Department of Housing and Urban Development
Office of Inspector General

Audit Related Memorandum
00-SF-121-0802

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U.S. Department of Housing and Urban Development
Office of Inspector General
Pacific/Hawaii District
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Audit Memorandum
No.00-SF-121-0802

April 6, 2000

TO: Joseph C. Bates, Acting Director, Santa Ana Homeownership Center, 9JHH

Roger E. Niesen

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

SUBJECT: Internal Audit - Single Family Housing
Los Angeles Area Office and Santa Ana Homeownership Center
Santa Ana, California

INTRODUCTION

We completed a limited review of the Los Angeles Area Office and Santa Ana Homeownership Center's single family housing loan production operations. The purpose of our review was to determine whether the Office and Center implemented management controls needed to adequately oversee mortgagees' loan origination practices and compliance with HUD regulations and requirements. Specifically, we determined whether the existing controls would have been sufficient to have detected and/or corrected apparent irregularities in loans originated by a mortgagee, Allstate Mortgage Company (Allstate).

On March 30, 2000, we issued to the Assistant Secretary for Housing/Federal Housing Commissioner, a nationwide audit report disclosing the results of an internal audit of Single Family Production Homeownership Centers, including Santa Ana. The recommendations contained in that report are similar to the recommendations in this memorandum; however, this memorandum is being issued to the Santa Ana Homeownership Center because it gives details on the fraudulent scheme that occurred and provides the Center the opportunity to initiate immediate corrective actions.

SUMMARY

Based on our review of Federal Housing Administration-insured loans originated by Allstate and an evaluation of mortgagee monitoring practices, we determined that the Los Angeles Area Office and

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Santa Ana Homeownership Center did not implement the management controls needed to adequately oversee mortgagees' loan origination practices and compliance with HUD regulations and requirements. The same mortgagee monitoring practices that allowed Allstate to generate fraudulent loans while under the purview of the Los Angeles Office continued to exist, but to a lesser extent, at the Santa Ana Homeownership Center after it assumed responsibility for loan origination. If adequate controls were in place, Allstate's fraudulent loan origination scheme would have been detected earlier and the damage resulting from it could have been significantly reduced.

In our opinion, the problems occurred due to the turmoil resulting from the implementation of HUD's 2020 Management Reform Plan and a policy change that was designed to achieve targeted staff reductions and streamline program operations. The policy change was instituted to enable HUD field offices to operate their single family loan programs with fewer staff and less direct monitoring of direct endorsement lenders by doing away with the individual "report cards". The "report cards" were previously sent to the underwriters informing them of the results of post-endorsement technical reviews. The Los Angeles Field Office's staff misinterpreted the policy change to mean follow-up on poorly originated loans with direct endorsement lenders was no longer required. This misinterpretation and resulting inaction to take follow-up thwarted the Office's ability to detect and act on improperly and, in the case of Allstate, fraudulently originated loans. Additionally, the Homeownership Center did not implement needed management controls to oversee mortgagees' lending practices and ensure compliance with HUD's requirements.

As a result of the Los Angeles Office's inaction, the Federal Housing Administration insurance fund was exposed to potential and actual losses attributable to 427 fraudulent loans totaling $97 million. The loans were originated by Allstate during the period June 1996 through July 1997. In addition, Allstate used strawbuyers[1] to approve HUD-insured loans on properties that were later rented to low- and moderate-income tenants. The tenants had to cope with the termination of their utility services, deferred maintenance problems, and health and safety building code violations. These problems were inevitable because the property owners, by design of the Allstate scheme, did not pay utility and mortgage expenses, nor make needed repairs.

On January 21, 2000, we provided a copy of our draft report to Santa Ana Homeownership Center officials for their review and requested that they provide us with their comments by February 25, 2000. HUD's Office of the Deputy Assistant Secretary for Single Family Housing in Headquarters, however, required Center officials to provide Headquarters with the comments for Headquarters review prior to release to OIG. As of April 5, 2000 the comments were not provided to OIG. In a March 27, 2000 exit conference, we discussed the results of our audit with Santa Ana Homeownership Center officials. The officials generally agreed with the finding and recommendations and provided oral comments. We have included their verbal comments in the memorandum.

[1] Not bonafide loan applicants

BACKGROUND

Direct Endorsement Program

The National Housing Act (12 U.S.C. 1709) authorizes the Federal Housing Administration to insure mortgage loans made by private lending institutions to buyers of single-family homes. In 1983, the Federal Housing Administration implemented the Direct Endorsement Program, which authorized Federal Housing Administration-approved lenders to underwrite and close insured loans without the Federal Housing Administration's prior review and approval. Presently, direct endorsement lenders underwrite almost all insured single-family mortgages. Underwriting usually includes determining the borrower's willingness and ability to repay the loan and reviewing and approving appraisals that establish the value of the property to be mortgaged.

HUD's procedures for cases submitted under the Direct Endorsement Program consist of two processing cycles. The first is the pre-endorsement review which for an acceptable submission, results in the endorsement of the mortgage. The second is the post endorsement technical review.

The pre-endorsement review is cursory, and no further review is required or authorized prior to endorsement unless HUD has reason to suspect fraud in the origination process.

The post-endorsement technical review of mortgagee underwriting is critical to the success of the Direct Endorsement Program. Post-endorsement technical review consists of desk reviews of mortgage credit and valuation underwriting, and field reviews of appraisals. Since underwriting decisions rely heavily on the subjective interpretation of the mortgagee, it is imperative that Homeownership Centers identify and respond to underwriting problems. In order to accomplish this, Homeownership Centers review how the underwriter, the appraiser, and the mortgage credit examiner, arrived at a decision, whether problems were addressed, and whether reasonable conclusions were made.

Based upon these reviews, Homeownership Centers must provide meaningful, constructive and legible comments to ensure that quality underwriting is maintained in the future and that irregularities are identified and acted on. HUD instructions require the following reviews to be performed, most of which are performed by technical review contractors:

- *Desk Reviews* - HUD's computer system selects about ten percent of each mortgagee's cases for desk reviews. A Homeownership Center contractor desk reviews and rates the quality of the appraisal, the mortgage credit processing, and the underwriting. Rating levels of Good, Fair, or Poor are given based on the review. A poor rating is given for any deficiency that results in a significant increase in mortgage risk, through either greater credit risk or a decrease in property security.

- *Field Reviews* - Field reviews consist of senior review appraisers going on-site to verify the reasonableness of previously completed appraisals. It is essential that about ten percent of appraisals be field reviewed by a senior review appraiser or designee. Five percent of each

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appraiser's work should be field reviewed. Appraisals that were judged poor based on a desk review should be field reviewed.

- *Supervisory Reviews* - A supervisor, or designee, should review all "poor" and a representative sample of "good" and "fair" post-endorsement technical review ratings in order to ensure compliance with review guidelines. The supervisor or designee should document and maintain a record of problems associated with all review ratings categories that are useful in managing the quality of the reviewer's work.

Santa Ana Homeownership Center

On March 31, 1998, the Los Angeles Area Office's Single Family Division became part of the Santa Ana Homeownership Center. The Santa Ana Homeownership Center began operations in February 1998, and within the first year of its operation, insured 272,688 loans.

Each Homeownership Center is responsible for day-to-day monitoring of loan origination practices for single family mortgagees within its jurisdiction. Homeownership Centers monitor the performance of mortgagees, underwriters, and mortgagees' technical staff primarily through the use of contractors who review cases during post-endorsement technical reviews. Also, Homeownership Centers monitor mortgagees by analyzing quality control reports, following up on construction complaints or consumer complaints, and sharing information with their Quality Assurance Divisions, the Enforcement Centers, and the Housing Civil Penalties Panel. Further, a Homeownership Center's Quality Assurance Division, a subdivision of the Office of Lender Activities, monitors the origination and servicing performance of HUD-approved mortgagees.

Allstate Mortgage Company's Loan Origination Scheme

Allstate Mortgage Company set up straw companies to enter into purchase agreements to acquire apartment buildings, typically worth $100,000 to $180,000. It then hired its own appraisers who inflated the value of the buildings, usually from $100,000 to $150,000 greater than the actual market value of the properties. It also instructed appraisers to certify that properties contained four residential units even though many had more than four units. Allstate knew under the single family insurance program HUD only insured mortgages on properties with four or fewer units. Allstate then recruited low-income individuals (strawbuyers) to apply for Federal Housing Administration-mortgages that were inflated by as much as $150,000 more than the actual property values. As part of the scheme, Allstate filed false sales agreements and loan applications at the inflated property values. At the time the Federal Housing Administration-insured loans were funded, Allstate simultaneously closed on its original purchase of the properties for the actual price, pocketed the difference between its actual purchase price and the insured loan proceeds, and then sold the fraudulent loans to legitimate mortgage companies.

AUDIT PURPOSE, SCOPE AND METHODOLOGY

The purpose of our review was to determine: (1) whether the Santa Ana Homeownership Center implemented management controls to adequately oversee mortgagees' lending practices and compliance with HUD regulations and requirements, (2) whether the implementation of any controls would have been sufficient to have detected and/or corrected apparent irregularities in loans originated by Allstate, and (3) the impact that changes in regulatory or program requirements, organizational structure, and staffing had on management control weaknesses that may have contributed to the problems involving Allstate.

In order to accomplish our audit objectives we:

- reviewed relevant HUD Handbooks, and Mortgagee Letters to gain an understanding of the program requirements and major changes since 1993;

- interviewed the available HUD director/staff formerly responsible for the Los Angeles Area Office's operations and the director/staff responsible for the Santa Ana Homeownership Center's operations and reviewed their policies, procedures, and practices pertinent to the processing of the loans;

- reviewed the technical review contracts for compliance with HUD requirements;

- reviewed documents and reports pertaining to HUD's processing and oversight of contractors who performed the endorsement and post technical reviews of the Federal Housing Administration insured loans originated by Allstate; and

- interviewed the contractors who performed the post technical reviews of the Allstate cases.

The audit generally covered the period June 1996 through December 1998. The audit was conducted according to generally accepted government auditing standards.

FINDING

The Federal Housing Administration Insurance Fund Was Exposed to Potential And Actual Losses

The Federal Housing Administration insurance fund was exposed to potential and actual losses attributable to fraudulent loans totaling $97 million originated by a mortgagee, Allstate Mortgage Company. The problems occurred because of HUD's reduction in staffing and a program policy change that was unclear. Our review of mortgagee monitoring practices disclosed HUD's Los Angeles Area Office Single Family Division and Santa Ana Homeownership Center did not implement needed management controls to adequately oversee mortgagees' lending practices and ensure compliance with HUD's requirements. As evidenced by our review of fraudulent Federal Housing Administration-insured loans originated by Allstate, the Los Angeles Area Office and its Government Technical Representative did not:

- perform the required field and supervisory reviews of property appraisals in cases rated as "poor" by a HUD technical review contractor for valuation services;
- evaluate or take corrective action on ratings and comments by a HUD technical review contractor for cases rated as "poor" due to faulty appraisals; and,
- conduct critical supervisory reviews of technical review contractor's mortgage credit underwriting reviews that would have identified the fraudulent nature of the loans.

As a result of HUD's reorganization, Los Angeles Area Office's Single Family Division was merged in 1998 into a newly organized HUD component, the Santa Ana Homeownership Center. The same mortgagee monitoring practices that allowed Allstate to generate the fraudulent loans, however, continued to exist at the Santa Ana Homeownership Center, but to a lesser extent.

In our opinion, the problems occurred due to the turmoil resulting from the implementation of HUD's 2020 Management Reform Plan and a HUD policy change that was designed to achieve targeted staff reductions and streamline program operations. The Los Angeles Area Office responded to HUD's reforms by reducing its staff by more than 60 percent and implementing HUD's policy change. The policy change eliminated individual ratings of mortgage underwriters and was instituted to enable HUD field offices to operate their single family loan programs with less staff and less direct monitoring of direct endorsement lenders. The HUD field office staff believed the change meant follow-up on poorly originated loans with direct endorsement lenders was no longer required. The staff's interpretation resulted in a lack of follow-up, and thwarted the staff's ability to detect improperly and, in the case of Allstate, fraudulently originated Federal Housing Administration-insured loans.

In addition, since Allstate used strawbuyers to approve Federal Housing Administration-insured loans on properties that were later rented to low- and moderate-income tenants, the tenants had to cope with the termination of their utility services, deferred maintenance problems, and health and safety building code violations. These problems were inevitable because the property owners, by design of the Allstate scheme, did not pay utility and mortgage expenses, nor make needed repairs.

HUD Did Not Perform Required Field and Supervisory Reviews

Contrary to HUD's handbook requirements, the Los Angeles Area Office and the Government Technical Representative did not conduct the required field and supervisory valuation underwriting reviews of a Technical Review Contractor's ratings for Federal Housing Administration insured loans originated by Allstate. In addition, the Los Angeles Area Office and the Government Technical Representative generally did not ensure Allstate's compliance with HUD's valuation underwriting requirements.

To streamline its single family development operations, HUD established a policy change and issued Mortgagee Letter 96-5. The Letter permitted lenders, such as Allstate, to select the appraisers of their choice to value single family properties to be insured by HUD. The decision to allow lenders to select appraisers, delegated/transferred HUD's system of control to the industry. To mitigate this transfer of control, HUD increased its percentage of required field reviews of appraisals from five to 10 percent of endorsed loans.

The Los Angeles Area Office, however, did not perform the required field reviews for Allstate cases, even though the Technical Review Contractor assigned appraisal desk review ratings of "Poor" for 15 of the 17 sampled cases. The Contractor concluded that Allstate's appraisals were overvalued in 11 cases, unsupported in 10 cases, and based on distant and/or dissimilar comparable properties in eight cases.

HUD Handbook 4000.4, Rev-1, Change 2, Paragraph 4-9.D(4), says "Appraisals that were judged poor based on the desk review should be field reviewed. It is important that at least five percent of every appraiser's work is reviewed and that the work of every mortgagee is analyzed." The field reviews measure the quality of the appraiser's performance. The purpose of the field reviews is to assure that the appraiser followed accepted appraisal techniques and arrived at a logical conclusion, including value determination and property eligibility.

Paragraph 4-9.A(5) of the same handbook says a supervisor, or designee, should review a representative sample of "Good" and "Fair", and all "Poor" post endorsement technical review ratings in order to ensure reviewers' compliance with review guidelines.

<u>Field Reviews of Completed Appraisals Were Not Conducted</u>

Los Angeles Area Office staff said field reviews of completed appraisals were not performed from October 1996 through June 1997. The staff attributed this to: (1) HUD's policy to downsize its program staffing, (2) their inability to secure a contractor for the field reviews of appraisals, and (3) HUD's indecisiveness over whether the San Francisco or the Denver field offices would be responsible for contract administration. HUD's failure to act promptly on these matters exposed the agency to fraud and abuse and unnecessary losses to the insurance fund. We believe, had the Los Angeles Area Office performed the required field reviews of the Allstate cases rated “poor” during the desk review, it would have identified the fraudulent nature of the appraisals and could have taken action to terminate Allstate’s scheme.

The Los Angeles Area Office’s Chief of Production Division said during and after the period of the Allstate scheme, his staff of 15 shrunk to five. He said the substantial staff reduction undermined the Division's operations and only left a skeleton crew to process thousands of loans within their jurisdiction with no time to perform field appraisal reviews.

Government Technical Representative Did Not Perform Required Supervisory Reviews Of Property Appraisals Or Provide Technical Direction

The Government Technical Representative’s role includes the day-to-day monitoring of the contractor's performance, providing direction to the contractor, determining whether HUD regulations are followed and that loans are an acceptable risk, and ensuring contractors’ reviews are adequate to identify underwriting problems.

The Government Technical Representative, however, did not monitor the Contractor’s work, compliance with contract requirements, or provide any technical direction on any of the Allstate cases. The Government Technical Representative said she was unable to perform these functions due to her overwhelming workload.

The Los Angeles Area Office and Government Technical Representative Did Not Evaluate Or Take Corrective Action On Technical Review Contractor’s Ratings, Comments And Recommendations

The Los Angeles Area Office and the Government Technical Representative did not conduct reviews of the Contractor for valuation underwriting’s work or ratings given to the Allstate cases. Even more importantly, the Government Technical Representative did not only not adequately monitor the technical review contractor's performance, but also did not follow-up on the recommendations and review results that clearly identified Allstate’s fraudulent underwriting practices. The Contractor provided the Los Angeles Area Office with written comments on the individual underwriter rating sheet to support the poor rating given for each case. In all 15 cases, the Contractor concluded the appraisers selected by Allstate obviously violated HUD’s valuation underwriting instructions and overvalued properties. Discussed below are the results of the 15 cases reviewed by the Contractor:

- Overvaluation - In 11 of the 15 cases, the Contractor clearly marked "Over Valuation" on the underwriting reports, and described the elements in the appraisal reports that elevated the value of the property. For example, in Federal Housing Administration Case Number 041-9573565, the Contractor commented, "subject appears to have been overvalued by approximately $60,000". HUD Handbook 4150.1, REV-1, Paragraph 9-2.D, requires that judgments rendered by appraisers should be reasonable.

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- Midrange Value Used - In nine of the 15 cases, the Contractor concluded that a midrange value was used that obviously targeted the sales price. For example, in Federal Housing Administration Case Number 041-9568014, the Contractor commented, "midrange value utilized in violation of outstanding HUD instructions obviously targeted to the sales price with no indicator within $20,000". HUD Handbook 4150.1 REV-1, Paragraph 9-2.A, requires conclusions of value to be reasonable and logical.

- Comparables Indicate Much Lower Value - In eight of the 15 cases, the Contractor concluded that more current, closer and similar comparables indicated a much lower value than Allstate's valuation of the subject property. The comparables in these cases were over six months old, their distance from the subject was not reasonable, and/or the properties' sizes and designs were not similar to the subject. For example, in Federal Housing Administration Case Number 041-9573565, the Contractor commented that "more current, closer, and more similar computations indicate a much lower value". HUD Handbook 4150.1 REV-1, Section 9-2.H(4), requires comparables to be reasonably equal to the subject in size, age, and design. Paragraph 9-2.H(2), also requires comparables to be current and their sales data not over six months old.

- Irrelevant, Unwarranted, And Lumped Adjustments - In 10 of the 15 cases, the Contractor provided the Los Angeles Area Office with written comments that the estimated value of the subject property was high and was based on unsupported, unwarranted, overstated, missing, lumped, or excessive adjustments. For example, in Federal Housing Administration case number 041-9573571, the Contractor commented, "bedroom and bathroom adjustments are lumped; location adjustments are unsupported; condition adjustments appear excessive; the estimated value of subject appears high and based on unsupported adjustments". HUD Handbook 4150.1, REV-1, Section 9-2.H, requires adjustments to comparables to be reasonable.

- Excessive Errors - In all 15 cases, the Contractor concluded that excessive errors were found in the reporting of data. A typical example was Federal Housing Administration Case Number 041-9568014. In this case the Contractor commented that "comp #1 was reported as a 4/3, 1,970 sq. ft. floor plan when is was actually a 5/5, 3,186 sq. ft. As previously mentioned, under the single family insurance program, HUD only insured properties with 4 or fewer units. The Contractor also noted that if comp #1 was 1/2 mile away, comp #3 must have been almost 2 miles away. The Contractor went on to indicate that the report was not per Uniform Standards of Professional Appraisal Practice. HUD Handbook 4150.1, REV-1, Section 9-1.C(1).a, requires that the factual information submitted be correctly reported.

As previously mentioned, the Los Angeles Area Office and the Government Technical Representative took no action to follow up and/or resolve with Allstate the appraisal related deficiencies noted by the Contractor. The Los Angeles Area Office placed the results of the technical review contractor's reviews in the Computerized Homes Underwriting Management System without further action. Had the

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Los Angeles Office or the Government Technical Representative followed-up on the Contractor's review comments, the Allstate scheme would have been discovered early on and damage limited.

The Los Angeles Area Office Did Not Conduct Critical Supervisory Reviews Of Contractor's Faulty Underwriting Reviews

Contrary to HUD's handbook requirements, Los Angeles Area Office and the Government Technical Representative did not conduct critical supervisory reviews of the Underwriting Contractor's, Ervin & Associates, technical reviews. Ervin & Associates, the Contractor for mortgage credit analysis underwriting, assigned erroneous ratings to all 17 cases that we selected for review. Specifically, Ervin & Associates did not perform adequate reviews that would have identified obvious (1) questionable underwriting deficiencies and (2) fraud warning signals. Most importantly, the Los Angeles Area Office and its Government Technical Representative did not ensure Ervin & Associates complied with contract provisions to determine whether Allstate's loans were an acceptable risk.

HUD Handbook 4000.4, Rev-1, Single Family Direct Endorsement Program, Chg-2, Section 4-9A(5), Supervisory Review Process, says a supervisor, or designee, should review a representative sample of "Good" and "Fair", and all "Poor" post endorsement technical review ratings to ensure compliance with review guidelines. The major purpose of the reviews is to: (1) maintain accuracy, consistency, and soundness among mortgage credit processing personnel, (2) assess the quality and efficiency of work completed by mortgage credit branch staff and contractors, and (3) identify the need, if any, for training or remedial instructions.

Questionable Underwriting Deficiencies

We reviewed 17 cases and found that Ervin & Associates did not question obvious underwriting deficiencies in the files and accordingly did not properly rate the underwriting and alert HUD to problems. Contrary to Ervin & Associates assigned ratings of "Good" for 16 cases and "Fair" for one case, we concluded all 17 cases should have been rated "Poor" based on obvious underwriting deficiencies contained in the files. In addition, the appraisal desk review ratings of "poor" for 15 of the 17 cases, mostly due to overvaluation, should have alerted the reviewer to potential problems. HUD Handbook 4000.4 Rev-1 Chg-2, paragraph 4-9B, Direct Endorsement Post-Endorsement Technical Review Checklist (Checklist) Instructions reference the Checklist that mortgage credit reviewers' should use to evaluate and assign ratings of underwriters. The Checklist identifies the most common deficiencies resulting in fair or poor ratings. The Handbook says, "....Any one element rated poor should result in an overall poor rating..." The applicable elements are listed on the Checklist under two underwriting categories: "Asset Verification Documents and Analysis" and "Application/Underwriting/ Closing Documents."

Ervin & Associates did not consider the effect of the elements in the Checklist and; therefore, it was unable to detect the deficiencies that should have resulted in a "poor" rating for all of the 17 cases we reviewed.

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The following table breaks down the 17 cases we reviewed and shows the number cases that included questionable underwriting item(s) which Ervin & Associates did not identify during their technical reviews.

QUESTIONABLE UNDERWRITING DEFICIENCIES NOT DETECTED OR REPORTED BY ERVIN &ASSOCIATES

Number Of Cases	Elements	Amounts Not Questioned
16	**Overstated Closing Costs**	**$10,092**
14	**Unidentified Disbursements**	**$1,984,881**
13	**Excessive Seller Concessions**	**$65,089**
9	**Unaccounted Down Payments**	**$9,000**

- Overstated Closing Costs - In 16 of the 17 cases, the Ervin & Associates' reviewer did not determine that closing costs were overstated, resulting in over-insured mortgages totaling $10,092. Ervin & Associates assigned 15 "Good" ratings and one "Fair" rating to these cases. We believe the Ervin & Associates' reviewer should have rated all of the 16 cases as "Poor" due to the overstated mortgage insurance amounts.

- Unidentified Form HUD-1 Disbursements - In 14 of the 17 cases, the Ervin & Associates' reviewer did not question significant unidentified disbursements shown on the HUD -1 Settlement Statement as required by HUD Handbook 4000.4, Rev-1. The Checklist specifies that a "Poor" rating is warranted if "Settlement Statement/HUD-1 indicates unidentified charges, overcharges, etc." Because escrow instructions for the disbursements were not included in the loan files reviewed by Ervin & Associates, we considered the disbursements in question as "unidentified charges" that should have been questioned by the Ervin & Associates' reviewer. Accordingly, Ervin & Associates should have rated all 14 cases as "Poor" based on the handbook instructions and the Checklist.

  On the contrary, Ervin & Associates rated 13 cases as "Good" and one case as "Fair". The unidentified disbursements ranged from $18,000 to $292,481, totaling $1,984,881.

- Excessive Seller Concessions - In 13 of the 17 cases, the Ervin & Associates' reviewer did not identify and question seller concessions totaling $65,089 that were not supported by the sales agreements, the loan applications, or the Mortgage Credit Analysis Worksheet This is contrary to the requirements of HUD Handbook 4000.4, Rev-1. For each of the cases in question, the seller concessions were in excess of what was allowed in the sales contract, and were not disclosed in the loan application on the Mortgage Credit Analysis Worksheet. This should have alerted the reviewer to potential problems with the loans. The Ervin & Associates' reviewer rated 12 cases as "Good" and one case as "Fair". We believe that the Ervin & Associates' reviewer should have rated all 12 cases as "poor" due to the excessive undisclosed seller concessions.

- Unaccounted for Downpayment - In nine of the 17 cases, the Ervin & Associates' reviewer did not verify that the earnest money credits identified in the purchase contracts were adequately supported or accounted for at closing, as required under HUD Handbook 4000.4, Rev-1. In these instances the purported borrowers did not get credit at closing for their claimed earnest money deposits. Again, this should have alerted the reviewer to potential problems with the loans. The Ervin & Associates' reviewer assigned eight "Good" ratings and one "Fair" rating for the nine cases. We believe that Ervin & Associates' should have rated these nine cases as "Poor" based on the Mortgage Credit Analysis Worksheet instructions.

Los Angeles Area Office's staff said they did not perform supervisory reviews of Ervin & Associates' work and ratings of the Allstate cases. In fact, Los Angeles Area Office staff said they did not perform and/or document supervisory review of Federal Housing Administration-insured cases originated by 469 lenders in 1997.

The Government Technical Representative also did not monitor or provide the necessary technical advice to Ervin & Associate's staff. The Government Technical Representative explained that she was unable to do so because of the overwhelming workload she was responsible for. As a result, the Government Technical Representative did not detect and correct Ervin & Associates' deficient technical reviews and questionable ratings for all 17 cases described above.

The Ervin & Associates' Reviewer Did Not Complete Or Submit The Fraud Warning Signal Checklist

The Ervin & Associates' reviewer did not complete or include with the technical review documentation the required "Fraud Warning Signals Checklist" for 14 of the 17 cases reviewed. Ervin's contract with HUD requires that the "Mortgage Fraud Warning Signals Checklist...must be completed, signed and dated on each case." The Fraud Checklist was designed to alert Ervin & Associates and HUD to indications of fraud and deficiencies that may warrant indemnification by a direct endorsement lender.

We identified obvious fraud warning signal elements in 15 of the 17 cases that Ervin & Associates reviewed. A breakdown of these fraud warning signal categories and the fraud warning signal elements are shown in the following table:

FRAUD WARNING SIGNAL CHECKLIST

Fraud Warning Signal Category	Fraud Warning Signal Elements
Credit Report	**No credit history/Recent inquiries**
Source of Funds	**Unusual downpayment source**
Sales Contract	**Purchase transaction with no real estate agent involvement**
Legal, Closing Document	**Unusual credits or disbursements shown on HUD-1**

The fraud warning signals included:

- No Credit History - In 14 of the 17 cases, the borrowers claimed very high monthly income levels, between $3,371 and $10,550 (average $7,544), but did not have any bank accounts, savings or credible financial history.

- Unusual Downpayment Source - In 14 of the 17 cases, the borrowers claimed that their relatives donated large sums of money ranging from $4,500 to $35,000 (average $27,533) to pay for all of the borrowers' required minimum cash investments.

- Purchase Transactions With No Real Estate Agent Involvement - In 15 of the 17 cases, no real estate agents were used and/or commissions paid.

- Unusual Credits Or Disbursements Shown on Form HUD-1 - In 14 of the 17 cases, large unidentified credits or disbursements were shown on HUD-1 Forms.

The existence of these red flags should have alerted Ervin & Associates to the potential fraudulent nature of the transactions.

Reduction In Staff Affected And Weakened HUD's Controls

Beginning in 1994, HUD experienced a significant reduction in staff. The reduction in staff coupled with other critical decisions affected the Federal Housing Administration's management, and put its insurance fund at risk during the transition from field office to Homeownership Center management of the single family insurance program.

In accordance with HUD's plans to reduce staff by about 29 percent (from 10,500 to 7,500) by the year 2002, the Los Angeles Area Office greatly downsized its staff and as a result, it was left with a skeleton crew who could barely handle the 30,000 loans processed annually in its jurisdiction. The former Los Angeles Area Office's Single Family Housing director said due to the severe shortage and loss of staff, the Los Angeles Area Office operations were undermined. Further, he said during the last year of its operations, the Los Angeles Area Office's staff shrunk by 65 percent. The Los Angeles Area Office's Chief of Production said since 1995, the Los Angeles Area Office's Production branch down sized from 15 to 5 people. As a result, the Los Angeles Area Office was unable to properly monitor the lenders or its contractors, as required. The two Government Technical Representatives responsible for monitoring lenders, or contractors who were reviewing lenders work, said they could not adequately perform their duties due to the overwhelming workload.

The former Los Angeles Area Office Single Family Housing director said HUD headquarters was aware of the difficulties in monitoring lenders due to the shortage of staff and; therefore, decided to expand the Quality Assurance Division. However, the Quality Assurance Division had different work priorities and was not involved in the daily oversight of lenders, or in following-up on the individual ratings of underwriters.

During our audit at the Santa Ana Homeownership Center, we noted the Center was also experiencing staffing problems and until recently, had been unable to consistently perform and document its supervisory efforts. The experienced staff were mostly involved with providing customer service (by phone) and performing pre-closing reviews. The transition to the Homeownership Center affected HUD's ability to carry-on the monitoring responsibilities due to the lack of qualified/experienced staff. At the time of our audit, the Processing Division lacked the planned number of experienced staff.

Mortgagee Letter 95-36 Revised HUD's Policy

As part of an August 1995 HUD policy revision to streamline the Federal Housing Administration processes and reduce or eliminate unnecessary requirements, HUD revised a critical and substantive procedure which previously required HUD staff to follow-up on individual underwriter ratings of single family loans originated by direct endorsement lenders. HUD's policy revision was instituted by Mortgagee Letter 95-36, Mortgagee Approval -- Single Family Loan Production -- revised Mortgagee/Program Requirements. Item 5 of the letter, Elimination of Individual Ratings ("report cards") for Mortgagees' Underwriters, states in part:

> "....Individual rating sheets, i.e., "report cards", will no longer be sent to the underwriters. We will continue to perform post-endorsement reviews and we will continue to send semi-annual reports to the CEOs/Presidents summarizing the underwriting using the post-endorsement technical review sheets. Since individual loan reports will not be issued, appeals of the ratings shown on the summary reports will not be possible...."

<u>Policy Change Was Misinterpreted By Los Angeles Area Office And Santa Ana Homeownership Center</u>

The change was intended to reflect the Department's policy of holding lenders accountable for their underwriting decisions. According to both the Los Angeles Area Office's Single Family Division and the Santa Ana Homeownership Center's interpretation, the policy revision effectively removed HUD's responsibility to resolve underwriting deficiencies that were identified on the report card prepared by the technical reviewer. Because the report card for a specific loan rated poor was not forwarded to the direct endorsement lender, the underwriting deficiency(ies) noted for that loan did not necessarily get corrected or resolved. Additionally, HUD's termination of the report card issuance to the direct endorsement lenders also removed a critical aspect of its monitoring function to have an open and ongoing dialogue with the lender concerning their underwriting problems.

After the policy revision, the Los Angeles Area Office and subsequently the Santa Ana Homeownership Center continued, through their post technical review contractors, to determine the underwriting ratings for selected loans endorsed by direct endorsement lenders and update HUD's database information. However, the contractors' individual ratings including poor ratings, were not effectively pursued or corrective actions taken. Instead, the ratings were input into Computerized Homes Underwriting Management System’s database without any subsequent follow-up. Although the Santa Ana Homeownership Center recently began taking more actions in this area, problems still existed.

HUD Headquarters Officials Disagreed With The Field Offices Interpretation

HUD Headquarters officials disagreed with the field office’s interpretation of the policy change. HUD's former Director of Office of Insured Single Family Housing said the change did not in any way lift HUD's previous responsibility for monitoring lenders' performance. The field offices were still required to monitor, track down, and communicate with lenders whose performance was poor and to resolve deficiencies noted in loan originations. The policy revision did not change HUD staff's responsibilities; the staff should still follow-up on the individual ratings.

Mortgagee Letter 95-36 Did Not Clearly State Field Offices' Responsibilities

We believe the Mortgagee Letter 95-36 was unclear and inadequately addressed HUD field offices’ or the Homeownership Centers’ responsibilities in following up on the ratings of the individual underwriters. In the absence of clearer procedures, the Los Angeles Area Office and Santa Ana Homeownership Center staff believed they were no longer required to follow-up on the poor ratings, and, in effect, were relieved from tracking down and keeping an open dialogue with the lenders, whose performances were poor.

The Insurance Fund Was Exposed To Potential And Actual Losses

Due to inadequate oversight, Allstate exposed the Federal Housing Administration insurance fund to potential and actual losses attributable to 427 fraudulent loans totaling $97 million originated during the period June 1996 through July 1997. The fraud scheme was uncovered by the Federal Bureau of Investigation and HUD OIG's Office of Investigation and culminated in a United States Attorney's Office indictment of two Allstate officials who were charged with 10 counts of mail fraud and five counts of causing false statements made to the HUD. Program responsibility has shifted to the Santa Ana Homeownership Center. However, because the Center also misinterpreted Mortgagee Letter 95-36, the problems that occurred with Allstate while the Los Angeles field office was responsible for program oversight, could occur again.

Low- And Moderate-Income Tenants Suffered

In addition to substantial losses incurred by the Federal Housing Administration, Allstate's scam affected hundreds of low- and moderate income families who lived in 250 units of the apartment buildings located in the City of Long Beach, California, and the surrounding areas. The tenants had to cope with the termination of utility services, maintenance problems, and health and safety violation codes. The owners of title to the properties were "strawmen", who did not have any invested interest in the properties. Allstate officials who perpetrated the fraud scheme also collected the rents but never made mortgage payments.

Auditee Comments

At the exit conference, Santa Ana Homeownership Center officials generally agreed with the finding and recommendations. They said improvements have been made and procedures have been put in place to correct the problems cited in the audit memorandum. In support of their statement, they provided us with a copy of their quality assurance contract oversight plan outlining steps to be taken when evaluating the performance of and reviewing the work done by technical review contractors. With respect to the audit recommendations, Santa Ana Homeownership Center officials provided the following:

Recommendation 1A. The Production and Underwriting Division has never reached its intended full time equivalent level of 66 employees. The current level of 40 full time equivalents is inadequate, but six recruitment actions are being processed. Home Ownership officials estimated selection of personnel should be made within 60 days. They also projected the remaining vacancies will be announced and filled soon. In the interim, staff out-stationed in Boise, Phoenix, and Alaska are assisting them with the reviews.

Recommendation 1B. Santa Ana Homeownership Center officials said they have established and implemented a quality assurance contract oversight plan to monitor post endorsement technical review contractors' performance.

Recommendation 1C. Santa Ana Homeownership Center officials said they have developed an ACCESS tracking system to assist them in identifying underwriters, appraisers, and lenders with overall "poor" performance ratings. All cases receiving "poor" ratings will be reviewed by the Homeownership Center's appraisal and underwriting staff. In addition, they will target reviews to identify lenders or underwriters that consistently do not adhere to HUD rules and regulations. If lenders are identified, additional action will be taken, such as reviewing default and claim rates, placing mortgagees on 100 percent review, recalling additional cases to determine trends, or placing them on pre-closing status. Underwriters or lenders receiving an extraordinary number of "poor" ratings will be reviewed for Limited Denial of Participation actions and pre-closing status or referrals to the Quality Assurance Division for indemnification.

OIG Evaluation of Auditee Comments

We believe the actions the Santa Ana Homeownership Center has taken and planned should help correct the deficiencies identified in this memorandum if the actions are consistently implemented, completed, and followed.

Recommendations

We recommend the Acting Director, Santa Ana Homeownership Center:

1A. Assesses the Santa Ana Homeownership Center's Production Division's staffing and takes necessary action to ensure staffing is appropriate to properly monitor the contractors and direct endorsement lenders participating in the program.

1B. Establishes and implements specific policies and procedures to:

- monitor post endorsement review contractors work product, and
- take corrective action, including contract termination, if the contractor is not properly performing its duties under the contract.

1C. Establishes and implements policies and procedures to monitor results of post-endorsement technical reviews and take appropriate action when these reviews identify problems with a particular loan or lender, appraiser, underwriter or other party.

* * * *

Within 60 days, please furnish us a status report on the recommendations stating (1) the corrective action taken, (2) the proposed corrective action and the date to be completed, or (3) why action is not needed. Also, please furnish us copies of any correspondence or directives related to this review.

Should you have any questions, please contact Ruben Velasco, Assistant District Inspector General for Audit, at (213) 894-8016.

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