a targeting system that would assign a quantitative score to each lender based on weighted risk factors. This type of system would rank lenders objectively and create a priority listing of lenders for review. Some Quality Assurance managers expressed resistance to the system saying it could subject the department to criticism if they fail to review the high risk lenders identified. One Branch Chief at the Denver center also expressed concern that an objective ranking system would not appropriately factor judgment into the targeting process.

The Denver Quality Assurance Division suggested a targeting approach that would include 5 percent of selection based on random targeting, 15 percent from a "highest priority list" based on objective criteria, and 80 percent from current procedures (monitor selections). This approach would also include additional documentation showing management approval and a justification for why each lender was selected. In our opinion, since current procedures were found to be inadequate, this method would only be appropriate if specific criteria and standards were established and enforced for weighting risk factors in the lender selection process.

Quality Assurance and Processing and Underwriting Divisions did not coordinate on referrals of lenders

Referrals from the Processing and Underwriting Division can provide an additional means of identifying high risk lenders for on-site lender reviews. During Post-tech reviews, the Processing and Underwriting Division can identify poorly performing lenders that warrant on site monitoring reviews by Quality Assurance or improperly originated loans which warrant indemnification. However, the Quality Assurance and Processing and Underwriting Divisions did not properly coordinate referrals between the departments. At the Atlanta and Santa Ana centers, few referrals were made and little feedback was provided to correct problems and promote quality referrals in the future. When referrals were made, they rarely resulted in the selection of lenders for on-site Quality Assurance reviews.

According to the Atlanta Quality Assurance Director, they received few referrals from the Processing and Underwriting Division and no feedback was provided regarding the referrals. Santa Ana Quality Assurance staff informed us that the Processing and Underwriting Division stopped referring cases because most prior referrals were rejected and no feedback was provided. The Denver Processing and Underwriting Division referred 335 cases to Quality Assurance in Fiscal Year 1999. Denver Quality Assurance staff said the referrals usually related to less significant issues and few reviews were started based on the referrals. However, the Denver Quality Assurance Division achieved some results based on the referrals as 6.9 percent of the 335 cases resulted in an indemnification agreement.

Several factors contributed to the inadequate targeting of lenders

- **Emphasis on numbers goals rather than the quality of reviews.**

  Emphasis on production goals rather than quality caused Quality Assurance managers to allow and, in some cases encourage, the selection of low risk lenders for review. Quality Assurance Directors and Branch Chiefs described a "crisis atmosphere" associated with constant pressure to meet production goals. The Santa Ana Quality Assurance Director said he was told by HUD Headquarters "if you need to review lenders with no delinquencies, go do it". This Director also said if a serious fraud case emerged, it would have been put aside because it would have taken too much time. Quality Assurance monitors at the Santa Ana center said low risk lenders were selected to increase the number of reviews completed and meet the production goal. A Quality Assurance Branch Chief at Denver said in an email message dated 4/1/99, "…emphasis on number of reviews has in some measure distorted the priorities in terms of both long term planning and day to day decisions of how to approach our mission."

- **Lack of guidelines or criteria for weighting risk factors for prioritization.**

  Although the Quality Assurance Division Guide sets out general factors to be used for identification of high risk lenders, it does not provide enough guidance on how these factors should be weighted. Field monitors often justified lender selections based on only one risk factor rather than on an analysis of overall risk relative to other lenders in the area.

- **Some Quality Assurance Division monitors lack adequate skills and experience.**

During the HUD reorganization, some staff were placed as Quality Assurance monitors without prior related experience. According to center Quality Assurance managers, some monitors had not acquired the necessary skills to perform quality reviews. A Denver Quality Assurance Branch Chief said 6 of the 28 (21.4 percent) Denver field monitors were currently unable to perform reviews of high risk lenders due to lack of experience.

According to center Quality Assurance managers, some low risk lenders are selected for training purposes. These managers said inexperienced monitors do not review high risk lenders because problems may be made worse if they go undetected in a Quality Assurance review.

- **Travel funding limitations.**

Each Quality Assurance Division receives a travel fund allocation from the individual center. Travel funds are received in blocks throughout the year without a predetermined travel funds budget. Center Quality Assurance managers said this lack of a known travel budget hindered review planning and caused some reviews of high risk lenders to be postponed.

According to Quality Assurance staff at the Denver and Santa Ana centers, additional travel funds are needed. However, staff at HUD headquarters said, despite center complaints regarding insufficient travel, some travel funds usually go unused. Additionally, a letter dated April 1, 1999 shows the Santa Ana Quality Assurance Division did not request any additional travel funds for the last six moths of Fiscal Year 1999.

- **Insufficient communication between Quality Assurance and Processing and Underwriting Division staffs.**

Quality Assurance staff at the centers said many of the referrals from Processing and Underwriting were not adequate, yet little feedback was provided to establish a clear understanding regarding appropriate referrals. The lack of communication resulted in a decrease in the number of referrals and has not promoted increased quality.

Quality Assurance Division has not taken appropriate follow up action on overdue lender responses

Once reviews are completed, results of reviews are communicated to lenders who are supposed to respond. Lenders are asked to explain the problems noted, list actions taken to prevent future problems, and/or agree to indemnify HUD for possible losses associated with improperly originated loans. However, we noted that in numerous instances the lenders did not respond, yet Quality Assurance took no follow up action.

We reviewed a list of Quality Assurance review files in open status for each center visited to evaluate whether timely action was taken for late lender responses. We found the following as of December 10, 1999:

- The Santa Ana Quality Assurance Division had 56 review files with lender responses greater than 60 days overdue and no further follow up action was taken. The Approval / Recertification / Review / Tracking System (ARRTS) indicated significant problems were noted during some of the reviews. There were 63 indemnification requests for 28 of the reviews and possible fraud or falsified documents were noted in 5 of the reviews.

- The Atlanta Quality Assurance Division had 29 reviews with lender responses greater than 60 days overdue and no further follow up action taken. Indemnification requests were made for 13 of these reviews and 12 of the reviews noted possible fraud or falsified documents.

- The Denver Quality Assurance Division had 15 reviews with lender responses greater than 60 days overdue and no further follow up action taken. The ARRTS indicates 3 indemnification requests were made for 1 of the reviews.

In addition to the reviews noted above, one Atlanta Quality Assurance review had a lender response greater than seven months overdue with no follow up action taken prior to an OIG inquiry regarding the review. According to the ARRTS, 16 indemnification requests were made for that review. In addition, a Santa Ana review was also found to have an overdue lender response with no further follow up action taken. According to the ARRTS 15 indemnification requests were made as a result of that review.

The ARRTS produces a report that lists Quality Assurance files with overdue lender responses. We determined this report was inaccurate and therefore, unreliable as a tool to monitor late responses. Report inaccuracies were due to data entry procedures that were inconsistent with ARRTS system requirements. When multiple letters are sent from Quality Assurance to a lender, a response received date must be entered in the corresponding "response received" field for each of the multiple letters sent. We found Quality Assurance did not always input a date into the "response received" field for each of the letters sent. This resulted in some reviews appearing on the late lender response report when, in fact an adequate response had been received.

Atlanta Quality Assurance staff said they had not taken follow up action for lenders that did not respond due to a heavy work load. However, in general, we attributed this deficiency to a lack of adequate controls needed to ensure appropriate follow up action is taken on lenders that do not respond to findings letters.

The failure of the Quality Assurance Divisions to consistently target the highest risk lenders for review or take appropriate follow up action reduces the adequacy of HUD's mortgagee monitoring efforts and increases the risk to the Federal Housing Administration insurance fund. Corrective actions need to be taken to improve the effectiveness of the Division.

Auditee Comments

Management did not provide comments to address this finding.

Recommendations

We recommend the Assistant Secretary for Housing, Federal Housing Commissioner:

2A. Focus on the quality rather than quantity of lender reviews. The Quality Assurance Division should establish and implement performance measures or goals that incorporate review quality standards and lender targeting standards rather than limiting goals to a specific number of reviews.

2B. Develop specific criteria to target the highest risk lenders that provides a clear standard and improved monitor and manager accountability. This should encompass the use of default rates, number of late mortgage insurance premiums and serious complaints;

2C. Continue classroom and on-the-job training for less experienced monitors and not limit reviews conducted for training purposes to only low risk lenders;

2D. Develop a travel funds budget for the Centers' Quality Assurance Divisions and periodically assesses the adequacy of Quality Assurance travel funds;

2E. Establish and implement controls to ensure appropriate follow up action is taken for lenders that do not respond to findings letters; and

2F. Correct problems associated with the inaccurate ARRTS overdue response report.

Controls Over Direct Endorsement Appraisals Were Inadequate to Protect HUD's Interests

Controls over the appraisal review process were not adequate to protect HUD's interest on loans processed and closed by Direct Endorsement lenders and their loan correspondents. More specifically, the Home Ownership Centers' Technical Assistance Branches: (1) Improperly disregarded field review selection requirements, (2) Did not field review 84 percent of the appraisals that had received poor ratings during the desk review, (3) Did not verify the work of field review contractors through on-site evaluations, and (4) Did not use the results of the field reviews to take immediate and appropriate action against appraisers, lenders, and others who violated HUD requirements. As a result, HUD lacks assurance about the quality of appraisals supporting loans processed and approved by lenders. HUD can not be assured that the appraised properties meet minimum physical, health and safety criteria, the values support the mortgage amounts, and that fraudulent appraisals are identified and resolved. Adequate controls were not established because most of HUD's efforts in the appraisal review process were targeted to meet numerical goals and not to ensure that appraisals were accurate. Also, HUD's Home Ownership Centers were hampered by inadequate review contracts, a shortage of qualified HUD staff to handle an increased loan volume, lack of clear operating policies and procedures for the centers' operations, and outdated handbooks.

In July 1997 the General Accounting Office said field reviews of appraisals were inadequate

In July 1997, a General Accounting Office audit[7] found that during the period October 1, 1996 through June 20, 1997 six HUD Field Offices conducted few or no field reviews of completed appraisals in their jurisdiction. In response to this report, the HUD Deputy Assistant Secretary for Single Family Housing informed field offices that "This lack of performance subjects the agency to fraud and abuses that not only cost the insurance fund unnecessary losses, but are detrimental to the very customers we are striving to serve, i.e. the home buying public."

A sample of appraisals should be field reviewed

As discussed in Finding 1, after insurance endorsement, a sample of case files undergo desk reviews to evaluate the quality of the loan processing, underwriting, and appraisal related to the subject loan and property. Appraisals may also receive an additional "field review" by an appraiser under contract with the Centers.

[7] Homeownership: Information on Changes in Federal Housing Administration's New Single-Family Appraisal Process (General Accounting Office Report Number 97-176, July 25, 1997).

Appraisals should be reviewed by appraisers

Chapter 4 of HUD Handbook 4000.4 REV-1, Single Family Direct Endorsement Program, describes the importance of reviewing appraisals and the number of field reviews which should be done. Paragraph 4-9D states "It is essential that appraisals are reviewed by a senior review appraiser." The handbook provides that ten percent of all appraisals are to be field reviewed, and all appraisals that were judged poor based on the desk review should be field reviewed.

Every appraiser and lender's work should be reviewed

Further, it is important that at least five percent of every appraiser's work is reviewed and that the work of every mortgagee is analyzed.

HUD Handbook 4000.4 was last revised in 1994 and was written when the endorsement and review of Federal Housing Administration cases were being done by HUD field office staff. Under the current organization, each center has contractors to perform the desk review and the field review of appraisals. However, the logic of this handbook requiring the field review of appraisals that receive poor ratings in their desk review is still appropriate. Whether HUD staff or contractors do the reviews, it makes good business sense to evaluate all appraisals that were rated as "poor" through desk reviews and conduct field reviews of these appraisals when determined warranted.

Handbook 4150.2, Valuation Analysis for Single Family One-to-Four Unit Dwellings, replaced and superseded **Handbook 4150.1, Valuation Analysis for Home Mortgage**, in July 1999 The new handbook incorporated numerous Mortgagee Letters. The instructions relevant to appraisers in HUD Handbook 4000.4, Chapter 4-9D were incorporated into the new Handbook 4150.2. Chapter 6 of this new handbook introduced a review process whereby the Federal Housing Administration will monitor appraisals and appraisers using statistical analysis and field reviews. Chapter 7 of the new handbook covers Regulatory Environment, Enforcement, and Sanctions. Handbook 4150.2 was partially implemented in July 1999, but the portions relating to sanction of appraisers have not been implemented.

Handbook 4150.1, Chapter 9, stipulates that appraisals that are field reviewed are given a rating of 1 to 5, with a 1 or 2 being considered "poor" and warranting a response from the appraiser. The appraiser has 15 days to provide a response. If an appraiser receives three or more "poor" ratings, the appraiser must be either removed from the approved list of appraisers from which lenders select their appraisers for Federal Housing Administration loans or required to obtain additional training. Although the prior Field Offices had the authority to remove appraisers, the centers must go through the Limited Denial of Participation process in order to remove an appraiser. This is a cumbersome process according to center staff. Paragraph 9-8A also specifies that the Chief Appraiser (or designee) must review five percent of every field reviewer's work.

HUD's Real Estate Assessment Center is establishing a new appraisal review process

The Real Estate Assessment Center, which was established March 1, 1998, is in the process of establishing a new appraiser quality assessment review process. The process will be target appraisals for field review, assign risk assessment scores, and designate appropriate sanctions that should be taken. This review contract/process is scheduled to be implemented in approximately the middle of March 2000, after initiating procedures to capture data, target appraisals, and train all centers is completed. We only received an overview of the Real Estate Assessment Center's proposed involvement in the appraisal review process. Therefore, we did not fully evaluate whether it would correct deficiencies in the current appraisal review process discussed below. However, as discussed later, we do have certain concerns with the new process.

Home Ownership Centers disregarded appraisal review requirements

The Home Ownership Center's had no systematic procedure for selecting appraisals for review to ensure that the required five percent of each appraiser's work was reviewed. This occurred because: (1) centers did not have review contracts for all areas within their jurisdiction when the field review responsibility shifted from the Field Offices to the centers; (2) Lenders did not always provide a required second copy of the appraisal, or the appraisal report was not complete, and the centers accepted the cases instead of rejecting them; and (3) The centers primary emphasis was placed on meeting their goal of completing field reviews on 10 percent of the appraisals instead of ensuring the program was working properly. As a result, some areas within a center's jurisdiction were not subjected to reviews or only to relatively few reviews, and some lenders and appraisers' work was not reviewed.

The Centers did not always have a field review contract when they assumed field offices' responsibilities

When the responsibility for field reviews was shifted from the 81 HUD Field Offices to the four Home Ownership Centers, the centers did not have field review contracts for all areas under their jurisdiction. Sometimes there was no one left in the Field Offices' Single Family Office with knowledge about the existing field review contracts or the contract had expired. This left the centers with areas not covered by a field review contract and no staff in the respective areas to do the field reviews.

We noted geographic areas within each of the three centers we reviewed where few or no field reviews were done during the time since the center became responsible for those areas. For example:

- The Santa Ana center performed no field reviews of appraisals in February 1999 for the Honolulu, Las Vegas, Portland, Reno, Sacramento, Spokane, and Tucson Field Office areas. There were only 21 review appraisals done for San Francisco, Anchorage, and Boise. A total of 8,152 cases were insured for these ten offices in February 1999. No field reviews were done for the Sacramento office during October 1998 through February 1999, and none were done for the Reno office during October 1998 through May 1999.

- The Denver center did not have contracts for Tulsa, New Orleans, and Shreveport when those field office operations migrated to the center. The Branch Chief told us that all areas under the center are now covered by review contracts, but Oklahoma City and Kansas City were not covered during the entire year. Field reviews performed for these two field office areas were well below the 10 percent goal. For Fiscal Year 1999, Oklahoma City was at 2 percent and Kansas City was at 5.1 percent.

- The Atlanta center completed no field reviews for the Knoxville field office area during October 1998 through March 1999. At the Atlanta center, we identified 48 appraisers who performed 50 or more appraisals in October 1998 through March 1999 without any field reviews of their appraisals. Twelve of these appraisers did more than 100 appraisals and two did more than 200 appraisals without review by HUD or its contractors.

Normally, when lenders submitted cases for insurance endorsement on properties located in one of the areas that did not have a field review contract, the cases were insured but the extra copies of the appraisal reports were thrown away and no field reviews were done. In a few areas where there were some out-stationed center staff with appraisal experience, the staff performed a limited number of field reviews.

On numerous occasions we asked Technical Branch officials and other officials at the centers about proposed transfer of the appraisal review responsibility to the Real Estate Assessment Center. However, nobody could tell us when it would happen, what it would entail, and what their responsibilities would be under the new procedures. This uncertainty about the Assessment Center take over exacerbated the proliferation of inadequate field reviews. Some review contracts were not renewed in anticipation of the transfer, which has repeatedly had its planned start date pushed back.

Lenders could easily avoid field reviews of appraisals

The centers that received cases without a complete second copy of the appraisal report did not always reject the cases or make their own copy in order to send it to a contractor for field review. Thus, lenders that did not submit the required two complete copies of the appraisal usually avoided having a field review of the appraisals. In a September 25, 1997 memorandum to the centers, the Deputy Assistant Secretary for Single Family Housing advised them that effective November 1, 1997, appraisers would not be required to send a copy of their appraisal report to the field office for a pre-endorsement review. Instead, the Direct Endorsement mortgagee would include two copies of the appraisal report in each review case binder, changing field reviews from a pre-endorsement function to a post-endorsement function. Recently, in anticipation of the Assessment Center taking over responsibility for appraisal reviews, the centers have begun to reject cases submitted without the extra complete copy of the appraisal.

HUD staff responsible for sending appraisals to the field review contractors generally made a haphazard selection of the available appraisals to meet their contract requirement, such as 100 reviews per month. The HUD staff responsible for each geographic area would select as many appraisals as needed to fulfill the review contract requirements by pulling from the most recent reports received and discarding ones that were incomplete or exceeded the number needed. On rare occasions, the HUD staff would try to identify and pull appraisals that were done by a particular appraiser or lender that needed a more intensive look.

Contrary to Handbook requirements, the centers did not ensure that all appraisals that received "Poor" desk review ratings were field reviewed. At the Santa Ana and Atlanta centers there was generally no linkage between the desk review of appraisals and the field review of appraisals. The Denver center would field review "poor" desk reviews only if the reviewer indicated a need for it.

According to the Denver Technical Services Branch Chief, poor desk reviews should be sent to his branch for field review, but he thought this was a hit or miss situation. The appraisals should be reviewed by experienced valuation staff and a decision made as to whether field reviews are necessary. This is because a problem or deficiency is identified through the desk review process by staff that have little or no appraisal experience. Experienced valuation staff may decide the identified deficiency does not warrant a poor rating, the appraisal has already been field reviewed, or there is a need to send an appraisal to the field review contractor to fully document the problem and determine sanctions to be taken against the appraiser and possibly the lender.

HUD's Single Family Data Warehouse information system showed that during the two year period ending September 30, 1999, there were 15,526 appraisals that received "Poor" desk review ratings and 13,007, or 83.8 percent, of these were not field reviewed as required by Chapter 4 of HUD Handbook 4000.4 REV-1, Single Family Direct Endorsement Program as shown below.

HOC <u>*Office*</u>	*#Appraisals rated Poor in a* <u>*Desk Review*</u>	*Appraisals rated Poor in a Desk Review But* <u>*Not Field Reviewed*</u>	*Percent of Poors Not* <u>*Field Reviewed*</u>
Atlanta	7,123	5,755	80.8 %
Philadelphia	4,641	4,133	89.1 %
Santa Ana	3,208	2,683	83.6 %
Denver	554	436	78.7 %
Total	15,526	13,007	83.8 %

These poor ratings were entered into the Computerized Homes Underwriting Management System without any follow-up actions. Further, the ratings did not count against an appraiser's performance, as they would have been if they had been field reviewed. For most of the period, the Denver and Santa Ana centers had Technical Branch, or staff with a valuation background conduct the supervisory reviews of desk reviews that contractors had completed. However, even these supervisory reviews were not used to determine whether field appraisal reviews were warranted.

The centers did not make regular onsite evaluations of field review contractors

The centers performed field review verification of their Field Review Contractors' work only when resolving complaints. This occurred because each center's jurisdiction covers numerous states and they did not have out-stationed staff in most areas. We were unable to obtain data about the extent that HUD staff changed field reviewers' ratings but each center indicated that changes were common. Some center officials said they were not satisfied with all of their field reviewers, but had little option because some areas only received one contract bid.

Another recent General Accounting Office report[8] stated that the two centers they visited did not regularly verify the work of field review contractors through on-site evaluations. The General Accounting Office concluded that this weakens HUD's ability to accurately assess the quality of the appraisals used to support the loans the Federal Housing Administration insures.

Center officials changed many "poor" field review ratings to acceptable ratings and told us some of the field review

[8] <u>Weaknesses in HUD's Oversight of the Federal Housing Administration Appraisal Process</u> (General Accounting Office Report Number 99-72, April 16, 1999).

contractors were not competent reviewers. Yet, we found no instances where HUD went out and did any quality control reviews of the contractors' work except in response to a complaint.

Centers did not use review results to take action against appraisers, lenders, and others who violated HUD requirements

Each center we reviewed established databases to accumulate a record of poor field review ratings given to appraisers, but none of the centers effectively used the results to take immediate and appropriate action against appraisers, lenders, and others who violated HUD requirements. Further, poor ratings given appraisers through desk reviews were not counted against appraisers and merely were entered into Computerized Homes Underwriting Management System to facilitate a Headquarters report to the lenders several times a year. Branch Chiefs at all three HOCs commented that they did not have enough staff to effectively monitor appraisers or to sanction poor performers.

The Santa Ana center's Technical Assistance Branch had a database of Poor ratings and had requested Limited Denial of Participation actions against several appraisers that had multiple poor ratings. However, staff assigned to screen the submittals or General Counsel, normally returned the requests with instructions to gather more examples and provide more details. We noted that even the appraisers that provided numerous fraudulent appraisals as developed and documented in a separate criminal case (Allstate Mortgage Company), had not been removed from HUD's approved appraiser listing, issued a Limited Denial of Participation or debarred, and are still doing Federal Housing Administration appraisals for other lenders within the center's jurisdiction. Several center officials expressed much frustration at not being able to get Limited Denial of Participation requests through the General Counsel system. The center person responsible for processing Limited Denial of Particpations said the Technical Branch officials needed a better understanding of what was required to issue a Limited Denial of Participation. However, even when the Technical Branch tried issue a Limited Denial of Participation to an appraiser who had 3 poor field reviews, their request was rejected because it was not enough. Clearly, there is a lack of communication as to what constitutes sufficient competent evidence for an action.

The Denver center had a "poor-rating" database that included a system to follow up on appraisals, but the staff did not follow up or update the system in a timely manner. One Housing Specialist's report showed that 10 of 17 responses from appraisers were overdue between two and six months. However, while the Atlanta and Santa Ana centers rarely initiated Limited Denial of Participation actions, the Denver center requested actions on 21 appraisers in Fiscal Year 1999 (eight Limited Denial of Participations were issued).

Atlanta center Technical Assistance Branches had a system to follow up on field reviews that received ratings of "1" or "2", but it was not effective. When we reviewed the follow up on 21 appraisals that had received the "1" (poor rating), 8 of the 21 were not on the center's enforcement control log for appraisals receiving poor ratings. Two underwriters could not locate anything on their single cases with "1" ratings. On 6 of the 21 appraisals that had been rated "1" by the field reviewer, the rating was changed to a "3" by the Branch Chief because it would not support a Limited Denial of Participation action, not because the Poor rating was unsupported. The Technical Branches had made numerous action requests for poor appraisers, but most came back from legal not substantiated. At each of the centers, officials mentioned that formerly they sanctioned bad appraisers by removing them from the approved list. Mortgagee Letter 94-54 states that two or more ratings that put the Department at risk are sufficient to remove an appraiser. The concept was easy-on, easy-off; but now the current process is too lengthy and discourages HUD staff from trying to take quick action to protect the Department and the very people that HUD is supposed to be helping. One Atlanta Technical Branch did not send lenders a notice of poor ratings given in field reviews.

Emphasis placed on meeting numerical goals adversely affected quality controls

We believe that adequate quality controls over the appraisal review process were not established because most of HUD's efforts in the appraisal review process were targeted to meet numerical goals without regard for ensuring that the program was running properly. Other causes for the deficiencies were inadequate review contracts, a shortage of qualified HUD staff to handle an increased loan volume, lack of clear operating policies and procedures for the Home Ownership Center operations, and outdated handbooks.

Centers emphasized numerical goals

The three centers we examined placed their greatest emphasis on meeting their numerical reviews goal rather than ensuring they were receiving quality field reviews that subjected each lender's and appraiser's work to field reviews. Each center had a Fiscal Year 1999 Business Operating Plan goal of field reviewing 10 percent of all appraisals logged for the center's jurisdiction. Each center met this overall goal, but did so without regard for the Handbook requirement for reviewing at least five percent of each appraiser's work. As a result, numerous appraisers and lenders had none of their work reviewed or had much less than the required percentage reviewed.

As HUD reorganized its Single Family operations from 81 field offices to four Home Ownership Centers in 1997 and 1998, the new centers often found that some of the field offices had not kept up with their field reviews or did not have contracts which would have allowed contractors to do the reviews. In February 1999, one year after its establishment, the Santa Ana center was still in the process of obtaining contract information from the field offices. Because they had started out behind in their numerical goal of field reviewing 10 percent of the appraisals logged for each field office area, the centers took measures intended only to catch up on their goals rather than ensure the program was working properly.

For example, each center instructed its endorsement contractor to pull more or fewer appraisals for a geographical area when the area fell behind in its 10 percent review goal or when more than enough appraisals were on hand to meet the goal. On July 9, 1999, one Atlanta center Technical Assistance Branch sent a message to that center's endorsement contractor identifying some states not needing more reviews, others needing to pull 10 percent of their cases, and others needing 100 percent of their cases pulled. Then on July 30, 1999, the second Technical Assistance Branch advised the endorsement contractor that they did not need to pull any more appraisals for field reviews for Illinois, Indiana, Kentucky, Georgia, Alabama, and Mississippi. When we inquired about the reason for this notification we were told it was done because enough appraisals had already been pulled for those states to meet their 10 percent goal. This indicates that no appraisals performed during a two-month period in these states were reviewed.

A Santa Ana official commented that with field reviews, they were just pushing numbers, getting cases in and out. For example, during the first eight months of fiscal year 1999, Santa Ana field reviewed 9.7 percent of 136,551 appraisals. Thirty-three percent of the Fresno area appraisals were field reviewed and that accounted for 27.9 percent of the centers total. However, Fresno's appraisals were only 8.2 percent of the center total. This disproportionate level of field reviews in the Fresno area was solely due to the availability of review contractors.

HUD needs to update its operating handbooks

HUD Handbook 4000.4 REV-1 contains outdated policies and procedures that were written prior to the reorganization of Field Offices into Home Ownership Center operations. Some centers were unclear as to whether this Handbook was still applicable. As a result, some center issued their own policies and procedures to provide assistance to individuals and organizations involved in the Federal Housing Administration lending process.

Examples of outdated or unclear policies and procedures include whether the requirement to field review 10 percent of appraisals conducted within each field office's jurisdiction still applied to the centers or whether the centers only had to field review 10 percent of the appraisals conducted within their jurisdiction. Also, unclear is whether the centers should attempt to hold lenders responsible for poor appraisals in addition to sanctioning appraisers.

Real Estate Assessment Center's planned policies and procedures may not correct deficiencies we found

During our review, we learned of plans to transfer the responsibility for appraisal review from the centers to the Real Estate Assessment Center. We requested and obtained from the Assessment Center, a description of the planned procedures including risk factors for selecting appraisals, sanctioning criteria, desk/field review contracting, and Home Ownership Center responsibilities, along with a timetable or implementation schedule. Since the Assessment Center process will not be in place until at least March, 2000, its effectiveness cannot be determined at this time. However, in our opinion the Assessment Center plan, does not establish adequate quality controls over the review of appraisals. The risk factors do not include factors that often are associated with fraudulent transactions; such as, resale of a property and comparables during the previous year, large increases in value since the previous sale, etc. We also believe the Assessment Center should use the expanding computer technology to target properties that appear to be incorrectly valued. For example, develop or obtain access to a database system to provide a property's estimated value range based on its location.

The Assessment Center's monitoring of the quality of appraisals is to be implemented in March, 2000. These efforts are set up to better target HUD field reviews of appraisals using an automated selection system. The automated system is supposed to select appraisals for review based upon a formula using various statistical indicators including: price, value, adjustments, and comparable property proximity to the subject property.

The Assessment Center will assign contractors to perform field appraisal reviews of properties targeted by this automated selection procedure. If problems are noted, then swift enforcement action against poorly performing appraisers is supposed to be taken. However, HUD is further reviewing proposed regulations that would allow easy removal of poorly performing appraisers. As discussed previously, a concern raised by Home Ownership Center staff during our audit was the difficulty of getting rid of poorly performing appraisers and a resultant reluctance to take any action at all. It remains to be seen as to whether new regulations will be implemented to address this problem.

Auditee Comments

Management did not provide comments to address this finding.

Recommendations

We recommend the Assistant Secretary for Housing, Federal Housing Commissioner:

3A. Establish risk-based criteria for the selection of appraisals to be field reviewed; such as, properties purchased within the past few months and being resold at a significantly higher price;

3B. Establish and implement procedures that ensure all appraisals selected for field review are actually field reviewed;

3C. Establish and implement procedures that ensure the quality of Home Ownership and Real Estate Assessment Centers appraisal reviews are not sacrificed in order to meet numerical goals;

3D. Require all appraisals rated poor through desk reviews to be submitted to the Technical Assistance Branches for a determination as to whether a field review of the appraisal is warranted;

3E. Ensure the Home Ownership Centers or appropriate Real Estate Assessment Center staff effectively monitor each field review contractor’s performance, including evaluating the contractors’ work on-site by visiting appraised properties;

3F. Revise Handbook guidance to incorporate all previous handbooks and notices concerning appraisals;

3G. Establish clear guidance on what performance warrants issuing a Limited Denial of Participation sanction against appraisers, and also provides for easy removal of poorly performing appraisers from the appraiser roster; and

3H. Require a field review of the appraisal prior to endorsement. Selection of the appraisal could be made based upon data entered into HUD’s system by the lender. This information is often available days, weeks, or months prior to the case being submitted to HUD.

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Direction and Oversight of Endorsement Contractors Need Improvement

Endorsement contractors have not received adequate direction or oversight from Home Ownership Centers to properly carry out their contractual responsibilities for ensuring that loan file documents are both accurate and complete. We found instances where endorsement contractors failed to identify important document omissions and inaccuracies which should have precluded insurance endorsement. Because centers have not provided these contractors with proper guidance and have not adequately monitored their work, the risk that unacceptable loans have been and will be insured is greatly increased.

Contractor responsibilities

Although the terms of endorsement contracts varied somewhat between the three centers we reviewed, all contracts included work specifications requiring the contractors to determine that certain key loan documents were in the file prior to insurance endorsement. The contractors were also responsible for verifying the accuracy of certain loan information as included in loan file documents and as input into HUD's automated systems by lenders. The contractors were required to verify that some loan documents were in every file while other loan documents were only required under certain circumstances. Three examples of the special circumstance document requirements are:

1. A late submission letter and payment history (showing payments as current) for loans received at the center 60 or more days after closing.
2. Builder Warranties for new construction loans.
3. Gift letters for loans involving gift payments to the borrowers.

The late submission documentation is extremely important to avoid the possibility of insuring loans that have already defaulted. Builder documents are necessary to protect buyers and HUD against construction defects. The risk of default is much greater for buyers who are unhappy with their homes because of construction defects for which the builder cannot be held accountable. Gift letters represent an affirmative certification by the mortgagor and the donor that the funds have been (or will be) provided without any expectation or obligation for repayment.

Home Ownership Centers' documentation of endorsement reviews varied

At the Atlanta center, the endorsement contractors were completing a checklist for each loan evidencing their review of the file for all required documents. The checklist then became part of the loan file for Atlanta center cases. Neither the Denver nor the Santa Ana center required that the endorsement contractors prepare a checklist or other documentation demonstrating their adherence to contract requirements for determining loan file document accuracy or completeness.

The checklist procedure used by the Atlanta center did not preclude errors on the part of the endorsement contractors. It did, however, require the contractors to make a detailed affirmative statement of contract compliance for each loan file. We believe that this improves the probability that the contractors will do what they are being paid to do. The checklists also provide HUD with a means for more effectively monitoring and enforcing contract compliance.

Center monitoring of endorsement contractors was insufficient

We found weaknesses in the oversight of endorsement contractors at all three centers. HUD's right and responsibility to monitor any contractor are incorporated into the contract terms in accordance with Federal Acquisition Regulations (FAR 52.246-04) and HUD Acquisition Regulations (HUDAR 2452.246-70) under Section E - Inspection and Acceptance of Services. Common sense also dictates that appropriate monitoring be provided for any contractor working for the Federal government and receiving taxpayer funded payments.

At the Atlanta center, there was no documentation of any endorsement contractor monitoring. The Denver center had evidence of ongoing (almost daily) endorsement contractor monitoring, but it was limited to reviewing contractor responsibility for ensuring data entry accuracy and did not address loan file document completeness. The Santa Ana center performed monitoring reviews of both endorsement contractors (one time) in February 1999, but there was no subsequent formal monitoring because center staff did not believe it was warranted based on the results of the initial monitoring. Actually, the one-time review disclosed a 33 percent error rate for one endorsement contractor and a 50 percent error rate for the other. The Santa Ana center advised the contractors of the monitoring results but, in doing so, pointed out that the review was only "....a training and information exercise", and no follow up or subsequent monitoring took place.

Our review of endorsement contractors' work disclosed problems

We found problems with the endorsement contractors' work at the Atlanta and Santa Ana centers. At Atlanta we reviewed 25 cases which had been processed by the contractors and found discrepancies in 18 of the cases, or 72 percent. At Santa Ana we reviewed 30 cases for endorsement contractor compliance and found discrepancies in 4 cases, or 13 percent. We did not review any Denver cases specifically for endorsement contractor compliance, but we did identify two instances in our review of post endorsement and default cases (see Finding 1) where the endorsement contractors failed to identify missing or inadequate payment history documentation for Denver late submission cases.

The reason we were able to identify a much higher incidence of contractor error at Atlanta is because of the checklist prepared for and retained in each Atlanta case file. Most of the Atlanta endorsement contractor errors we identified were instances where the contractor failed to indicate on the checklist that they had looked for one of the special circumstance documents discussed above. Absent the checklists, we would have only been able to identify three cases where Atlanta contractors apparently failed to fully comply with their contract responsibilities, i.e. where documents were missing. The following is a tabulation of the Atlanta center endorsement contractor discrepancies for the 25 cases we reviewed.

Case Count	Case Numbers	Contractor Firm	Discrepancy (1)	(2)	(3)	(4)	(5)	(6)
1	101-875334-2	MS	X	X	X			
2	153-008067-9	MS			X	X	X	
3	101-863907-3	MS	X					
4	101-856754-3	MS	X					
5	153-007806-9	MS	X					
6	281-265132-6	MS	X					
7	281-264639-0	MS	X					
8	101-838671-5	MS	X					
9	101-854402-0	MS			X			
10	153-007799-9	MS					X	X
11	101-877095-8	MS					X	
12	281-265656-2	MS					X	
13	483-269168-2	HOR	X					
14	483-270850-0	HOR			X			
15	092-781873-0	HOR					X	
16	092-799880-1	HOR					X	
17	501-576472-0	HOR	X				X	
18	092-802311-5	HOR					X	
		Discrepancy Count	9	1	4	1	8	1

Item

(1) Checklist indicates file was not checked for required late submission documents.
(2) Required late submission documents were not in case file.
(3) Checklist indicates file was not checked for required builder documents (new construction).
(4) Required builder documents were not in the case file.
(5) Checklist indicates file was not checked for required gift letter.
(6) Required gift letter was not in the case file.

This schedule demonstrates that in most instances where special circumstance documents were required, the endorsement contractors did not recognize the requirement (although the documents normally were in the file.) Although this review did not disclose a significant incidence of actual missing documents, the apparent fact that the contractors were not looking for these documents represents a significant weakness in the single family direct endorsement process. This is particularly true with regard to late submission documents since HUD could be insuring loans that have already defaulted.

At the Santa Ana center we only identified four incidences of endorsement contractor error in the 30 cases we reviewed and three of those were mortgagee data entry or document data errors. However, the fourth case was another late submission without appropriate payment history documentation. Since Santa Ana and Denver endorsement contractors did not prepare a checklist or other detailed record of their case file reviews the centers are limited in their ability to identify contractor noncompliance.

Several factors contributed to poor contractor performance

In our opinion, the absence of ongoing comprehensive monitoring with appropriate follow-up may have conveyed the impression to endorsement contractors that HUD does not care whether they actually do what they are being paid to do. Endorsement contractor staff at two of the three centers also indicated that one of the main problems they have in conducting their work has been the inconsistent and ever changing informal instructions they receive from the centers. There are also both financial and administrative disincentives for the contractors to do a good job.

The endorsement contractors for all three centers have been paid on a per case basis ranging from $3.13 to $4.60. Contractors for two of the centers can only receive payment for a case one time no matter how many times they process it. The endorsement contract for the Denver center provides for full payment on Notice of Rejects, but limits the payment of Rejects to no more than five percent of total cases processed monthly. Therefore, the contractors actually lose money (or reduce profits) whenever they reject a case (Atlanta and Santa Ana) or when they reject too many cases (Denver).

Finally, the only real feedback endorsement contractors get relative to their handling of individual cases is when lenders complain about Rejects. If they endorse cases that should not be endorsed, nobody complains; but if they reject cases, the lenders complain.

Although endorsement contractor duties are admittedly less critical than those of post-endorsement contractors in limiting risk to the single family direct endorsement origination process, they are nevertheless very important. Inadequate direction and oversight of endorsement contractors by HUD contributes to poor contractor performance and increases the risk that unacceptable loans have been and will be insured.

Auditee Comments

Management did not provide comments to address this finding.

Recommendations

We recommend the Assistant Secretary for Housing, Federal Housing Commissioner:

4A. Establish uniform comprehensive endorsement contractor monitoring procedures that address the contractors' responsibilities for determining both data accuracy and document completeness;

4B. Revise endorsement contract specifications to eliminate any financial disincentive for rejecting cases and to provide some form of financial incentive for doing a good job as determined through the new comprehensive monitoring procedure;

4C. Revise endorsement contracts to require the preparation of a checklist or other detailed affirmative statement of contract compliance for each loan file; and

4D. Take timely and appropriate action against poorly performing contractors up to and including contract termination.

Quality Assurance Divisions Did not Maintain Accurate Data Documenting the Status and Results of Their Reviews

The Approval/Re-certification/Review Tracking System (ARRTS) database used to track the status and results of Quality Assurance Division reviews contained significant errors and; therefore, did not provide sufficient accountability for audit and staff evaluation purposes as required by the Quality Assurance Division Guide. We attributed this deficiency to a lack of uniform procedures and controls for review status and results reporting. The ARRTS contained a significant number of errors at the Atlanta and Santa Ana Home Ownership Centers relating to the reported number of indemnification agreements, number of loans reviewed and letters sent to lenders. As a result of these inaccuracies, clear and accurate data was not available to monitor the scope and results of reviews and their effectiveness may have been overstated.

What is the tracking system (ARRTS)?

ARRTS is a database used to track the status and results of Quality Assurance Division monitoring reviews. This system contains data fields including, review start date, review status (open/closed), number of loans reviewed, and number of indemnification agreements. Quality Assurance field monitors complete a form that is later used by Quality Assurance staff at the related center to enter data about the review into the tracking system. The Quality Assurance Division Guide requires all centers to use the tracking system and to maintain consistent and accurate data for audit and staff evaluation purposes. Properly used, the system should provide a measure of Quality Assurance effectiveness in reducing the Department's potential for losses (based on the number of indemnification agreements executed.)

The number of indemnification agreements reported was overstated

According to Quality Assurance staff at the Santa Ana and Atlanta centers, the number of indemnification agreements shown in the tracking system for a review in "open" status represents the number of agreements requested when field work is completed. When a case is closed, the number of indemnification agreements should be adjusted to reflect the actual number executed. We found the number of requested indemnification agreements was not always correct or was not changed when a review was closed to reflect the actual number of agreements executed.

Santa Ana

We reviewed a non-statistical random sample of 21 Santa Ana Quality Assurance case files in closed status and compared information in the files to data reported in the tracking system. We found the number of indemnification agreements in the tracking system was overstated in three of the 21 (14.3 percent) cases by a total of 20 agreements (500 percent of actual agreements executed for these files). During other field work at Santa Ana, the following tracking system reporting errors relating to the reported number of indemnification agreements for two other reviews were also noted:

- For one closed review, (File # 7870) the number of indemnification agreements was overstated by four. The tracking system reported four agreements when zero were executed.
- For one open review, (File # 8025) the number of requested indemnification agreements in the tracking system was overstated by 12. The system reported 15 indemnification requests when the file indicated only three.

We did not find any instances where accomplishments were understated in the tracking system at Santa Ana.

Atlanta

We reviewed a non-statistical random sample of 20 Atlanta Quality Assurance case files in closed status and compared information in the files to data reported in the tracking system. We found the number of indemnification agreements was overstated in four of the 20 (20 percent) cases by a total of eight agreements (114 percent of actual agreements executed for these files).

We also reviewed a list provided by Atlanta showing 35 closed Atlanta Quality Assurance reviews that resulted in at least one actual indemnification agreement. We compared this list to data reported in the tracking system and found the system overstated the number of indemnification agreements in nine of the 35

(25.7 percent) cases by a total of 44 agreements (50 percent of the actual number of agreements for these cases). The tracking system understated the number of agreements in three cases by a total of five agreements. These errors resulted in a net overstatement of 39 indemnification agreements (44.3 percent of the actual agreements for the 35 reviews).

ARRTS was not properly updated to show all letters sent to lenders

We judgmentally selected six Atlanta Quality Assurance review files and requested a statement on what action had been taken for the reviews. Based on the response from Atlanta Quality Assurance staff, we concluded the tracking system was not properly updated in at least four of the six reviews to reflect response letters sent to lenders. Since the letters sent were not shown, the reviews appeared in the system as in open status when, in fact, the reviews were closed, or the reviews appeared to have no follow up action taken by Quality Assurance when a follow up letter had actually been sent.

The number of loans reported as reviewed was inaccurate

The tracking system has a field for the number of loans examined during each Quality Assurance review. Based on a review of Atlanta and Santa Ana Quality Assurance files, we found the number of loans reviewed was not reported in the system in a consistent manner. The number of detailed loan reviews was often added to the number of "recently closed and rejected" loan reviews that were very limited in scope. For other files, the number of recently closed and rejected loan reviews was not included in the reported number of loans reviewed. This inconsistent method of reporting (total loans reviewed does not always include recently closed and rejected loans) along with the combined reporting of reviews that vary significantly in scope (full versus recently closed and rejected reviews) results in misleading reporting of work performed.

Unexplained reporting errors were also found in the tracking system that did not relate to the inconsistent reporting of reviews that varied in scope.

We found the number of loans the system showed as reviewed by Atlanta was overstated by 130 (61 percent of the number of full loan reviews for these files). Similarly for Santa Ana the system overstated the number of loans reported as reviewed 273 (91 percent of the number of full loan reviews for these files). These overstatements were due to inconsistent reporting and reporting errors. Examples of these overstatements include:

- Atlanta Quality Assurance review # 8242 included a full review of only two loans, yet the system showed reports 22 loans were reviewed.
- Atlanta Quality Assurance review # 7795 included a full review of only four loans, yet the system reported 19 loans were reviewed.
- Atlanta Quality Assurance review # 7794 included a full review of only seven loans. The system reported 27 loans were reviewed.
- Santa Ana Quality Assurance review # 7824 included a full review of only five loans. The system reported 15 loans were reviewed.

We noted other system reporting errors relating to the number of cases reviewed that were consistent with the pattern of overstatements we identified. For example:

- For one open Santa Ana QAD review, (File # 7829) the number of defaulted cases reviewed was overstated by approximately 145. The tracking system reported 16 total loans reviewed during this five day review, however, the system also showed 161 defaulted cases were reviewed.

We attributed the tracking system reporting errors to a lack of uniform standards for system reporting and a failure to input and maintain consistent and accurate data from review files.

Auditee Comments

Management did not provide comments to address this finding.

Recommendations

We recommend the Assistant Secretary for Housing, Federal Housing Commissioner:

5A. Establish standards and implement controls to ensure the accuracy and consistency of data reported in the ARRTS system.

Management Controls

In planning and performing our audit, we obtained an understanding of the management controls applicable to single family loan originations that were relevant to the audit. Management is responsible for establishing effective management controls. Management controls, in the broadest sense, include the plan of organization, methods, and procedures adopted by management to ensure that its goals are met. Management controls include the processes for planning, organizing, direction, and controlling program operations. They include systems for measuring, reporting and monitoring program performance.

Relevant Management Controls

We determined that the following management controls were relevant to our audit objectives:

- Post-endorsement technical reviews;
- Quality Assurance Division monitoring reviews;
- Pre-endorsement screening;
- Pre-closing reviews;
- Credit Watch program;
- Homebuyer Protection Plan;
- Mortgagee Review Board; and
- Automated underwriting

We reviewed the first four listed management controls, but made only a limited review of the last four.

It is a significant weakness if management controls do not provide reasonable assurance that control objectives are met.

Significant Weaknesses

Based on our review, we believe the following items are significant weaknesses:

- Post-endorsement technical reviews have been ineffective for identifying poor underwriting, bad appraisals and cases exhibiting indications of fraud. Neither have they been used properly by HUD to take appropriate sanctions or other corrective actions against poorly performing lenders or appraisers (see Findings 1 and 3).

- Quality Assurance Division reviews have not been properly targeted at the worst performing (highest risk) lenders (see Finding 2).

We believe the deficiencies discussed in Findings 1, 2 and 3 of this report constitute material control weaknesses under the Federal Managers' Financial Integrity Act. As such, these weaknesses should be disclosed in the Department's annual assurance statement to the President and Congress.

Follow Up On Prior Audits

There have been several prior audit reports containing findings that are relevant to this audit. These reviews consistently identified deficiencies in the loan origination process, including underwriting, appraisals, and use of sanctions.

- OIG audit (Report Number 93-HQ-121-0012, dated April 30, 1993) of the direct endorsement program included the following three findings:

  1. HUD post-endorsement reviews do not consistently ensure quality underwriting.
  2. Sanctions were not effectively used to protect the integrity of the direct endorsement program.
  3. The direct endorsement underwriter approval process was not effective.

- A General Accounting Office audit (Report Number 97-176, dated July 25, 1997) on the Federal Housing Administration's new single family appraisal process stated, "...no assurance exists that the Federal Housing Administration can monitor the quality of appraisers and identify Federal Housing Administration lenders with deficient appraisal practices."

- A General Accounting Office audit (Report Number 99-72, dated April 16, 1999) on HUD's oversight of the Federal Housing Administration appraisal process concluded that HUD did not adequately monitor appraiser performance and did not hold either the appraisers or lenders accountable for poor appraisals.

- A General Accounting Office audit (Report Number 99-124, dated June 14, 1999) on the 203(k) home rehabilitation loan program reported that HUD does not adequately ensure that lenders comply with the program guidelines and does not target the admittedly risky 203(k) loans for post-endorsement technical reviews or mortgagee quality assurance reviews.

  An audit of the Federal Housing Administration's 1998 financial statements, performed by KPMG, LLP (Report Number 99-FO-131-0002, dated March 12, 1999) concluded that,

"...there was little analysis and lender follow up based on the results of (post-endorsement technical) reviews, even though certain lenders were identified with risky underwriting practices." The audit of the 1999 financial statements (Report Number 00-FO-131-0002, dated February 29, 2000) reported that post-endorsement technical reviews still needed to be improved. As in the prior audit, the February 29, 2000 report stated that "…there was little analysis and lender follow-up based on the results of these reviews, even though certain lenders were identified with inadequate underwriting practices."

As discussed in detail in the Findings and Recommendations section of this report, the conditions cited in our original audit of the Direct Endorsement program (Report No. 93-HQ-121-0012) continue to be unresolved. Findings 1 and 2 of the original report were classified as material weaknesses reportable under the Federal Managers' Financial Integrity Act. We found the same weaknesses existed during the current review and have classified Findings 1, 2, and 3 of this report as material weaknesses.

Scope Limitation

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-4500

OFFICE OF THE INSPECTOR GENERAL

MAR 2 4 2000

MEMORANDUM FOR: Frederick Douglas, Deputy Assistant Secretary for Single Family Housing, HU

Kathryn Kuhl-Inclan

FROM: Kathryn Kuhl-Inclan, Assistant Inspector General for Audit, GA

SUBJECT: Draft Internal Audit of Single Family Production Home Ownership Centers

This is to advise you that we will issue the subject draft report without Housing's comments and without an exit conference.

We transmitted our draft audit report for comments on February 9, 2000 and it was received by your office the next day. We requested comments by March 13, 2000. This allowed 32 calendar days for response. When we did not receive the comments, we notified your office that we needed them by March 17, 2000 to ensure their inclusion in the final report. Your office informed us that we would be given comments no later than March 20th. As of today, we have not received written comments.

We initially scheduled an exit conference for Wednesday, March 16, 2000. Your office later rescheduled the exit conference for March 22, 2000. When my staff arrived for the exit conference on March 22, 2000, they were advised the exit conference was canceled because your staff were busy with Congressional appropriation hearings. Four of my staff, two from California and two from Phoenix, unnecessarily traveled to Headquarters for the scheduled conference. While your office knew for many weeks that Congressional hearings were scheduled for March 22, 2000, no one tried to cancel the meeting until March 21, 2000, after my staff was already en route to Washington, DC. Based on numerous unsuccessful attempts made by my office, I believe the OIG has provided Housing ample opportunity to provide comments and schedule an exit conference.

As required by Generally Accepted Government Auditing Standards, paragraph 7.25, the OIG's attempts to obtain written comments or conduct an exit conference to obtain oral comments will be included in the final report as a scope limitation. A copy of this memorandum will be included in our final report.

This audit is a comprehensive assessment of the single family origination program. It identifies serious internal control weaknesses in many aspects of the program that need immediate attention. We believe auditee comments are important in that they provide for management's assessment of the findings and allow you to suggest alternate recommendations that could correct the weaknesses identified. Your programmatic insight and knowledge of future organizational plans would have been beneficial in finalizing this report.

If you have any questions, please call me on 708-0364.

cc: William Apgar, Assistant Secretary for Housing, Federal Housing Commissioner, H

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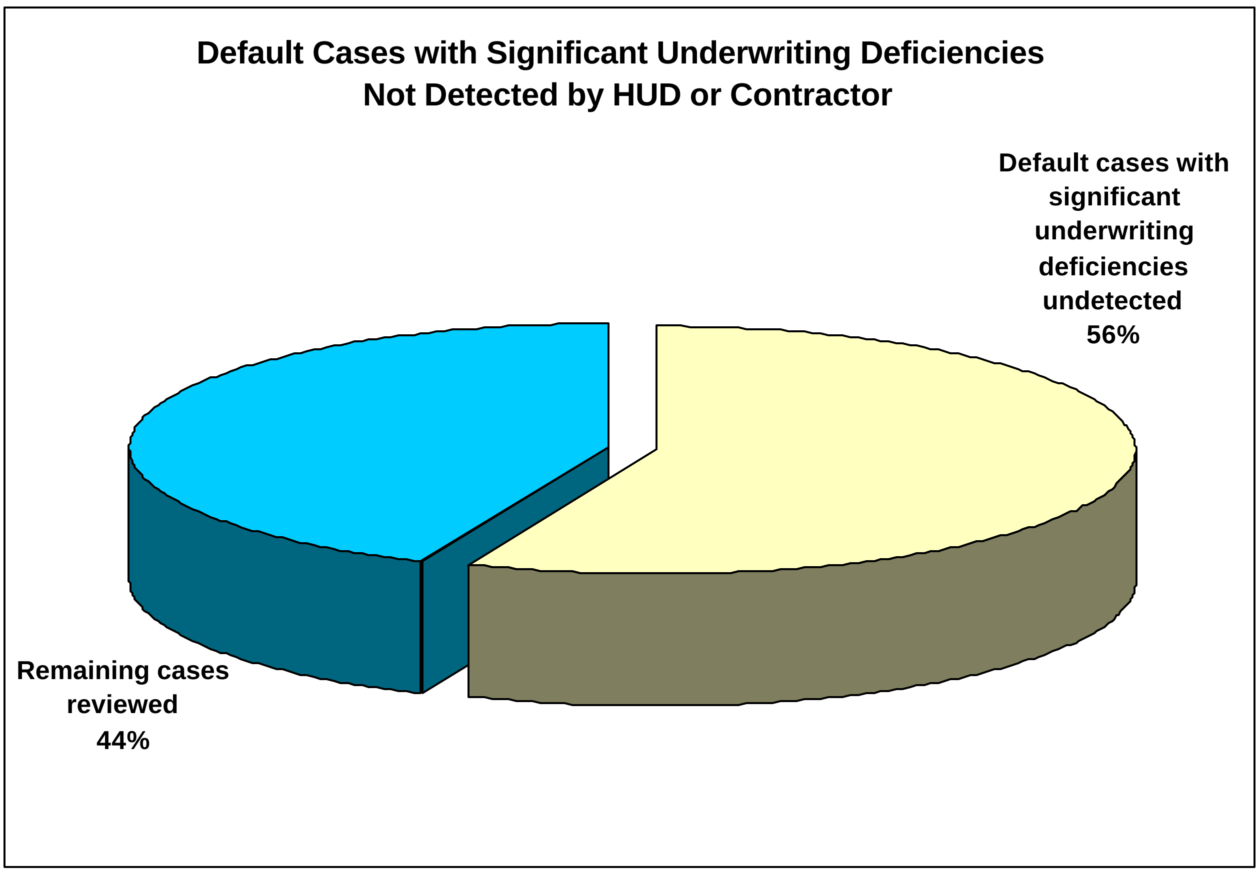
Defaulted Cases with Significant Underwriting Deficiencies Not Detected by HUD or Contractor

HOC	Santa Ana	Denver	Atlanta	Philadelphia	Total
Number of cases reviewed by OIG	**24**	**22**	**20**	**19**	**85**
Defaulted cases with significant underwriting deficiencies not detected by HUD or contractor	14	13	11	10	48
Percent	**58.3%**	**59.1%**	**55.0%**	**52.6%**	**56.5%**



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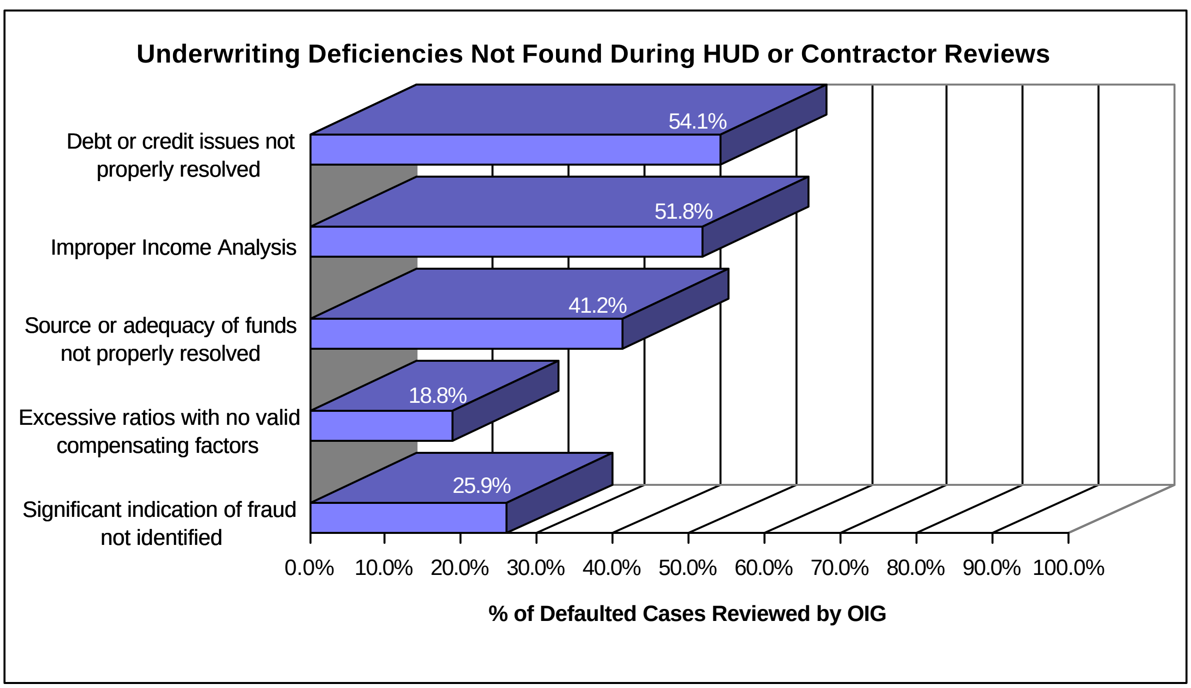
Types of Underwriting Deficiencies Not Detected by HUD or Contractor

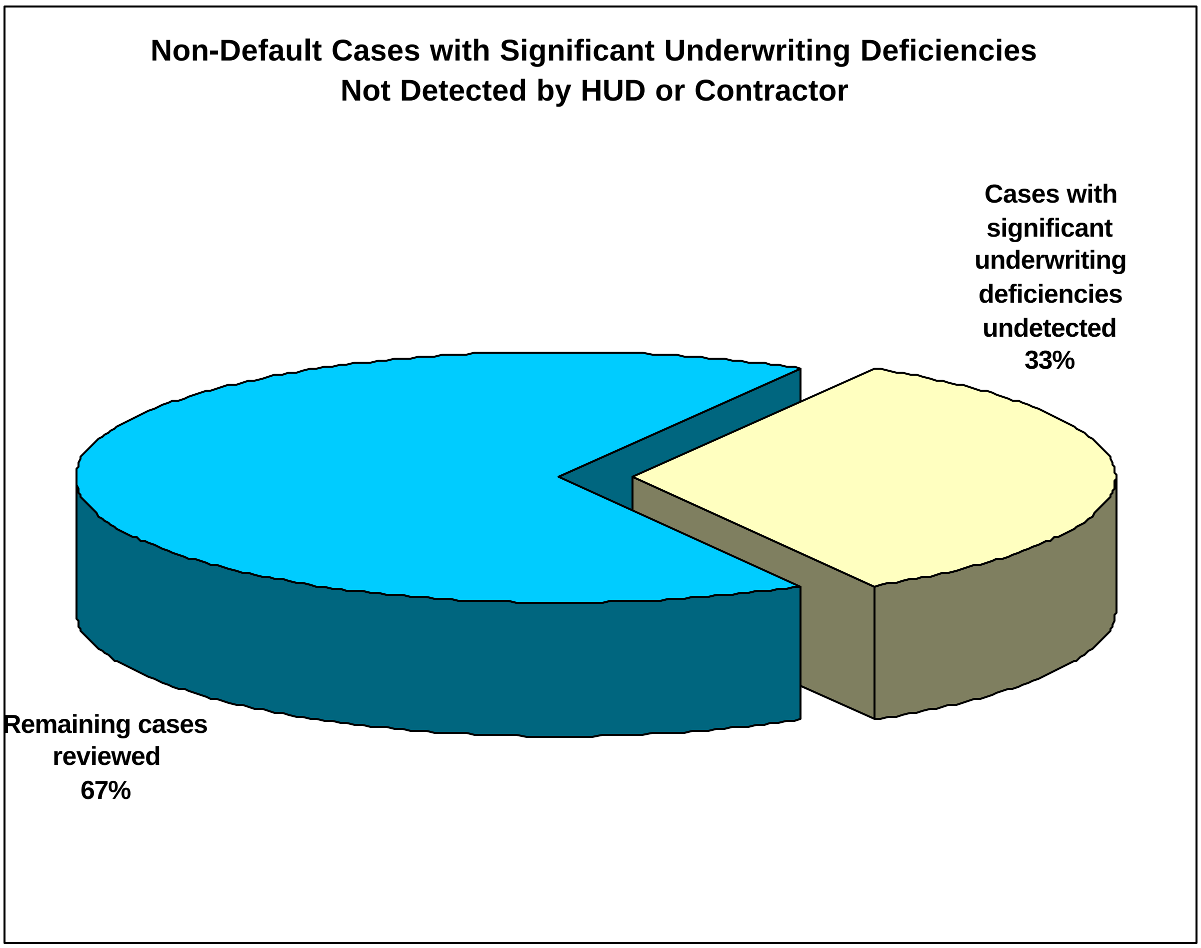
(Defaulted case files reviewed)

HOC	Santa Ana	Denver	Atlanta	Philadelphia	Total
Number of cases reviewed by OIG	**24**	**22**	**20**	**19**	**85**
UNDERWRITING DEFICIENCIES					
Significant indication of fraud not identified	10 **41.7%**	2 **9.1%**	6 **30.0%**	4 **21.1%**	22 **25.9%**
Excessive ratios with no valid compensating factors	7 **29.2%**	2 **9.1%**	3 **15.0%**	4 **21.1%**	16 **18.8%**
Source or adequacy of funds not properly resolved	12 **50.0%**	9 **40.9%**	8 **40.0%**	6 **31.6%**	35 **41.2%**
Improper Income Analysis	12 **50.0%**	12 **54.5%**	10 **50.0%**	10 **52.6%**	44 **51.8%**
Debt or credit issues not properly resolved	11 **45.8%**	15 **68.2%**	8 **40.0%**	12 **63.2%**	46 **54.1%**



Non-Defaulted Cases with Significant UnderwritingDeficiencies Not Detected by HUD or Contractor

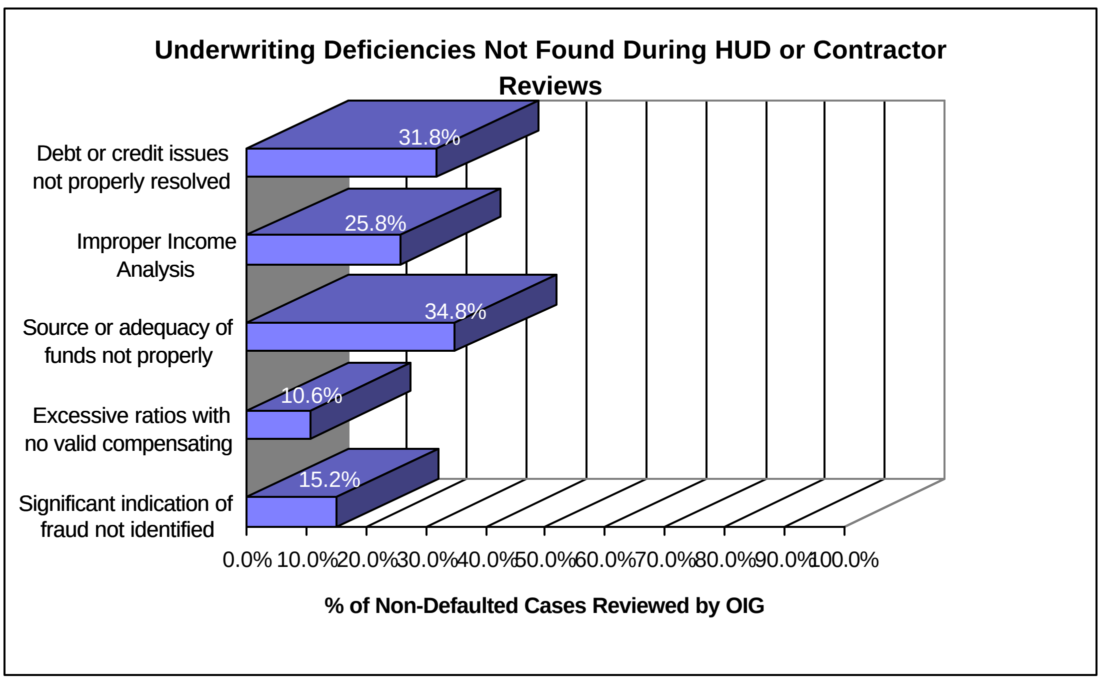
HOC	Santa Ana	Denver	Atlanta	Philadelphia	Total
Number of cases reviewed by OIG	**30**	**17**	**19**	**0**	**66**
Non-Defaulted cases with substantial underwriting deficiencies not detected by HUD or contractor	9	10	3	0	22
Percent	**30.0%**	**58.8%**	**15.8%**	**0%**	**33.3%**



Types of Underwriting Deficiencies Not Detected by HUD or Contractor

(Non-Defaulted case files reviewed)

HOC	Santa Ana	Denver	Atlanta	Philadelphia	Total
Number of cases reviewed by OIG	**30**	**17**	**19**	**0**	**66**
UNDERWRITING DEFICIENCIES					
Significant indication of fraud not identified	5 **16.7%**	4 **23.5%**	1 **5.3%**	0 **0%**	10 **15.2%**
Excessive ratios with no valid compensating factors	6 **20.0%**	1 **5.9%**	0 **0%**	0 **0%**	7 **10.6%**
Source or adequacy of funds not properly resolved	13 **43.3%**	9 **52.9%**	1 **5.3%**	0 **0%**	23 **34.8%**
Improper Income Analysis	7 **23.3%**	6 **35.3%**	4 **21.1%**	0 **0%**	17 **25.8%**
Debt or credit issues not properly resolved	10 **33.3%**	7 **41.2%**	4 **21.1%**	0 **0%**	21 **31.8%**



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